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# Accounting Questions: Marketable Securities on Balance-Sheet, Profits and Losses of Subsidiary Companies

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# Accounting Questions

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### *MARKETABLE SECURITIES ON BALANCE-SHEET*

*Question:* The balance-sheet shows marketable securities at cost. Since the date of acquisition there has been a shrinkage of approximately 50 per cent. in the market value of these securities. Would it be well to deduct a reserve for this shrinkage direct from the asset itself on the balance-sheet or would it be better policy simply to appropriate a portion of the earned surplus as a reserve for this shrinkage? If neither of the above methods is correct, we would appreciate information on the method which you would suggest.

*Answer No. 1:* The question does not state whether the company is an investment trust or an industrial concern. It is generally thought to be the best practice in the case of any industrial company to carry marketable securities in the balance-sheet at market value, either by way of writing down such securities or deducting a sufficient reserve from the cost. Even in the case of an industrial company the relative size of the amount is of importance. In some cases the shrinkage in market value of securities is trivial in comparison to the total current assets. In such instances it would be acceptable to indicate parenthetically the market value of the securities if the company does not wish to write them down to market. In the case of other industrial companies, however, the marketable securities may make up a material part of the current assets and the shrinkage, if not deducted, would distort the current asset position.

In the case of investment trusts, the practice is not uniform. However, it is probable that the best practice in the case of investment trusts is to carry the securities at market values. Many statements will be found, however, in which large shrinkages are indicated only by the parenthetical statement of the market value.

In an investment trust the question as to whether a reserve or write-down should be charged to earned surplus depends on the policy of the company in showing profits or losses realized on securities. If an investment trust has segregated surplus representing realized profits or losses on securities, any write-down of the securities on the balance-sheet should be charged against such segregated surplus so far as it is available. As a general rule, however, when there has been no such segregation of surplus, any write-down should first be charged to earned surplus and, if the write-down is in excess of earned surplus, it should be charged against capital surplus.

*Answer No. 2:* 1. In general we believe that the marketable securities should be shown on the balance-sheet at cost in the following manner: "marketable securities (market value $150,000) at close $300,000."

2. If a very unusual situation presents itself we believe the accountant should consider all the facts and suggest to the board of directors of the corporation his views of the matter.

3. The New York stock exchange, for the purpose of securing reasonable uniformity in the annual reports of listed companies, requires that:

"Full disclosure should be given of any change since the previous annual report in the basis of valuation in investments, inventories or property account."

4. Seemingly a full disclosure as to marketable securities is given when the market value appears upon the balance-sheet. This market value fluctuates from day to day and it would hardly be possible to keep on adjusting surplus to meet the change which occurs daily.

5. If the object sought is to prevent an ill advised distribution of earned profits as dividends to stockholders, a footnote could be attached to the earned surplus calling attention to the decline in the market value of marketable securities and stating that the earned surplus at the given date is subject to a possible reduction by reason of any loss which might be sustained upon sale of the said securities, which for conservative purposes is measured by the loss in the value at the date.

6. If the situation is acute and seems to call for positive action we think it would be better to set up a reserve for contingencies as a charge against earned surplus rather than to follow either of the plans suggested.

7. While the condition with respect to the value of marketable securities is pertinent at the present time, it might be said that not only current assets of this nature but also fixed assets have had a drop in value which may have a material bearing upon the condition shown in any balance-sheet. The current position might be sound as to a creditor even with the decline of 50 per cent. in the value of securities, but the position as a whole from a stockholder's standpoint might well be quite serious.

8. A banker will analyze a statement when credit is asked. He will also ask for whatever information he requires which is not stated on the balance-sheet. Stockholders and the general public are inclined to take a statement literally and to accept it without the investigation the banker gives it.

9. And from all of this we are brought to the conclusion that an accountant can so qualify the items on the balance-sheet and in his certificate that no one need be in doubt what the balance-sheet represents should he take the trouble to study it carefully, and that book entries are not really needed to express the facts except where the directors have seen fit to pass resolutions about the situation.

### *PROFITS AND LOSSES OF SUBSIDIARY COMPANY*

*Question:* A large corporation controls a small selling organization for one class of trade only. This selling organization is separately incorporated.

The parent corporation has carried the investment in the selling organization (100%) at cost, since the investment is a permanent one, and since a consolidated balance-sheet is furnished in addition to the individual corporation statements.

Is this procedure correct? Or should the profits and losses of the subsidiary be reflected in the parent-company books? No dividends have ever been paid on the selling-company stock.

If profits are not taken up, should losses be taken, on the theory that valuations should be on the basis of "cost or market whichever is lower"?

*Answer No. 1:* The presentation of a consolidated balance-sheet, and presumably consolidated profit-and-loss and surplus accounts, in addition to statements of the same nature applicable to the parent corporation and to the subsidiary, should provide all the essential information.

We understand that legally the profits and losses of a subsidiary should not be entered periodically in the books of the parent corporation and carried into the surplus account of the latter except as profits are formally declared by way of dividends. But circumstances and practical considerations at times may be such as to justify incorporation in the books of the parent corporation of the profits and losses of a subsidiary. In the case under consideration the subsidiary is in all probability virtually a branch selling organization. That being so we see no objection to the incorporation of the results of the operations of the subsidiary in the books of the parent corporation. Thus, in effect, the books of the parent corporation would be representative of the situation which would exist if the subsidiary had in fact been operated as a branch. By this procedure the investment in the capital stock of the subsidiary will become adjusted annually to accord with the net worth of the subsidiary as shown by its balance-sheet, assuming that the original investment cost corresponds with the net worth of the subsidiary at the time the investment was made.

When profits and losses of a subsidiary are not incorporated in the accounts of the parent corporation, except as dividends received, care should be exercised to assure proper disclosure of results by a footnote to the statements or in other ways—if, for instance, (a) the circumstances are such that the dividends received are from subsidiaries operated at a profit sufficient to cover the dividends whereas other subsidiaries are operated at a loss which might exceed the profit of the profitable subsidiary, or (b) dividends may have been paid by subsidiaries in excess of current earnings of such subsidiaries.

*Answer No. 2:* It is our idea that it is quite proper to continue carrying the investment in the subsidiary at cost on the books of the parent company and to transfer neither profit nor loss, except as dividends are received by the parent company.

As a consolidated balance-sheet is furnished, the true situation is set forth on that statement. However, in submitting a statement of the parent corporation without consolidation, we believe that suitable notation should be made showing that the investment in the subsidiary company is carried at cost and giving information as to the actual net worth of the subsidiary—that is to say we believe reference should be made to the accumulated surplus or deficit.