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THE BALANCE SHEET

COUCHMAN

THE JOURNAL OF ACCOUNTANCY INCORPORATED

THE BALANCE-SHEET

THE BALANCE-SHEET

Its Preparation, Content and Interpretation

BY

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INTRODUCTION

BY EDWARD E. GORE

President American Institute of Accountants

The accountant who gives of his time, his talents and his experience to make easier the way for future generations of his kind is entitled to unrestrained applause. Perhaps no service rendered to one's profession is more useful than that resulting from a contribution to its literature.

In the accounting profession there has been, and still is, a lack of literature representing the fruits of the practitioner's experience. Considerable numbers of books have been written, most of them of a high order of merit, but the work of the accountant is so diversified, and is so influenced by the peculiar circumstances surrounding individual cases handled, that the experience of many practitioners must be drawn upon to afford an understanding of truly representative conditions.

As time passes and experiences which aid in the formation of opinions are exchanged, the fundamental principles of accountancy are more clearly recognized and their identities more generally conceded. Every effort made to render easier the understanding of accountancy, the application of its principles and the meaning of its terms is a distinct service, not only to the profession, its practitioners and its devotees, but to the cause of the advancement of commerce itself. Such an effort has been made in this book by Mr. Couchman, with what must be conceded to be outstanding success. Practising accountants will find much in it that only the experience gained from actual practice could produce, and they will feel for the book an immediate friendship. Teachers of accountancy will find it a most valuable aid in making plain and understandable the essential truths of the science. Students will feel more certain of their acquaintance with accounting terminology and with the principles and methods it describes. Everyone interested in accountancy is to be congratulated that Mr. Couchman's light has been thrown upon the dark places, and Mr. Couchman is to be felicitated upon his unusual success in plainly defining terms that have often failed of satisfactory definition.

The literature of the profession has been enriched.

CHAPTER I

THEORY OF THE BALANCE-SHEET

1-1. It is not the intention of this book to discuss the history of the balance-sheet, but rather to explain its use in the business world of America today. It is a statement of such tremendous importance and such continuous use that it is desirable for everyone associated even in the slightest degree with the business world to understand, not only its function, but the meaning of each of the items displayed therein and the proper methods of measurement applicable thereto.

Among the many kinds of financial statements which confront the man in business today, the balance-sheet holds the most important place. Nearly all other financial statements support it or are based upon it, or in some other way are reflected in it. Every financial item to which an organization holds title or legal claim, and likewise every legal claim against it, has its place in that organization's balance-sheet. Every attempt to measure or define the wealth of one man or of one commercial unit, as apart from that of another, finds expression in the balance-sheet. It is the vital statement in any broad scheme of recording ownerships.

The balance-sheet attempts to display, through condensed symbols, the true financial condition at a given date of some individual or other financial unit. These symbols are classifications or group names which have a definite significance. Full knowledge of the meaning of these symbols is evidently necessary in the preparation of a balance-sheet if it is to be anything more than a mere jumble of words and figures. Similarly, full knowledge of these symbols is necessary if one is properly to read a balance-sheet which someone else has prepared.

If a classification means one thing to the one who records it and another thing to the one who reads it, there can be no exact transmission of knowledge or opinion from the one to the other. Either misstatements of fact or misunderstanding of statements, or both, must result where there is not a common understanding of the language of the balance-sheet on the part of those concerned. Unfortunately, such differences of understanding are frequent in

business. Such misstatements and misconstructions should decrease as there is a common increase in the knowledge and understanding of exactly what properly may be included in each classification used in a balance-sheet and of how the values applicable to them are determined.

It is the purpose of this book, not only to discuss the balance-sheet forms and arrangements, but to give with regard to each classification generally found in balance-sheets, as clear an idea as possible of exactly what facts should be included in it and the accepted methods of valuing or measuring it, as these ideas have gradually become definite in the opinions and practice of business men, accountants and other financial authorities. With regard to certain of these classifications a specific understanding is now generally accepted. With regard to others, the idea is still in a state of development and uncertainty. To one authority it means one thing; to another authority, equally eminent, it means a slightly different thing. It is here attempted to state all that is generally accepted — to express as it were the common denominator of understanding. Where practical, the reasoning back of the differing opinions is explained or an attempt is made to explain it.

It must be kept in mind that there is no potentate of accountancy who decrees that a certain term shall mean thus or so. Rather, the meaning today is the result of a gradual development, which may carry it on to quite a different meaning tomorrow. This is true of all the principles which find expression in accountancy today. They are not the result of some vote of legislature or committee or any other such body. Instead, they are merely the classified results of the accumulated experiences of business men.

As it is not possible to define and explain fully all the classifications which may appear upon a balance-sheet, an effort has been made in this book to select those that are most common, an understanding of which is necessary in the preparation of correct balance-sheets. Occasionally one finds in practice an unusual classification such as should justify special explanation in the balance-sheet itself, as it probably pertains only to one particular organization. It is evidently impossible to include in a book of this kind such items. Also there are certain classifications pertaining only to limited kinds of business, such as some of the classifications defined by the public service commissions of the various states, which it has not seemed desirable to incorporate herein. Aside from such

unusual accounts, this volume covers practically all the classifications appearing in the balance-sheets of commercial organizations of standing, such as those whose securities are listed on the New York Stock Exchange.

STATEMENT OF ASSETS AND LIABILITIES
STATEMENT OF RESOURCES AND LIABILITIES
BALANCE-SHEET

1-2. Any one of the foregoing headings may be used as the designation for the statement displaying the financial condition of an organization at a specified date. Some attempts have been made to indicate when one rather than another of these headings should be used. Such efforts are probably worth while; but at present in the business world there is not sufficient differentiation of usage to justify any such distinction in this volume. All discussion concerning the elements of a balance-sheet apply equally to the elements of a statement bearing either of the other designations.

BALANCE-SHEET HEADING

1-3. In the heading of any financial statement there should appear at least three items:

First, the name of the person, activity or organization whose financial facts are presented by the statement.

Second, the character of the statement — that is, as to whether it is a balance-sheet, a profit-and-loss statement, a statement of affairs, or whatever other type of statement it purports to be.

Third, the date, if it is a statement of static facts, or the period of time if it is a statement of financial movement.

There is no fixed order which must be rigidly followed with regard to these three items, although usually the one showing the date or time comes last. There is little choice between the following, though some authorities prefer the first:

American Manufacturing Corporation
Balance-Sheet
December 31, 1922

or

Balance-Sheet
of the American Manufacturing Corporation
as at December 31, 1922

It is a matter of great importance, however, that the name of the organization be correct. If the legal name of the above unit is The American Manufacturing Company, that exact wording should be used in the heading of its financial statements. Even the word "The" should be used or omitted, depending upon whether it is or is not a part of the corporate name. There are many organizations whose official names differ from each other by only one word, yet their balance-sheets may have little in common. An error, apparently slight, in the name used on a balance-sheet might therefore result in serious error as to its statement of facts.

Abbreviations should not be used in headings of financial statements nor in the body of the statement if they can be avoided. To use in the heading "The Amer. Mfg. Co.," or "as at Dec. 31, 1922," might convey the impression that all the work involved in preparing the statement had been similarly slighted.

COMMERCIAL UNITS

1-4. A balance-sheet is intended to show, with regard to any commercial unit, the assets, liabilities and proprietorship, properly classified and properly measured. This unit of organization may be an individual, a partnership, a corporation, an estate or trust, or any other unit recognized commercially.

Balance-sheet of an Individual

1-5. A balance-sheet may be prepared for any person, displaying all his assets, all his liabilities and his net worth. Or, again, a balance-sheet may be prepared for a certain activity only, as for instance a balance-sheet of a particular enterprise which may be only one of several enterprises owned by an individual. Such a balance-sheet would show the assets, the liabilities and the net worth of this enterprise but would not include other assets or liabilities of the owner.

To illustrate: Jonathan Jones may own a store. A balance-sheet of this store would display all the assets associated with it, the liabilities that properly apply against it and the resulting net worth. On the other hand, an entirely distinct balance-sheet might be made for Jonathan Jones as an individual, displaying, not only all the assets shown related to his store, but all other assets which he may have. It would also display all his liabilities; and the

resulting proprietorship would show his net worth as an individual. This might differ considerably from the net worth shown by the balance-sheet of his store.

This condition frequently presents many problems to the accountant. When preparing a balance-sheet for a single industry owned by an individual, the determining of what assets to include is not so difficult. The problem lies in the liabilities. Presumably, only the liabilities attaching to this particular industry should be tabulated. Yet, since the proprietorship is not a legal entity, its integrity may be jeopardized by other liabilities of the proprietor. In such a case, the failure to display these liabilities would be reprehensible. The accountant must keep in mind that if there is a possibility that any liability will become effective against the assets shown in the balance-sheet, he must display this liability also. Further than this, there does not seem to be any well established rule adopted by business or by accountants covering this problem.

Balance-sheet of a Partnership

1-6. The organization for which a balance-sheet is prepared may be a partnership. A partnership, because of the contractual relationship established between the partners, is recognized as having a commercial existence somewhat distinct from the proprietors as individuals. As a result, certain assets are recognized as the assets of the partnership as distinct from the assets of any one of the partners. Similarly, there are liabilities of the partnership as distinct from the liabilities of the individuals composing the partnership. Because of this line of demarcation, a definite balance-sheet can be established for a partnership, which must include all of the assets belonging to it and the liabilities applying against it, the resultant net worth being that of the partnership without regard to the net worth of the individuals composing it.

Balance-sheet of a Corporation

1-7. The commercial unit for which a balance-sheet is prepared may be a legal unit known as a corporation; or it may be that the commercial unit really involves a number of corporations under the same or affiliated ownership. In the latter case, the consolidated balance-sheet might be prepared to express the combined assets, the combined liabilities, with resulting combined proprietorship, of the various inter-owned corporations. (Chapter XXI.)

Balance-sheet of Other Commercial Units

1-8. Other commercial units, such as joint-stock associations, trusts, syndicates, estates, etc., may be the basis of balance-sheet display. These are essentially no more than modifications of one or more of the three types of proprietorship just discussed. (See ¶ 3-13, 16-8.)

BALANCE-SHEET DATE

1-9. A balance-sheet may be prepared as at any date, and that date should be definitely indicated in the heading. Since a balance-sheet represents financial facts in a static or stationary condition, and since the financial facts of an organization may change continuously during the business day, a balance-sheet unless otherwise indicated is presumed to represent the condition existing at the close of business of the date named.

Illustration: A balance-sheet headed "As at April 30, 1923," is presumed to represent the conditions as they existed after giving effect to all the financial transactions of the day, April 30th. It may have been true that at 10 o'clock in the forenoon of that day the conditions were entirely different from those presented. In any active organization it is evident that conditions at various times during a business day may differ considerably. It is necessary therefore that some exact time be definitely indicated. This is presumed to be the period of rest following a day's transactions. Since the balance-sheet is frequently not prepared at that date but at a later date the phraseology "as at" or "as of" is used.

Sometimes business men assume that if the above balance-sheet were dated "As at May 1, 1923," it would be equally correct. This is not necessarily true. At the beginning of business, May 1, 1923, the conditions presumably would be the same as those at the close of business the night before, but during the day various transactions might take place, so that the condition *as at the close of business*, May 1, 1923, might involve quite different amounts for various items.

If it is desired to display a condition other than that at the close of a day, this fact must be indicated by some modifying phrase in the heading, as:

Balance-sheet of Adams & Baker
as at Beginning of Business May 1, 1923

Unless this were a new firm just starting, presumably the condition shown here would be the same as if the balance-sheet had been dated "as at April 30, 1923," for the condition after the close of business one day, in the absence of some unusual happening, is supposed to be identical with that prior to beginning of business on the following day.

JONES & SMITH
BALANCE-SHEET
PRIOR TO DISSOLUTION, MARCH 15, 1923

In this illustration the balance-sheet may be prepared for the purpose of showing what transactions are needed exactly to wind up the affairs of the firm. All or a part of these transactions may take place the same day, that is, March 15th, and quite a different condition may exist at the close of the day. A balance-sheet of this firm "as at March 15, 1923" would disclose the condition after such transactions had been recorded. If the dissolution were completely effected, there would be nothing to display upon such a balance-sheet.

ACCOUNTING PERIOD

1-10. Any period of time may constitute an accounting period. The heading of statements showing the results over such period should be so worded as to make the period definitely identifiable. Since a balance-sheet discloses facts at a point of time, no indication of a period is needed save with regard to the one item which may be displayed showing profits for a particular time. Therefore under the proprietorship group one may find an item "Profits for year 1922." It is only with such an item that the period of time need be mentioned in a balance-sheet. Usually this period will be the fiscal year, that is, the twelve months ending with the date of the balance-sheet. If the fiscal year of a corporation should end March 31st, the balance-sheet for that date might contain an item "Net Profit for Year." This would be construed to be the net profits as the result of the operation of this corporation from April 1st of the preceding year to March 31st of the year indicated, inclusive.

The relation of the balance-sheet to the transactions of an organization may be illustrated by consideration of a motion picture. Such pictures, when thrown on the screen, are in reality a succes-

sion of individual pictures, each recording facts photographed as they exist a fraction of a second after the preceding picture. Frequently one of these is developed and enlarged for display purposes and is known as a "still." It shows the exact condition of everything within the range of the camera as at the instant when this particular picture was taken. Another "still," taken later, might display the same scene, but with characters in a different position. A projection on the screen of the pictures between the two "stills" would display an analysis of every change that had taken place between the one and the other. Actors in the first picture may have passed from the scene, new actors may have come on, while other actors may have remained throughout, but changed from one location or position to another.

In like manner, the financial books of an organization record every movement of its financial characters. The condition at periodic intervals may be displayed by means of balance-sheets, corresponding to the "stills" of motion pictures. The financial records during the period between such balance-sheet dates record every change that takes place in the elements that appear therein. Assets in the first balance-sheet may pass away before the second balance-sheet is prepared. New assets may come in during the period. Other assets may increase or decrease. Every change in each asset account as well as in the liabilities and other accounts displaying condition is recorded in detail in the financial books. These movements may be reflected in other financial statements, but the balance-sheet displays only the condition at an instant of time and no movement finds expression in it.

BALANCE-SHEET ARRANGEMENT

1-11. The balance-sheet displays three broad groups of accounting classifications: assets, liabilities and capital or proprietorship. Each of these is discussed fully in subsequent chapters. The most common arrangement of these in America is in a balanced form, with the assets upon the left half of the page and, in opposition to them, the liabilities and capital upon the right half.

In the general form of British balance-sheet, this arrangement is reversed. The history of the balance-sheet in Great Britain explains this arrangement, but, in addition to its historical derivation, a certain philosophy applies to its use. The assets evidently came from creditors or from proprietors or from profits. The British dis-

play the source of the assets before they do the assets themselves. That is, on the left-hand side of the balance-sheet they display the capital, the liabilities and the surplus from profits, and on the right-hand side they display the assets which have come from these sources. This is a logical arrangement.

In America there is a slightly different philosophy. Here the liabilities and the capital are considered as classifications measuring the legal claims or liens upon the assets. Evidently, there must be an asset in order for a lien upon it to have any great significance. Therefore, in America the assets are displayed first, that is, on the left-hand side, and on the right-hand side are displayed the classifications which represent the legal claims to these assets. This, too, is a logical arrangement.

It has been said with a certain degree of facetiousness that there is also a psychology back of the arrangement: that the British business man, being conservative, thinks first "What do I owe?" and afterward "What have I with which to meet these claims?" He therefore desires to see his liabilities placed first on his statement. On the other hand the American business man's first thought upon seeing his balance-sheet is "What have I?" his liabilities being of secondary importance. It is not our purpose to quarrel with either arrangement but rather to discuss the classifications and the measurements as used in America.

1-12. In addition to the balanced form, often referred to as the "account form," balance-sheets in America are sometimes arranged in what is commonly called the running form or schedule form. This is an arrangement in which the liabilities and capital are placed below the assets instead of in opposition to them. It is favored because it can be made on standard-size paper with a typewriter and because it allows of a greater number of indentions for the purpose of setting out distinctly certain important subtotals. Many organizations desire to prepare periodic balance-sheets upon their own typewriters, and if they have only the narrow carriage generally used for correspondence, they find the running form of balance sheet more convenient.

The advantages of the balanced form consist chiefly in the fact that the relationship between various assets and liabilities are displayed more advantageously. This and other advantages will be discussed under the respective headings, such as working capital. (See ¶ 2-16, 23-4.)

1-13. There is again a different arrangement of the various classes of elements under the main headings. This difference applies particularly to the assets, the liabilities and capital accounts usually being arranged to conform to them. In one arrangement usually known as the "capital" arrangement, the permanent or capital assets are placed first, and a logical progression is maintained down to "cash" as the other extreme. The other common arrangement of assets, frequently called the "current" arrangement, places the current assets first and the capital assets last. Beginning with "cash" as the most liquid, a logical progression is maintained down to the most permanent, such as "real estate." Specific classes of assets, such as deferred charges, investments and goodwill, are given varying positions in each of these arrangements depending largely upon the viewpoint of the one preparing the balance-sheet. The logic of these arrangements is discussed subsequently and illustrations of the various types are offered.

VIEWPOINT

1-14. The accounting records of a business organization are operated from the viewpoint of the organization as an entity apart from the people who own it. To this entity certain values are presumably contributed by the proprietors. Other values may be acquired from creditors. Others may accumulate as a result of operations. It is the function of the accounting records to display at all times, on the one hand, the condition of these values under the custodianship of the business organization and, on the other hand, the responsibility for these values to creditors and to proprietors. To this end one or more accounts are opened with the proprietorship.

If Jonathan Jones owns a grocery store and the total assets thereof amount to $10,000 and he owes $4,000 to creditors, his balance-sheet would display on the one hand the various assets properly valued making up the total of $10,000. On the other side of the balance-sheet there would appear one or more accounts representing the liability to creditors $4,000 and an account "Jonathan Jones $6,000." The principle involved is that the business as an entity has $10,000 of value for which it is accountable to creditors to the extent of $4,000 and is accountable to Jonathan Jones for whatever remaining value there may be.

FOOTNOTES ON BALANCE-SHEET

1-15. There are elements which may affect the financial status of an organization but lack certain characteristics justifying their inclusion in the accounts of the organization. Such elements may be indicated upon a balance-sheet by means of footnotes instead of being displayed among the financial accounts. These elements may be divided into three classes: first, possible increases of assets not yet justifying expression in accounts; second, contingent liabilities; and third, possible preferences as to proprietorship. (See ¶ 3-18, to 3-21.)

CERTIFICATION

1-16. Balance-sheets frequently contain a certification signed by the accountant preparing the statement. The form of certification, its meaning and its limitations are discussed in Chapter XXII.

CHAPTER II

Foundation of the Balance-sheet

2-1. In the preceding chapter the idea was developed that the financial elements of a business change more or less constantly so that balance-sheets of the same business but at different dates may differ greatly as to the amounts of various items contained therein. It is evident that the management must keep definite control over such changes. This can be accomplished only through effective records. These records consist chiefly of (1) accounts, (2) chronological history of changes and (3) supporting documents and supplementary information.

Financial Account

2-2. There should be nothing mysterious about an account — that is, about an account in general — though some which accountants find are mysterious enough. An account is nothing more than a convenient place for the systematic recording of the increases and the decreases in a financial classification. By "financial classification" is meant any class or kind of expense, or of income, or of value, or of obligation with regard to values.

2-3. Since only two things may happen to the amount of an accounting classification — that is, it may increase or it may decrease — the account provides for the display of these opposing changes in two opposing "sides" or money columns. For convenience one of these is known as the "debit" and the other as the "credit" side of the account. (See ¶ 2-4.)

The original distinctions as applied to debit and credit have almost ceased to have any definite significance in the use of those terms in accounting. Debits originally referred to entries recording debts, that is, accounts with debtors; and credits applied similarly to those entries which represented creditors. From this as a base, there has been built up such a complexity of elements that are recorded by debit and credit entries that it is difficult to trace the resemblance between many of them and the original idea of debtors and creditors. Today it may be said to be sufficient to con-

sider debits as merely referring to one side of an account and credits as referring to the other side.

2-4. Broadly speaking, there are two classes of items recorded by accountancy. One of these classes includes the values known as "assets." The other class includes those elements which measure the legal rights to the assets. The latter class divides into two groups, the rights of creditors, known as "liabilities," and the rights of proprietors, known as "accounting capital" — frequently shortened to the one word "capital." This use of the word "capital" throughout accountancy must not be confused with the many other uses of the word, such as its use with economic significance.

Any one of the classes mentioned above may be affected in two ways which are opposite in charact One[illegible]. is an increasing effect; the other is a decreasing effect. It is a function of accountancy to record these increases and decreases. In America, as has been stated, assets are displayed on the left-hand side of the balance-sheet. The left-hand side of an account is known as the debit side, therefore:

Assets are recorded as debits.

Liabilities and capital are recorded as credits.

Decreases in any of these, being the opposite of increases, *are recorded upon the opposite side.* That is, decreases of assets are recorded by credit entries, and, similarly, decreases of liabilities or of capital are recorded by debit entries. Gains or profits, being capital, are recorded as credits. Expenses or losses represent decreases of capital or of profit and therefore are recorded as debits.

2-5. One or more accounts appear in the records for each item in the balance-sheet. Every change in the value or the amount of this item is recorded with proper supporting evidence. Any change in the value of one account must of necessity have a complementary effect upon one or more other accounts. The complete effect of any particular transaction or happening is indicated through what are known as "journal entries." These are recorded in chronological records known as "journals" or "books of original entry." With each such entry, or in documents supporting it, full authority for the transaction or official recognition of its effects must be indicated. From these entries records are made by the process known as "posting" in each account affected.

The system whereby the complete effects of all transactions are recorded is known as the "double-entry" system of bookkeeping, a

designation which is probably unfortunate as it suggests duplication of entry, whereas its real significance is "complete" entry. Single-entry systems, so called, merely record such detailed effects of business transactions as the keepers see fit to include, letting the rest go.

Through the application of the double or complete entry principle and through a system of accounting controls, which it is not possible to explain in the limited space of this book, the attempt is made to eliminate errors so far as possible. The goal of an accounting system is to fix definite responsibility for each change that takes place in an accounting classification and to make certain that all such changes, whether of value or of obligation, are duly and properly recorded so that the accounts will display as nearly as may be the true condition of all financial matters concerning the organization.

There is an advantage in a balance-sheet prepared from double-entry records wherein every transaction since the beginning of the organization has been duly and properly recorded, thereby establishing the authenticity of each item appearing therein, which would be lacking in a balance-sheet that had to be prepared merely from the result of efforts to discover what values an organization possessed and what obligations there might be against those values without such complete records to aid the process.

The Function of Assets

2-6. As to their function in business, assets may be discussed under three groups: cash; assets held for purpose of realization; and assets held for use or service.

It may be broadly stated that it is a purpose of all commercial enterprises to produce a sufficient amount of cash in excess of the needs of the enterprise to allow distribution to the proprietors. Also, a certain amount of cash is essential for the successful continuance of most commercial enterprises. It, therefore, is unlike other assets in that from a commercial viewpoint nearly all other assets exist for the purpose of ultimately producing cash.

2-7. This increased amount of cash just referred to is usually produced by the rendering of a service or the selling of commodities for an ultimately greater amount of cash than was required to produce and dispose of such services or commodities. The various assets acquired for the purpose of such sale or for the produc-

ing of such service may be known as assets held for realization. In a merchandising organization, all merchandise held for sale and all other accounts representing steps between that form and the cash form, such as accounts receivable or notes receivable, may be classed as such assets. In a factory, these also include all raw materials, supplies and other costs which enter into the creating of the commodities or the service intended for sale.

2-8. In order to facilitate the conversion of assets into cash, certain other assets usually are needed, which are not themselves intended for direct conversion but, instead, are intended for use or service. The merchandising organization needs a building, furniture, fixtures and other equipment. The factory needs a building, machinery, tools and other items necessary to produce the product which it intends to sell. These are not held for the direct purpose of turning into cash, but are held for use or service to aid in that conversion or realization process, whereby a profit may be made.

The three classes of assets just discussed do not appear upon a balance-sheet under the groupings indicated. Balance-sheet group names will be discussed later, but the above grouping has been made for the purpose of facilitating the explanation of their proper arrangement upon the balance-sheet and, more particularly, the reasons for the varying methods of valuation applicable to them.

2-9. A commercial organization presumably receives from its proprietors certain values at its beginning. It may obtain other values from creditors. These values, known as assets, are classified and recorded on the books, offset by accounts representing the responsibility or accountability of the organization for these values. At the beginning the assets consist of cash and items for which cash has been or must be paid. Profit can not arise until there is a transfer of values to others for a greater value, but losses may begin to appear almost at once, because many assets begin to decrease in value for one or another of a number of reasons almost as soon as they are acquired. As each accounting period passes, such decrease of asset value must be measured and recorded, resulting in a corresponding loss or expense.

2-10. Two great problems of accountancy lie in the accurate determination of the proper amount of gain resulting from the convertive processes of a period and the accurate measuring of the decrease in assets that may properly be deducted from such gains

to determine the true net profit or increase in proprietorship for that period. The preparing of a true statement of assets and liabilities at the beginning and again at the end of any period should disclose the amount of such change in net worth. However, that would not give any control over the amount nor show the causes which increased or decreased it.

2-11. Knowing merely the amount of a net profit is not nearly so important from a managerial point of view as knowing every element that affected the amount of the net profit. For purpose of control these elements must be recorded in detail so that all favorable and all unfavorable effects of business operations may be specifically measured. An essential of efficient business management lies in the finding, measuring and promoting of all favorable — that is, profitable — elements in the business and in finding, measuring and curbing or controlling all unfavorable elements such as expenses and losses. This procedure is accomplished through accounts set up for each such element. Those accounts which during a period measure the favorable, that is, the gain elements, and those which measure the expenses and losses, are known as "nominal" accounts. They are combined at the end of the period and form a net result which is merged into the proprietorship accounts.

2-12. At the close of each accounting period a *balance-sheet* may be prepared showing the assets, liabilities and proprietorship interest. The accounts that enter into this statement are known as "real accounts." They represent values the benefit of which comes to future periods and obligations to be met in future periods.

All nominal accounts — that is, those measuring values or obligations that no longer exist for the organization, or other elements belonging entirely to the period preceding the balance-sheet — are summarized in the *profit-and-loss* or *operating* statement which will consist, on the one hand, of all increase of net value — that is, all income elements — and on the other hand, of all asset values which have passed away — all cost of goods or service consumed during the past period.

All effects of transactions recorded in books of original entry must be posted to accounts and all accounts must be summarized ultimately into items in the balance-sheet or items in the profit-and-loss or operating statement. In other words, no transaction of a financial nature can happen without affecting two or more

accounts ultimately appearing in the balance-sheet or in the profit-and-loss or operating statement.

2-13. In order that each account shall display the correct total of the "real" or of the "nominal" value which it is supposed to present, adjustments at the date of the balance-sheet are frequently necessary. As an illustration: The nominal account representing labor may at the end of the year consist of the various charges made to it as the weekly payrolls were paid. If the year ended in the middle of the week there may have been several days of labor service rendered during the past year but not yet paid. In such circumstances an adjustment must be made, debiting (increasing) labor account with the value of the service rendered during those days and crediting the same amount to an accrued payroll account. The labor account — a nominal account representing value of services received in the past period — appears as an expense element in the operating statement. The accrued payroll account — a real account — represents an obligation passed forward to the next period and therefore appears as a liability upon the balance-sheet.

If the labor or any portion of it, in the above illustration, had entered into the production of a factory product which still remained on hand at the date of the balance-sheet, that portion of the labor would have been converted into a real element, as the period following the balance-sheet receives this value and has the benefit of it.

Balance-sheet Development

2-14. The relation of the various elements in the balance-sheet and the principles underlying the theory of asset valuation, as discussed in Chapters IV and V, can probably be developed best by means of a simple illustration. Assume a corporation formed with a capital stock of $50,000, paid for in cash. The corporation leases a building for a period of years, purchases for cash furniture and fixtures totaling $20,000, and pays $1,000 cash for the costs of organization. It further purchases merchandise amounting to $50,000, half of the amount being bought on open account. A statement of its financial condition at this moment would appear as follows:

"X" MERCANTILE COMPANY
BALANCE-SHEET
AS AT..........

ASSETS		LIABILITIES	
Cash	$ 4,000	Accounts Payable	$25,000
Merchandise	50,000		
Furniture and Fixtures	20,000	CAPITAL	
Organization Expense	1,000	Capital Stock	50,000
	$75,000		$75,000

2-15. It will be noticed that the credit side of this balance-sheet shows that $25,000 of value has been received from creditors and $50,000 from proprietors and, on the other side, the assets show the disposition of this $75,000. The assets are listed at what they have cost — that is, at the amount of cash which has been paid or is to be paid for them. So far no profit has been made. While it is hoped that the merchandise will be sold for greater value and that the furniture and fixtures will be of aid in the making of such sales, these are only future possibilities and have not as yet any place in the accounting records.

There may have been losses, however. The $1,000 paid out for organization purposes is gone and can not be recalled. This might be treated as a loss, so the balance-sheet above would display a deficit of $1,000. There is a well-accepted theory of accounting, however, which permits an organization to treat as assets those expenses which are necessarily incurred as a part of the organizing of a business and bringing it to a point where it may produce a revenue. These organization expenses are as necessary as are the furniture and fixtures. Under this accounting principle an organization is not supposed to begin operations with a deficit. A deficit may result from operations but should not be a necessary preliminary to operations. The $1,000 of organization cost may be carried as any other asset until the organization accumulates surplus from profits sufficient to write off — that is, to eliminate — this item without creating a deficit.

2-16. It has been noted that organizations usually find it necessary to invest their funds in two classes of assets, service assets and convertive assets. The conclusion is evident that a portion of their capital will usually be tied up in more or less perma-

nent assets — that is, in service assets — while another portion may be tied up in assets which it is presumed will be converted into cash in the ordinary operations of business. The latter amount of capital is usually called working capital. Since a portion of the convertive assets may have come from creditors who will have to be repaid from the proceeds of such conversion, the amount of working capital is determined by subtracting from the total of cash and of assets held for the purpose of turning into cash the amount of current liabilities — that is, of liabilities which mature within the current period of financing.

The amount of working capital and the character of working capital is of tremendous importance to nearly all business organizations, as it is frequently the test of solvency and of the ability to continue solvent operation. No item of this name appears on the balance-sheet. Instead it is represented by the current assets less the current liabilities. (See Chapter. III.)

In the above illustration a portion of the capital contributed by the stockholders has been invested in permanent equipment and in organization expenses. The remainder, $29,000, is available for current operations and constitutes the working capital. It is shown by the items of cash and merchandise totaling $54,000, less the amount advanced by current creditors $25,000.

2-17. Assume that the terms on which the corporation leased the building require a rental of $500 a month, payable in advance for six months. This transaction reduces its cash by $3,000, and in its place creates an account called "prepaid rent," which allows the total of the assets to remain the same. This prepaid rent is not yet an expense or a loss. It only becomes an expense with the passing of the days for which the rental is paid. In other words, it becomes an expense as the organization receives the service for which it made prepayment. Day by day this asset decreases in value, and a certain portion of it is properly transferable from consideration as an asset to consideration as an expense. At the end of the first month this asset has therefore decreased $500. It would be proper on the books of the company to credit the prepaid rent account with $500, debiting an expense account. Since in a balance-sheet all expense accounts are merged into the proprietorship, evidently a deficit of $500 would be created thereby unless some profit had been made against which this expense could be offset. The item of prepaid rent would decrease month by month

until the expiration of the six months, when the account would be reduced to zero and therefore be eliminated. As has been said before, nearly all assets are subject to a more or less continuous decrease in value. This decrease in value must, of course, be borne by the proprietorship and is treated as an offset against whatever profits have been made during the corresponding periods.

2-18. The furniture and fixtures are subject to decrease in value due to use. Market value does not enter to any great extent into the basic determination of asset treatment on the balance-sheet. The asset first comes on at the value which it cost. That is, at the amount of cash paid for it or agreed to be paid for it. Assets are presumably acquired for purpose of resale or conversion into cash or for purpose of service — that is, for use or aid in producing an income to the organization other than by actual disposal. The cost of those acquired for sale is offset against the income from such sale when made. The cost of those acquired for service will be offset proportionately against those periods receiving the service.

If a building is estimated to be serviceable for thirty years, the cost, less recoverable value at the end of the thirty years, measures the real cost of the service — that is, the use of that building — and should be charged proportionately to each of those thirty years. A piece of machinery costing $1,000 which may bring $100 as junk at the end of ten years of usage should be charged to the ten years receiving service from the machine in proportion to the amount of service rendered in each year. The spread or distribution may be considered as equal throughout the ten years. If so, the asset account "machinery" would be reduced by $90 each year, and this $90 would be charged as an expense of that year. For expense, after all, is only another word for indicating the cost of a service received. If the service rendered by the machine is considered to be unequal in the various years the total cost of the service, $900, may be apportioned to the years upon a more equitable basis. It is not our purpose here to consider how this charge is apportioned but rather to indicate the fact that assets acquired for service are treated for balance-sheet purposes as though they were prepaid expenses or prepaid services, and the net cost to the organization is distributed to the various accounting periods receiving this service.

2-19. In the balance-sheet it is often desirable with regard to more permanent assets to show both the cost and the portion of that cost which has already been charged to expense. If the furni-

ture and fixtures in the above illustration are supposed to depreciate at the rate of, say, 8% a year, the item will appear on the balance-sheet at the end of the first year as follows:

Furniture and Fixtures	$20,000	
Less Reserve for Depreciation	1,600	$18,400

If there were no additions to the furniture and fixtures, at the end of the second year, the item would appear

Furniture and Fixtures	$20,000	
Less Reserve for Depreciation	3,200	$16,800

This indicates that $20,000 of the resources of the organization have been invested in this asset, which is in reality a prepaid service over a period of years. Part of the period of service has expired and $3,200 has been charged as the cost of service over those years. There is a remaining prepaid value of $16,800 which will presumably be received in the form of service over future periods. This transfer of values from asset accounts to expense accounts, so far as assets of a permanent nature are concerned, may be accomplished on the records by periodic entries debiting an expense item called "depreciation" and crediting a "reserve for depreciation" account. This allows the asset account to remain at cost while the portion of that cost which has been transferred as an expense to past periods is shown at any time by the reserve for depreciation account. This reserve for depreciation becomes a constantly accumulating credit amount and on the balance-sheet appears as a deduction from the asset to which it applies.

The amount periodically transferred from an asset to an expense element is of necessity estimated. It is based upon three elements: first, the cost of the asset — that is, the amount of money invested in it; second, the estimated recoverable value; and, third, the probable number of accounting periods intervening before such recovery. If the estimate is accurate, the book value of the asset at the time of its ultimate disposal — the difference between the cost and the reserve that has been built up for depreciation thereon — will exactly equal the value recovered. Of course, in practice such an exact result is impossible save by accident. Never-

theless there is a constant attempt in business to approach as nearly as possible to such accuracy.

2-20. For accounting purposes "land" usually is presumed not to be subject to depreciation, but this does not make it an exception to the above rule. It is merely assumed that land is usually worth as much at the end of any given period as at the beginning of the period, and therefore that the recoverable value at time of sale is equal to the cost, so that there is no service cost to be spread over the periods between.

Prepaid expenses, such as rent or insurance, may be spread accurately over the periods of their service, as the time for which the service contract exists is definite and there is usually no salvage value at the end of that period. (See ¶ 3–7, 13–4.)

2-21. Certain other elements commonly appear in balance-sheets and should be brought into this illustration. In addition to the prepayment of rent, assume that during the first month of operation the above company sells merchandise which has cost $6,000 for $10,000, half of which is collected in cash, the other half remaining on open account. Further assume that $2,600 has been paid out in expenses for the month. If depreciation on furniture and fixtures be disregarded, a balance-sheet at the end of the first month will appear as follows:

"X" Mercantile Company
Balance-sheet
as at. . . . .

Assets		Liabilities	
Cash	$ 3,400	Accounts Payable	$25,000
Accounts Receivable	5,000		
Merchandise	44,000	**Capital**	
Prepaid Rent	2,500		
Furniture and Fixtures	20,000	Capital Stock	50,000
Organization Cost	1,000	Surplus	900
	$75,900		$75,900

Note that in this balance-sheet there are the following types of assets:

1. Cash.
2. Receivables — items which represent legal claim for the collection of cash from others.

3. Merchandise, including items held for the purpose of sale.
4. Service paid for but not yet received.
5. Service assets — assets acquired for permanent use.
6. Intangible assets, including items which for one or another accounting reason are included among the assets and may have a potential earning value but are not tangible. They represent neither property nor right to collect property from any one else.

The above six classes typify practically all items which will appear properly upon the asset side of any balance-sheet.

On the right-hand side of the above balance-sheet are three items, as follows:

1. Amounts representing claims of creditors legally enforceable against the organization.
2. Amounts contributed by the proprietorship.
3. Surplus measuring the excess of total asset value over the other two items.

Items measuring a decrease in asset value since the date of acquirement sometimes appear in balance-sheets as a fourth classification on the liability side. Usually such items are preferably shown as deductions from the assets to which they apply. (See ¶ 19-2.)

A careful study of the various elements in the balance-sheets which follow in this volume will show that, with very few exceptions, they fall under some one of the above classifications or some combination thereof.

2-22. It should be further noted that it is not possible to have a value to an organization upon the credit side of a balance-sheet. The values are all on the asset side. The credit side shows nothing but obligations to people or to other organizations for the values displayed upon the asset side. These obligations appear at the amount of value contributed by the parties whom they represent adjusted by whatever amounts may have accrued within the organization in favor of or against these parties.

With the exception of assets representing the result of conversion or sale by the organization of property or service, other assets are valued at what they have cost the organization less the portion of that cost which has been charged against income of past periods.

The assets which are the result of sales or other conversion of property or service by the organization are valued at the amount

of their expected realizability. It is now customary in business to value any asset which represents within itself a legal right to demand cash at the amount of cash thus evidenced. If merchandise costing $6,000 and carried on the books at that amount is sold on open account for $10,000, the resulting asset may be carried at the latter amount. The organization has not yet received cash, but, instead, has an open account with the debtor known as an account receivable or a trade-debtor account. This sale has given to the organization the right to demand from the debtor $10,000 in cash, and modern business allows the organization to list this asset as $10,000 less a reserve for any probable loss in the collection.

2-23. This recording of the asset "account receivable" at an amount in excess of the asset "merchandise" exchanged therefor results in an addition of $4,000 to the total assets of the organization. Such additions to assets constitute gross profit, which is offset to some extent by decreases in other assets or by obligations to decrease assets — in other words, by expenses.

If, in the illustration above, a note receivable instead of an account receivable had resulted from the sale, the treatment would have been the same. The receivable would have been listed at the amount of cash to which it gave the legal right of collection.

2-24. There was a time when it was not considered correct to record a profit on the books until it was represented by cash. Accordingly, in the above sale, no profit would have been recognized when the merchandise was converted into a receivable, but only when the receivable was converted into cash. Such profit is known as realized profit — that is, profit which is made real by being present in the form of cash.

Another accounting principle that has come into prominence in recent years has had an effect upon this method of valuation. This principle is embodied in the attempt to apportion justly to the respective years or other financial periods the profit or income earned in those periods and the cost or expense which properly offsets such income.

In the illustration above, if the sale of the merchandise had occurred in one year and the conversion of the receivable into cash had occurred in a subsequent year, the latter year would have shown the profit or income of the whole movement from merchandise into cash. Whereas, the cost or expense of converting the sale into a receivable, which occurred in the prior year, was probably

very much greater than the expense of carrying the receivable and of converting it into cash. It is, therefore, much fairer to allow to the year in which the burden of the expense occurs the profit that results therefrom, less an amount estimated as being sufficient to care for any possible loss in collection.

Therefore, at the end of the year in which the above sale occurred, the receivable would stand on the balance-sheet at the amount of $10,000 less a reserve for possible loss in collection, thus bringing into the year just ended the profit upon the transaction. (Some accountants advocate that an additional amount should be withheld to represent the cost of carrying the receivable, that is, an amount corresponding roughly to interest on the capital tied up in the receivable until it is made available again in the form of cash. This principle is treated fully in the chapter on cash discounts. See Chapter XXIV.)

2-25. The proper valuation of assets for the balance-sheet may be briefly expressed as being based upon *cost* for all assets, except cash and assets representing legal rights to collect cash, which are valued at their *expected realizability*. This basis is subject to adjustments such as the reductions discussed in Chapter V and to adjustments described in later pages in the discussion of the specific classes of assets to which they may apply.

CHAPTER III

Elements of a Balance-sheet

3-1. In the preceding chapter we discussed the development of a balance-sheet and used accounts typical of the various classes of items which appear therein. It is the purpose of this chapter to discuss these elements on the basis of the group names under which they are ordinarily collected in balance-sheet presentation.

ASSETS

3-2. Assets is a term used in accountancy to cover all property owned, all legal rights to collect property and all prepaid rights to service.

Property owned covers all property such as real estate, machinery, merchandise, supplies, etc., legal title to which is vested in the individual or the organization classifying it as an asset.

Legal rights to collect property cover what are frequently called receivables. They embrace what are termed in law "choses in action." They are not tangible property of themselves but they represent the right of appeal to the courts to enforce the collection of certain stipulated amounts of property. They include accounts receivable, notes receivable, accrued interest, etc.

Prepaid rights to service appear wherever payment for a service has been made before the service is received; for example prepaid rent, unexpired insurance, interest paid in advance.

At various times in balance-sheets certain items will appear among the assets which do not comply strictly with the definition above. Such items should not be so included unless to classify them otherwise would result in an injustice to individuals or to the results of certain accounting periods. An illustration of this might be the organization expense of a corporation. This is not property owned nor legal rights to property, nor does it strictly represent a prepaid service, though frequently it is treated as though it came under the latter classification. Nevertheless, it is accepted by accountants as a proper asset, if other treatment of it would result in a violation of any accounting principle. (See later discussion of prepaid expense and deferred charges, ¶ 3-7, 13-4, 13-9.) Similarly

"goodwill" may not come under the above definition, yet it is frequently included in the assets of an organization purchasing it. (See Chapter XII.)

CURRENT ASSETS

3-3. Current assets are sometimes known as liquid assets or floating assets. The group embraces cash and all assets held for the purpose of converting into cash. It includes merchandise held for sale, either in finished or unfinished form, together with the elements such as raw materials and supplies which enter into it, and all other classifications resulting from its sale until finally realized in the form of cash.

The chief function of mercantile or manufacturing concerns is to convert commodities or service into sufficient cash to cover the cost thereof, the expenses necessary for operations and a profit to the proprietorship. This conversion may be direct or the sale may be on open account creating a balance-sheet item called accounts receivable or perhaps notes receivable. Such classifications are valueless to the organization, save as they may later be converted into cash or its equivalent. Presumably all assets listed under the current classification move gradually toward a realized condition. In the period following the balance-sheet the merchandise will presumably be turned into receivables and the receivables be turned into cash. The length of time required for this process of conversion varies with the type of organization, the seasons and the efficiency of operation.

Current assets are sometimes defined as those which are most readily converted into cash. This is an erroneous definition. Frequently real estate may be very readily converted into cash, yet it belongs essentially in the group of permanent or fixed assets. On the other hand, inventory of merchandise is a current asset, yet often it is not readily convertible into cash, requiring, instead, the constant effort of a large organization to effect conversion. In fact, the conversion of merchandise into cash constitutes the chief problem of many great organizations whose staff is maintained and operated primarily to accomplish that purpose. (See Chapter VI.)

QUICK ASSETS

3-4. The term "quick assets" is sometimes used as almost synonymous with current assets. It includes cash, receivables

from others than officers, stockholders and employees, inventories and other items held for the purpose of converting into cash. When so used the total of the above groups appears as a subhead in the balance-sheet, to which may be added securities held for sale or readily salable and receivables from officers, stockholders, and employees. The total then obtained is known as "current assets." This is the use recommended by the Federal Reserve Board in its bulletin of April, 1917. In practice the usage frequently varies considerably, but the term always indicates assets which in the ordinary course of operations will soon be converted into cash.

Fixed or Permanent Assets

3-5. These are sometimes known as "capital assets." Whereas current assets are of value to an organization only if they are converted or convertible into cash, permanent assets include those which are themselves of use to a business. Their value to an organization lies in their use or service, rather than in their conversion. Buildings, furniture, machinery and equipment of various kinds may be held by an organization, not for the purpose of directly converting into cash, but because of their usefulness in aiding the process of realizing the current assets. (See Chapter X.)

Investments

3-6. In addition to the assets directly related to a business, organizations may own various other forms of property or documentary rights to property, which although owned by the organization play no essential part in its operations. Under this classification would come investments in the securities of other companies. These are preferably displayed in the balance-sheet under a separate grouping, so that they do not appear in the total of the permanent assets, nor of the current assets. There may be times when these investments are held purely as current items: that is, if they are of a readily convertible character they may be held in lieu of cash and as such may be grouped among the current assets. Amounts invested in United States government bonds or in certificates of indebtedness or in other bonds of a readily realizable character come under this group.

Again there are times when these investments are practically in lieu of permanent assets, as in the case of a publishing house which owns capital stock of a bindery. This stock ownership may enable it to make very favorable contracts for binding and so is treated as a permanent item, as it takes the place of the direct ownership of binding machinery and equipment. Unless there is some such close relationship between the investment and one or other group of assets it is preferable to treat the investment as a separate classification on the balance-sheet. (See Chapter VIII.)

Prepaid Expenses

3-7. Prepaid expenses are sometimes included by accountants with deferred charges. (See later ¶ 3–8, 13–1.) However, unless the amount is insignificant, prepaid expenses deserve a separate heading, for they are quite different from deferred charges, — discussed later. Prepaid expenses include those for which settlement has been made but for which the service has not yet been received by the organization. They are akin to receivables but different in the sense that receivables represent a legal right to collect cash, whereas prepaid expenses represent a legal right to receive service. They represent an investment of working capital in advance of receiving the service. Prepaid rent, prepaid interest and unexpired insurance are illustrations.

Deferred Charges

3-8. Deferred charges include those costs or expenses which for certain reasons are not charged against the income of the period in which the service is received but are temporarily capitalized, that is, set up as assets to be written down over future periods on some arbitrary basis. As previously stated, it is not desirable to include prepaid expenses under this heading unless they are small in amount. Deferred charges do not represent any legal right to collect from any one the amount shown in the form of cash, commodities or service; whereas prepaid expenses do involve such right. If an organization rents a building and pays $6,000 a year in advance, that constitutes a prepaid expense and the organization has the right to demand the service — that is, the use of the building — for the period covered by the contract. This prepaid rent is definitely chargeable to the particular months mentioned in the contract, the asset account being correspondingly

reduced month by month. On the other hand, if the organization paid out $10,000 as the cost of moving from an old location to a new, it might properly set up this amount as a deferred charge. It can write off the amount against expense over a number of years determined arbitrarily. The organization hopes that the new location will prove profitable and justify the expenditure which it proposes to charge against the increased profits of the future years, but it has no legal right to collect the $10,000 from any one, in the form of service or of other value.

As this point has not always been brought out as clearly as it should be, perhaps it justifies another illustration. Let us say that in 1922 a business firm spent $30,000 for advertising in periodicals and all of this advertising appeared in the year 1922. On December 31st it might decide that the advertising should be expected to bring in additional business in 1923; therefore it might further decide to let the year 1922 stand only half of the cost, capitalizing $15,000 as a deferred charge to be written off in 1923. Note that at December 31, 1922, it includes this item among its assets under the heading "deferred charges." This item does not represent property owned nor a legal right to collect property nor a legal right to receive service. It does not represent at that date any legal right to compel any one to pay anything or render any service in 1923. This is a typical deferred charge.

Suppose, again, that the same organization makes a contract in 1922 with a magazine to run advertisements during 1923 and for certain reasons makes a prepayment of $30,000 for this advertising. This amount is strictly a prepaid expense. On December 31, 1922, it represents an amount paid for a service which has not yet been received. The organization has at that date a legal right to receive during future months a specified service. Month by month as this service is rendered the advertising expense for the month may be debited and the prepaid advertising account be credited so that at the expiration of the contract period the prepaid expense will have been written down to zero. (See Chapter XIII.)

Intangibles

3-9. Intangibles, such as franchises, goodwill, copyrights, trademarks, etc., frequently appear in balance-sheets. These may be placed under the heading "intangibles" or they may appear with the permanent assets. They are discussed in detail in Chapter XI.

They are items presumably having some value to the organization but not in tangible form. They may be represented by some document or contract. The amount at which they properly appear upon the balance-sheet may have little relation to their true worth to the organization owning them.

Liabilities

3-10. The term "liabilities" includes all legal obligations incurred by an individual or organization to pay values to others than the proprietors, either at once or in the future. There is an increasing tendency to draw a more definite line between the legal rights of proprietors and the legal rights of others. The obligations to the latter group comprise the liabilities, though the term was once used in a broader sense to include proprietorship rights as well. The distinction between the rights of creditors and the rights of proprietors is recognized in law and is sufficiently vital to justify carrying the distinction accurately into the accounting records and statements.

Current Liabilities

3-11. Liabilities also are divided into two groups, sometimes given the same group names as the two chief divisions of assets, namely, current and fixed. The distinction here, however, is purely an arbitrary one, depending upon when the liability must be met. Current liabilities are those which should be paid within the current financing period, which is usually from sixty to one hundred and twenty days or perhaps one year. Those which do not mature for a longer period or those which are readily renewable in character are classed in the second group. For instance, a bond or a mortgage might fall due within thirty days after the date of a balance-sheet, but if arrangements had been made for renewal it would be tabulated among the fixed rather than among the current liabilities.

It is difficult to give any rule fully covering the difference between these two classifications of liabilities. Long-time notes and bonds are unquestionably fixed liabilities. On the other hand, the liabilities resulting from purchases on open accounts, short-time loans from banks or other sources should be grouped as current. Judgment and common sense must play a part many times in making the right grouping and it is a fundamental of accountancy that in

case of doubt the preference must lie with the more conservative line of action. To list a liability as current is more conservative than to list it as fixed if there be a reasonable doubt as to its proper classification. Among the current liabilities are found all short-time notes payable, open accounts resulting from purchases, accrued payables and similar items. (See Chapter XIV.)

Funded or Long-time Liabilities

3-12. Funded and long-time liabilities are sometimes called "capital liabilities," but there is danger of confusing such a term with the use of capital as applied to proprietors. Again, the terms "fixed liabilities" and "permanent liabilities" are frequently used. Objections may be found to any adjective yet suggested as part of this group name. "Long-time" or "funded" seem convenient words, but against the latter the point is raised that confusion may result because of the more limited application of this term in Europe.

The group includes all liabilities which do not have to be paid in the current financing period. The distinction has been discussed under the preceding heading. Among these liabilities are grouped mortgages payable and the various kinds of bonds payable and long-time notes payable. (See Chapter XV.)

ACCOUNTING CAPITAL

PROPRIETORSHIP

3-13. Proprietorship is a group name for all the accounts which measure the rights of the proprietorship of a business to the assets thereof. "Accounting capital" is another term with the same meaning. In balance-sheets the amount frequently appears with the designation "net worth." Accounting capital measures the excess of asset value over the liabilities. In other words, it is the measure of what should be left of the assets after the creditors are paid.

The accounts which may appear in a balance-sheet under this general heading depend upon the form of proprietorship. A balance-sheet of a sole proprietor might display only one account under this heading. Similarly one account might be used to report the combined proprietorship of the several partners in the balance-sheet of a partnership, or there might be separate accounts for each partner. In the balance-sheet of a corporation there might

appear under this heading separate accounts for each class of proprietors or stockholders and as many accounts for the surplus and subdivision thereof as may have been authorized by the corporation. These points are discussed in Chapter XVI.

Capital

3-14. The account called "capital" frequently appears on the balance-sheets of sole proprietors or of partnerships and represents the full amount of the accounting capital. In the case of partnerships it may be subdivided into separate accounts for the various partners. It is used as an abbreviation for the more complete term "accounting capital." Where there are restrictions upon the elements of capital as in the case of a corporation, more distinct terms (as given below) should be used in the balance-sheet.

Capital Stock

3-15. In corporations the term "capital stock" indicates certain rights to assets acquired by stockholders through their very act of becoming such. These rights are represented by stock certificates issued and outstanding. There are various classes of capital stock, such as preferred stock, common stock with par value, common stock with no par value and other classes which are discussed in Chapter XVII.

Surplus

3-16. In the case of corporations any excess of asset value over the total of liabilities and capital stock constitutes what is known as surplus. In a balance-sheet this may appear under various classifications, such as earned surplus, paid-in surplus, appropriated surplus, capital surplus, etc. These items are discussed in Chapter XVIII.

Deficit

3-17. A deficit is the excess of the sum of liabilities and capital stock over the book value of the assets. In other words, it is the deficiency or the amount by which the asset total fails to equal the sum of the liabilities and the capital-stock accounts. It is, therefore, the reverse of the surplus account. It is a surplus account with a debit balance instead of a credit balance. It is sometimes

displayed among the assets on a balance-sheet, but this is confusing and apt to be misunderstood. It is preferably shown in the proprietorship group as a subtraction from other items therein. (See ¶ 18–26.)

CONTINGENT ITEMS

3-18. Aside from the items which may definitely be classified in the balance-sheet under some of the headings just discussed, attention frequently must be given to contingent items. These are elements involving uncertainty — not as to their classification, but as to their future status. It is possible that they will affect the financial condition of the company in the future, but at the date of the balance-sheet that possibility has not yet been made a certainty. There may be items with asset potentialities, which do not as yet justify asset classification. Certain facts may result in true liabilities, but that result is yet too doubtful to justify inclusion among its positive liabilities.

As a rule no "contingent" heading is used in the balance-sheet unless as a footnote. Each contingent item must be studied and displayed or not, as seems right and proper. Such items may be of an asset, liability or proprietorship nature.

Contingent Assets

3-19. Items which represent contingent assets — items which may or may not become the property of the organization — must not be expressed in the financial accounts and statements unless offsetting reserves are set up so that the profit-and-loss accounts will not be affected by improper inclusions. Damage claims which are not in the nature of conversion of assets would come under this heading. Damage claims which merely represent attempts to collect from certain persons instead of from others, or claims which are in lieu of other assets not in the balance-sheet, may properly be expressed by accounts. They are not contingent assets. If a building has been destroyed by fire, the account representing that building should, of course, be closed. In its place there is a claim against the insurance company for a certain amount. Such a claim is a legitimate asset. However, the two assets must not both appear upon the balance-sheet; otherwise there would be a duplication.

A claim or suit which might result in producing an asset additional to those in the balance-sheet, but is of a contingent nature, should not be set up in an asset account, unless it has advanced to a stage where there is a legal claim for collection, such as a court judgment. It would be legitimate, however, to express such a contingent asset as a footnote on the balance-sheet if the accountant deems it of sufficient validity to justify such attention.

Contingent Liabilities

3-20. Contingent liabilities are much more common than contingent assets in financial statements. It is the duty of the accountant to call attention to any liability which may accrue against the organization. Investigation should be made to determine, if possible, any suits that may be pending or any judgments that may have been filed against the proprietorship. Indication of these things should be made by footnotes on the balance-sheet, even though they are not sufficiently definite to justify setting them up in liability accounts.

Contingent liabilities because of endorsement of negotiable paper should also be expressed by footnotes if not shown in the accounts under the heading "notes receivable discounted" or some similar account. (See ¶ 14–10.) In this case, any possible liability because of endorsement would result in a corresponding asset in the form of a claim against preceding endorsers or the makers of such paper, which would be expressed on the asset side of the balance-sheet. The method, therefore, of carrying both the asset and the liability items with regard to all endorsed commercial paper has the sanction of good usage and is considered preferable to the mere footnote display on the balance-sheet.

Contingent-Proprietorship Claims

3-21. It has been held that dividends payable to stockholders do not become liabilities of a corporation until they have been definitely voted by the board of directors from surplus or profits properly applicable to such use. This apparently applies to dividends on preferred stock as well as to dividends on common stock. When any dividends have been passed, if they are cumulative, they constitute a claim which becomes effective whenever the board of directors authorizes such distribution of profits. Until that time it is not desirable to display such accrued but unauthorized div-

idends as a liability. In a balance-sheet, it is proper to indicate such a condition by means of a footnote, so that proper warning is given to possible purchasers of common stock that certain priorities must be recognized before distribution in the form of dividends can be made to them. It should be kept in mind that if the holders of preferred stock have a positive claim to accrued dividends in the ultimate distribution of profits, it is not a contingent liability in the sense of one which may or may not become a liability; rather it is certain in character and amount but indefinite as to time.

CHAPTER IV

VALUATION OF ASSETS

4-1. While the proper method of valuing assets in a balance-sheet may be subject to some difference of opinion among accountants, the chief controversy centers about the valuation of those which are held for service and ordinarily classified as fixed or permanent or capital assets. (See Chapter X.) Present accounting practice requires that these shall be valued at cost less adjustments for decrease in value, discussed in Chapter V, and other adjustments, discussed in the following chapters with the particular assets to which they apply. This basis of valuation is not yet universally accepted and many business men find difficulty in seeing its logic as applied to some of their assets. They feel that assets should be listed at what could be obtained for them if they were sold, and they will frequently argue strenuously for such a method of valuation. Others are confident that an asset acquired under unusually favorable conditions should be listed on the books at the amount it would normally cost to obtain.

Again, business men manufacturing or constructing assets for themselves feel that they should carry such assets on their books at the amount required to purchase them from others, even though this amount is in excess of what the assets actually cost them.

Since no matter how carefully balance-sheets be arranged, nor how accurately their elements be classified, nor how scientifically the various relations be displayed, the vital results depend upon *how the assets are valued therein*, there will always be much difference of opinion upon this basic matter. However, various methods that have been tried have been found wanting and have gradually been discarded. Various theories have demonstrated their impracticability and have been cast aside. Today there is more uniformity of opinion, on the part of business men, accountants, legal authorities and others who have gone deeply into this matter, than is generally recognized.

Practically all methods that have been widely advocated for asset valuation concern one or more of the following bases:

(a) The amount that might be realized by sale of the assets.
(b) The amount that might be required to replace or reproduce the assets at the date indicated.
(c) The amount which the assets cost the organization now owning them.

Lengthy, labored and learned arguments have been frequently presented with regard to these bases, but we can do no more in this chapter than consider them briefly rather than exhaustively.

Basis of Realization

4-2. Every accountant finds some business men continually arguing the theory of realization value with regard to certain assets, especially if its application to their business would result in a higher amount than the one which the accountant thinks proper. There are two vital objections to this method. The first is that it offers no definite basis which can be unquestionably applied. How much a particular asset would bring at any time is a question of opinion which can only be confirmed by definite bids from third parties. To apply this method to all the assets would mean that a continuous succession of bids would have to be obtained or the realizable value would have to be estimated. But who would make the estimate? If this were left to the proprietor, evidently the balance-sheet of any business would show it to be worth just so much as the proprietor chanced to think it worth. Days when he was particularly pessimistic would show a marked fluctuation from other days when he felt optimistic. Balance-sheets prepared at a time when the proprietor desired a loan from the bank might differ tremendously from balance-sheets prepared for property taxation or for other similar purposes. A luncheon chosen unwisely might produce startling results in the display of net worth.

The valuation might be left to so-called experts, so that at each date of presenting a balance-sheet persons presumably qualified would pass upon the probable realizability of each item of the asset group. But even this would not overcome the second objection which is that the application of such a method would destroy completely one of the chief functions of accounting records, which is to measure the periodic results of activities as to gain or loss. If the valuation of assets be left to guess or appraisal, the resulting profit or loss for the period between two such balance-sheets would be correspondingly left to guess or appraisal, and the control over

custodianship built up by the double-entry method would be almost entirely lost.

BASIS OF REPLACEMENT COST

4-3. A like method, though differing slightly from the one just discussed, is urged by some business men with regard to assets; that is, to value them at the *cost of acquiring* similar assets at the date of the balance-sheet.

To illustrate: A certain proprietor bought a great number of machines at a forced sale and for a price considerably lower than would normally be demanded for them. He desired the value of them written up on his books to the normal price. He was holding these machines for sale, and when they were eventually sold the difference between cost to him and the amount received for them would be his gross profit. To write up the value prior to the date of sale would merely result in taking part of his profit then and a less amount of profit when the sale was made. Such anticipation of profit is contrary to good accounting and to conservatism.

The same manufacturer acquired some machinery for use in his factory. Later the price of this machinery was considerably advanced. He wished his accounting records to show the advanced price instead of the cost price, under the delusion that he had made a profit because of the advance in the price of the machinery. Manifestly there was no profit in such a case as there were no additional assets that he could pay out in dividends or pay to himself as income. The machinery was no more efficient because it had advanced in price. It would not turn out any better product nor turn it out faster. Moreover, the whole cost of the machinery, less reclaimable value, must eventually be charged to operations in the form of depreciation. To record it on his books at an amount in excess of cost would merely result in a larger charge to operations. To take an alleged profit at the time of the purchase would only increase the cost of his later product. This would violate not only conservatism and good accounting, but also common sense.

The advantages which he really gained in buying machinery at the low price were twofold: (a) it tied up less of his working capital, and (b) it resulted in a lower charge to depreciation than if he had been compelled to buy at a time when prices were higher. It did not require any manipulation of his financial records to enable him to receive these benefits. With these advantages he must be con-

tent. This theory is discussed further in the chapter on "theory of asset reduction" ¶ 5-3.

4-4. If an organization should attempt the method of valuing its permanent assets on the basis of the fluctuations in market price of such assets, it would be defeating the basic purpose of the financial records. If the general market prices for machinery advanced or receded, and if these changes were reflected by writing up or writing down the assets on the books of this organization, it would be distorting its records to show things with which it is not concerned. If Corporation "B" has to pay more for a certain machine than would Corporation "A" this is no reason why Corporation "A" should write up machinery value upon its books, for at a later date it might be that Corporation "C" would buy the same machinery at a much lower figure.

To follow such a theory to its logical conclusion would mean that Corporation "A" would be kept so busy adjusting its machinery prices up and down to agree with the purchase price to other organizations that it would seriously impair efficiency in recording true transactions. If Corporation "A" invests a certain sum in a machine the records should show that amount as being the cost of that machine and this record should not be influenced by what other organizations may have to pay for similar machines. The expenses of an organization are based on the cash or equivalent value which that organization pays or obligates itself to pay for service. This principle applies just as much to machine service as it does to payroll or rent or taxes, and it is doubtful if there is any organization which would insist on recording these latter elements at the amount which some other organization might be called upon to pay for them. (See ¶ 10-14.)

Assets Have Many Values

4-5. In advocating valuation of assets for balance-sheet purposes on bases other than cost, two facts are frequently overlooked. These are:

1. That an asset may have more than one value at a particular date, and
2. That a balance-sheet has certain recognized functions to perform which limit the range of asset values that may properly be used therein.

Consideration must first be given to the purpose back of the

valuation. Anyone who appreciates the complications of modern commerce must also appreciate that assets in business can no longer be considered as having only one value at a given time. In considering forced realization, as in bankruptcy, a certain value may be correct. In valuing for purposes of replacement, an entirely different amount may rightly be found. For purposes of determining a base for fair return in rate-making, the just value may be yet another amount. The proper value for a balance-sheet may be different from any of these. The purpose to be served must determine the method to be used.

The special purposes mentioned above must be kept distinct from the purposes of the balance-sheet as now recognized commercially. The attempt frequently made in the past to combine many of these functions in the regular balance-sheet and accounting records of business concerns has been illogical and confusing and has not produced satisfactory results. Whenever the need arises for a special method of valuation, such as those just noted, special statements may be prepared for that purpose; but it is seldom desirable to allow these special valuations to affect the amounts used for balance-sheet purposes.

4-6. In *forced realization,* where the owner of the assets is under stress of circumstances, the advantage in bargaining is all with the possible purchasers. If these be few or if competition be lacking the price obtained may have little relation to the value of the assets to the business had it been able to continue as a going concern. This must be considered in any statement made in expectation of forced realization, such as a statement of affairs (see Chapter XXV), but it has no place in the ordinary balance-sheet.

When valuing for *replacement,* as for insurance, or for damages under the enforcement of the right of eminent domain, the basis will be the cost of obtaining assets of similar character and efficiency brought to as similar conditions as may be. The purpose here is the determination of proper reimbursement, a function quite different from that of the balance-sheet.

When the assets of public service organizations are being valued for the purpose of allowing a *fair return* thereon in rate determination, due consideration must be given not only to the cost but also to the efficiency of the assets with regard to the purpose which they must serve. A management which has been skillful, has used good judgment in the acquiring of assets, has made few expensive mis-

takes and has kept its equipment in excellent condition must be allowed some reward therefor. On the other hand it would not be just to penalize the users of the service of another organization with an opposite type of management, whose costs had run far beyond a proper figure because of ignorance, mismanagement or poor judgment. Neither cost nor balance-sheet value alone is a sufficient basis for the determination of both a fair return to the proprietorship and a fair rate to the users of service.

4-7. Distinct from these, the balance-sheet valuation has its own functions to perform. These functions are being more and more generally understood and recognized, and the essential benefits that may be derived from balance-sheets account at least in part for the place these financial statements play in the world of commerce today. As progress is made in increased accuracy of business classifications and in increased accuracy of the measurement of such classifications, there must be more definite limitations upon the method of valuation used in the various statements of a financial nature, especially in the balance-sheet.

Some of the needs of business which are being met by the balance-sheet are:

1. An expression of the financial condition of running — that is, continuing — organizations, which will be commonly understood by the various parties interested therein.
2. A means for comparing conditions at a given date of various similar businesses or conditions of the same business at various dates.
3. A display to those, such as creditors or proprietors, who have advanced values to a business, showing what has been done by that business with the values so advanced.
4. A statement of the balances of the accounting records of the organization showing in condensed form the financial facts as revealed by those records.

The valuation, therefore, that is used in the balance-sheet is fundamental as a basis of business operation and of business records. It must be a continuing valuation repeated year after year on the same basis, so that progress may be measured by comparison. The nearer uniform the method of valuation in all businesses the more accurate is the information obtained by comparison of balance-sheets. Any fluctuations in the assets of an organization must be reflected in the balance-sheet by some account or accounts

upon the obligations side, that is, by liability or proprietorship accounts. Fluctuations in proprietorship that do not represent contributions or withdrawals of capital must be gains or losses. Therefore, if the basis for recording assets is not stable it will result in a showing of gain or loss not justified by accounting practice and disastrous to conservatism and administrative control.

4-8. Of the three bases suggested above for valuation of assets, only one is capable of accurate determination and that is the amount which the assets have *cost* the organization. The amount they might bring if sold can not be determined until they are sold, and this amount is of little interest to an organization which does not expect to dispose of its assets, unless the sale price should chance to exceed the worth of the assets to it as a running company. In that case the actual sale should be made and the value received therefor should be duly recorded. Unless such sale is made the amount can only be estimated.

No matter how expert the appraisers may be nor how fair their judgment as to realizability, the use of the appraisement method would destroy the value of balance-sheets for comparison and would prevent their chief function of measuring the periodic results of activities as to gain and loss. Conditions might be such at the end of one period that the fixed assets if sold would realize more than at the beginning of the period. If such appraisals were reflected in the records it would indicate a gain for the period and yet that gain would not be usable in any form. It could not be paid out to stockholders without disaster to the business; neither would it be represented by any increased capacity or increased efficiency of production. It would violate rules for determining gain which have been developed by long experience of the business world and are now accepted both commercially and legally. The general adoption of such a valuation would destroy the character of the balance-sheet as an expression of accounting records unless these changes were made also upon the accounting records. It would seem that if business organizations undertook to record on their ledgers every fluctuation in the realizability of any of their assets, the bookkeeping staffs would be so busy that they could devote little time to the recording of true accounting transactions.

4-9. Similar observations might be made with regard to the plan of recording assets at what it would cost to replace them. Such cost

is of slight interest to an organization unless it is going to replace its assets and even then the question has no place in the accounting records until replacement is accomplished, when the new assets may be brought into the records at cost.

It must be noted that the business world has tried these methods to greater or less extent and has found them unsatisfactory. It is sometimes urged that cost is the proper basis for certain assets, appraisal for others and realizability for others. The writer suggests that the purpose for which the asset is acquired or held must determine to some extent which of these is the logical method, but it certainly seems the advantage obtained by uniformity of valuation, not only in the successive balance-sheets of a particular organization, but also in the comparison of the balance-sheets of various organizations is so great that it should not be violated save in most unusual circumstances.

4-10. Flexibility is desirable in the application of rules to business as well as in the application of rules to everything else, such for example as building construction; but over-flexibility is as disastrous in the construction of sound accounting records as is over-flexibility in building construction. Evidently, if financial statements are to have any value, the basis of valuation of assets must be definite and sound. It must be one that will enable the interpreter of the balance-sheet to determine as accurately as possible the financial policy of the organization by revealing to him how the concern has invested the sums that have been raised by loans from creditors, by proprietorship contributions and by profits not withdrawn.

The present methods of accounting are the result of developments during years of bookkeeping experience. No czar of business or of law has declared that any basis shall be dropped and any other basis used. Instead, the commercial world itself has gradually discarded those methods found undesirable and has continued those which come nearer to expressing its true needs. The general bases of business records now used, which this book attempts to describe so far as they are represented by the balance-sheet, are not perfect. Changes will unquestionably be made in them as further experience evolves more satisfactory methods.

It is not the purpose of this book to attempt to give any new method for asset valuation, but rather to portray and emphasize the methods which seem to be most logical and most valuable and

already have the sanction of the best financial authorities and the approval of business and of accounting usage.

Throughout this book the words "worth" and "value" are used in the sense in which they are ordinarily understood in business today and as though they were more or less synonymous. There is no attempt to limit them to that exclusive and highly technical usage recognized by higher economists.

CHAPTER V

THEORY OF ASSET REDUCTION

5-1. In the chapter on theory of assets, an attempt was made to explain the principles governing the recording of asset value and to demonstrate that service assets in reality represent a prepayment for service over a period of usefulness. The difference between the cost price and the recoverable value is an amount which, during the periods between purchase and sale must be transferred from asset elements to nominal elements. This chapter is concerned with the various methods of accomplishing that transfer.

The various causes of decrease in value of service assets may be grouped under the five heads Depletion, Depreciation, Obsolescence, Inadequacy and Accidents.

DEPLETION

5-2. In some assets, which are of a tangible nature, the actual asset itself or at least the ownership thereof passes away during the period of use. Such assets are known as wasting assets, and the continuous decrease in value is referred to as depletion. (See ¶ 10–10.) Common illustrations coming under this classification are timber lands, mines, oil lands and development lands. As these assets are developed and as the sales are made, each sale transfers title to a certain portion of these assets. Some of the assets which made the timber land valuable pass from the ownership of the company with each sale of timber. Similarly, in each of the other illustrations, a portion more or less great, of the asset itself passes from the ownership of the company with every sale of the company's product.

It is quite customary to effect this transfer, not at the time of sale, but at the time when the product is prepared for sale. To illustrate: With every ton of coal that is mined the estimated amount of asset value is transferred from the asset of coal mines to the current asset of coal ready for sale. The result is that the passing from permanent asset value to the current inventory asset or, a step further, to the profit-and-loss account, is in proportion to the quantity of product rather than in the ratio of the passing

of time. The estimated amount of coal which the land will produce is calculated prior to the beginning of operations. The cost of the land divided by the estimated number of units gives the amount by which the asset is depleted with each unit removed.

It has become common practice in regard to oil lands and mineral lands to calculate the estimated amount of oil or of minerals producible from particular tracts and to capitalize this upon a definite unit value. The asset so set up should be shown as additional to the cost of the land or lease and should be so designated as to make clear its character, as, for example, "appreciation of developed leases." The credit from this entry should be carried to an account "surplus from revaluation," which should be carried on the balance-sheet separate from the surplus from other sources. (See ¶ 10–11, 18–21.) As operations are carried forward, a pro-rata amount is transferred periodically from the surplus from revaluation account and credited to the profit account or to the surplus account under the designation of realized appreciation. (See ¶ 18–25.)

DEPRECIATION

5-3. Under the head of depletion we have discussed assets which dwindle or diminish or waste away with the process of operation. There are other assets, however, whose value decreases over a period of usefulness, but without any great decrease in their physical quantities. A building that has been used for ten years may be just as large as it was in the beginning. Similarly, a machine after ten years of use may occupy just as much space, weigh just as much, have exactly the same parts, and even perform the same kind of work as at the beginning, yet its usefulness to the organization may have passed away and its value, therefore, has decreased from cost price to whatever price may now be obtained for it. This decrease of value is usually referred to as depreciation. Depletion involves an actual decrease in the quantity of the asset owned, whereas the phrase "decreased asset value" as used with regard to depreciated assets refers only to the decrease in the amount shown as an asset representing prepaid service cost. It does not necessarily imply that the intrinsic worth or effectiveness has been correspondingly decreased. This constant reduction of book value because of depreciation is no more than a measure of the "expired portion" of the outlay represented by the asset.

There are always at least three factors in the determination of the amount of depreciation: first, the cost of the asset; second, its ultimate recoverable value; third, the period of usefulness. The first of these is the only one that is definitely known at the time when the depreciation charge is determined. The other two at that time can only be estimated and the factors involved in this estimate are engineering rather than accounting in character. Nevertheless, the accountant frequently has to make such estimates or to give effect to those determined by engineers. In estimating, he must be guided by whatever engineering information he can obtain, supplemented by experience with regard to the various classes of assets, which have been condensed into tables of more or less general acceptance.

There are many methods of apportioning depreciation over the various accounting periods between the date of acquisition and the date of retirement. The amount to be depreciated is the difference between the proper cost of the asset at the beginning (which, as has been said before, may include legitimately all of those costs needed to bring the asset to a position and condition for rendering service), and the final recoverable value. (See also ¶ 10–11, 10–12, 18–25.)

Simple Method

5-4. One of the simplest methods of apportioning depreciation is to divide the amount of depreciation by the estimated number of accounting periods of usefulness. To illustrate: If a machine which costs $4,000 should have an estimated recoverable value of $400 after ten years of service, the amount of depreciation, $3,600, could be apportioned equally to each of the ten years, or at the rate of $360 a year. The accounting procedure would be to set up the asset at cost, $4,000, when acquired. At the end of the first year a journal entry would debit the operation accounts with $360, and credit an account "reserve for depreciation of machinery." After this entry the balance-sheet would appear thus:

Machinery	$4,000	
Less Reserve for Depreciation	360	$3,640

At the end of the ten years this reserve for depreciation would equal $3,600. On the balance-sheet the effect would be shown thus:

Machinery	$4,000	
Less Reserve for Depreciation	3,600	$400

If the machine be then retired and accepted for $400 by some purchaser, the journal entry would be:

	Debit	Credit
Account Receivable	$400	
Reserve for Depreciation to Machinery .	3,600	
To Machinery		$4,000

This entry would eliminate the machinery item and the reserve for depreciation thereon when the machine itself was eliminated, which is the correct treatment.

The above method operates on the principle that the machine will be equally useful in each of the years of its use, and therefore an equal amount of expense because of depreciation should be charged to each of the years. However, the method overlooks the probability that repairs and maintenance expenses will increase year after year and that the expense will therefore be much greater in the later years than in the earlier years. The actual cost of the service of a machine includes repairs and maintenance as well as depreciation. This means that although the later years of operation will be charged with a greater amount of cost than the earlier years, the value of the service of a machine will not be greater in those later years and, in fact, may be even less than in the earlier years.

Depreciation and Repairs Method

5-5. Many methods have been adopted in attempts to overcome this difficulty. One method involves an advance estimate of the probable amount of repairs which a machine would require during the years of its use, this estimate being based upon experiences with regard to similar machines under similar conditions. Each year of operation would then be charged with an equal amount sufficient in the number of years to cover the estimated amount of repairs and also to reduce the value of the asset to its recoverable amount. To illustrate: If for the machine mentioned above, it was estimated that repairs and similar maintenance costs to the amount of $800 would be required during the ten years of its use, the charge to each of the years should be sufficient to cover the $3,600 of depreciation, plus $800, a total of $4,400. The operating expenses for

each year, then, would be charged with $440. In some businesses, the credit for this $440 would be made to the reserve for depreciation of machinery, called in this instance "reserve for depreciation and repairs," and against this reserve the repairs are charged.

If the estimate prove to be exactly correct this method works satisfactorily. In the above illustration a total of $4,400 would have been credited to the reserve account in the ten years, against which $800 would have been charged because of repairs, so that the balance on the account at the end of the time would be $3,600, the same as under the first method. However, such an exact estimate is almost impossible, and in the absence of exactness this method frequently proves to be illogical and unsatisfactory. If the repairs should be much in excess of the estimated amount, the excess charged to the reserve would reduce the balance of that account, which, in turn, would result in showing upon the balance-sheet a greater book value for the machine. In other words, the greater the amount of repairs upon a machine the greater the book value of that machine would be, and vice versa — which would be a result quite contrary to fundamental accounting principles.

5-6. Some accountants use the method outlined above, except that the credit for the $440 is split between two accounts, one called "reserve for depreciation of machinery" and the other "reserve for repairs." This latter reserve is more in the nature of a contingent reserve, but it must be maintained with a credit balance. A debit balance upon it would indicate that the repairs had already become greater than the amount reserved to care for them, and such an excess would be an expense which could not rightly be carried over to later periods, but should be absorbed in the period of its incurrence.

If the reserve for repairs be made great enough there would seem to be no serious objection to its use, as it is as logical as any other reserve which is of an estimated character. Any excess upon it at the end of the period which it was intended to cover is an adjustment to surplus, as is any excess of a reserve for depreciation over the amount shown to be the true depreciation when the recoverable value is realized. The reserve-for-repairs method is merely an attempt to apportion the cost of repairs of a particular asset uniformly over the period of its usefulness, instead of having to charge to one period the cost of a repair made in that period which may have been the result of the strain of previous operating periods.

Sliding-scale Method

5-7. Another method of apportioning the depreciation with the intent to equalize the charges, both for depreciation and for repairs, to the various accounting periods involves charging the depreciation on what may be called the sliding-scale plan, by which the greatest amount of depreciation is charged to the first year, a less amount to the next year, and so on, on a constantly decreasing scale so that the years in which the repairs are presumed to be the greatest will be the years in which the depreciation charge is least. This gives effect to the idea that in the first years of use the machine is probably more efficient and that the efficiency decreases year by year.

Annuity Method

5-8. A method sometimes employed for recording the depreciation of equipment is known as the annuity method, by which depreciation is periodically charged with a constant amount calculated to be sufficient to write off the cost during the period of use and also to write off the annual interest charges on the decreasing investment as shown by the book value of the asset. This method involves the problem of calculating the proper annual charge correctly to accomplish this result. It is not the function of this book to go into the method of making this calculation; instead, the reader is referred to any of the text-books which explain annuities, especially as applied to the calculation of depreciation. (See also discussion of the annuity method of amortization of leaseholds, ¶ 9-6 et seq.)

The following table illustrates the application of this method to $1,000 investment in machinery, estimated to have a scrap value of $20 at the expiration of five years:

Year	Debit Depreciation	Credit Interest	Credit Reserve for Depreciation	Book Value
				$1,000.00
1st	$233.85	$60.00	$173.85	826.15
2nd	233.85	49.57	184.28	641.87
3rd	233.85	38.52	195.33	446.54
4th	233.85	26.79	207.06	239.48
5th	233.85	14.37	219.48	20.00

It will be noticed that under this method the amount debited to depreciation is uniform in all years, but this nominal element is

partly offset by another nominal element, interest. The credits to interest decrease year by year and the net effect upon the profit of each year exactly equals the amount credited above to the reserve for depreciation. This amount constantly increases during the period of use of the machine, and therefore this method, so far as its effect upon profit and loss is concerned, is the opposite of the method discussed previously in which the greater charge to operations was in the earlier years. It will be noticed that the total amount charged to depreciation is $1,169.25 and therefore exceeds by $189.25 the true cost of the machinery less the salvage value. This excess which is charged to depreciation is offset by similar credits to interest as shown.

5-9. This method of computation is based on the theory that the proprietorship is entitled to interest on its investment in the machine, that is, on the amount of the book value. The net profit or surplus for the five years is not affected by the method, as the net difference between the charge to depreciation and the credit to interest is $980. This is the excess of the investment cost over the estimated scrap value. However, if any portion of the nominal element, depreciation, has been merged into an asset which remains upon the books, such as inventory or construction, then it is clear that this asset has been more or less inflated depending upon the amount charged to it as the result of the credit to interest.

For an organization to charge itself interest so that the charge is set up as an asset and the credit is carried into the profit account is a violation of accounting fundamentals. It is based on the idea that capital deserves an interest return; but the acceptance of that idea does not justify one in considering that such a return has actually been earned, and that the assets are thereby increased, unless they have been converted into cash or into a legal claim upon some one for cash.

Such a theory is like that of a man having $1,000 in cash in his possession, but not invested, who says at the end of the year: "Now, this $1,000 is worth 6%, that is, $60 for the year that is past. I am entitled to that much on the theory that money is worth an interest return. Therefore, I will credit myself with profit, $60, and debit an asset account for the same amount. My assets are therefore $1,060 instead of $1,000 and, behold, I have made a profit of $60!"

Such an argument sounds absurd. Yet it is quite in keeping with the theory often expressed in business which sets up just such a

profit of interest, debiting some asset account as an offset. It is found most frequently, perhaps, in charging to cost of goods produced an estimated amount of interest upon certain elements of investment, crediting the same amount to interest as an income. So much of the merchandise as remains in inventory is therefore inflated by whatever amount of such interest is included.

Unit-of-product Method

5-10. In some cases, machinery and similar assets may have a life dependent upon the quantity of their output rather than upon the number of years of estimated life. In such cases the amount of depreciation for each accounting period would be based upon the number of units produced during that period.

5-11. Many other methods of apportioning the amount of depreciation to the various periods may be found. All are more or less arbitrary. It would be dogmatic to assert that any particular method of depreciation is the best. Rather, one should be governed by the circumstances of a particular case and the attempt should be conscientiously made to use that method which will be conservative and in keeping with good accounting practice and will at the same time apportion to each of the accounting periods involved as just an amount as may be ascertainable.

OBSOLESCENCE

5-12. Assets sometimes cease to have, to the organization which owns them, a value commensurate with their cost less reasonable depreciation. This may be due to developments of invention or to changes of taste on the part of the public. For instance, machinery designed for the manufacturing of certain electrical equipment was rendered almost immediately obsolete by improvements which rendered this equipment unmarketable. New machinery had to be built to produce the newer type of equipment required by the progress of invention.

The decrease in the value of the old machinery was not due to any of the causes recognized above as depreciation. However, the decrease in asset value had to be written off as a deduction from surplus. Such a decrease is known as obsolescence. Obsolescence also applies frequently to certain types of merchandise to which depreciation is not applied. It usually results from circumstances that cannot be definitely foreseen, and therefore does not enter

into the calculation of preceding periods. As a rule, therefore, no reserve for obsolescence is built up, although provision for this contingency might be made by reserves of a broad nature such as "reserves for contingencies," which would be in the nature of surplus appropriations rather than resulting from debits to any expense accounts.

INADEQUACY

5-13. Assets may have to be taken out of use merely because of their inadequacy to perform the full work for which they are intended. This may be due to a number of causes, such as the miscalculation of the efficiency of certain machines or unexpected demand for product, necessitating larger equipment.

As a result of any such cause, the value of machinery may drop below its purchase price to an extent not justifiably chargeable as depreciation for the period of use. As it would be unfair to charge the product of that period with this abnormal amount, the latter must be offset by direct reduction of surplus or must be capitalized as a deferred charge to future periods. The latter is sometimes accomplished by merging the loss in the capitalized cost of the new machinery which succeeds the old, or the amount may be capitalized under a specific name indicating its cause. The former method is questionable in that it inflates machine value by an amount not properly to be included therein.

ACCIDENT

5-14. Any asset may be wholly or partly destroyed, or its value be wholly or partly eliminated as a result of accidents of various kinds, such as explosions, fires, tornadoes, or other incidents which may not have direct effects but may reduce the value of assets in a way that cannot be definitely anticipated. A loss of this character should not be merged with the results of operation but should be shown as a distinct item resulting in a reduction of surplus or of some other form of proprietorship.

Provision against losses of this kind may generally be made to a greater or less extent by insurance. In that case the value recovered from the insurance companies takes the place of the asset value destroyed, any difference being adjusted through the surplus account or through the profit-and-loss account, distinct from the results of operations.

Insurance Claims

5-15. After the result of any accident is determined, claims against the insurance company may be set up on the books in lieu of the asset value destroyed and prior to the collection of these claims. Such claims are in the nature of receivables and usually appear upon the balance-sheet either among the current assets or adjacent to them.

AMORTIZATION

5-16. Amortization is defined as a periodic writing down of an amount. In its more general usage it is applied to financial accounts other than those representing tangible assets. However, in recent years its use has been broadened to include some kinds of assets built or acquired under the unusual conditions attendant upon war, and the term is applied to the periodic writing down of the excessive costs necessitated during that period so as to reduce assets to a normal cost. This is discussed further in ¶ 10–7.

CHAPTER VI

CURRENT ASSETS

6-1. Under the head of "current assets" may be grouped cash and other assets held by an organization for the primary purpose of conversion into cash. The essential characteristics of this group are described in Chapter III. The term "floating assets" is used occasionally instead of "current assets." Assets in this group are sometimes designated by the terms "quick assets" or "liquid assets."

The arrangement on the balance-sheet usually follows the logical order of realization. For this purpose current assets group themselves into three broad classes. At one extreme of the group stand cash and those items which may be regarded as the equivalent of cash. At the other extreme should be placed inventories of items held for purpose of sale or for the purpose of conversion into goods or service to be sold. Between these two groups are those of an intermediary character such as the receivables which usually have resulted from the sale of inventories but have not yet reached cash form.

The most common classifications coming under current assets are discussed in this chapter and in Chapter VII.

Cash

6-2. In modern balance-sheets the term "cash" includes all amounts of money in bank subject to the cheque of the organization, together with any other items which would be accepted as deposits by a bank. It includes money on hand, cheques from individuals or other organizations, drafts, money orders and other items which may be deposited in a cheque account without special negotiation with the bank. It does not include notes, acceptances or other promissory documents. Evidently it should not include I.O.U's, as banks could not be expected to accept these as deposits. It does not usually include certificates of deposits, savings-bank accounts or other moneys in bank which are not subject to cheque.

If at the date represented by a balance-sheet there is a net overdraft of cash in bank by the organization, the amount should appear on the balance-sheet as the first item in current liabilities. On the other hand, if the organization has two or more cash accounts, it does not seem to be necessary to set up an overdraft in one or more of these accounts as a liability, unless it be greater than the receivable balances of the other accounts. Rather it seems desirable to display under the heading "cash in bank" the net amount resulting from adding the various bank accounts and subtracting any overdrafts.

The amounts in the cheque accounts of banks, as shown by their statements of the same date as the balance-sheet, should be reduced by whatever cheques have been issued against them by the organization and are outstanding, that is, unpaid by the bank at the date of the statement. Some organizations follow the practice of considering the bank account for balance-sheet purposes as being equal to the balance shown on that date in the bank statements, thereby eliminating any outstanding cheques. The argument given in support of this is that at such a date these cheques were still under the control of the organization as it could have stopped payment upon them had it so desired. Good accounting practice, however, holds that the drawing of a cheque and the sending of it to the creditor should be considered for accounting purposes as a reduction of the bank account and a corresponding reduction of the liability. In other words, it treats the sending out of the cheque as a valid transaction for accounting purposes. This theory accords with general business practice and has the sanction of good accounting.

Cash on Deposit

6-3. Cash deposits, that is, deposits in bank in special accounts for specific purposes, frequently appear upon the balance-sheet. Their position thereon depends upon their purpose. Cash deposited in advance of the due date for the payment of interest is a current asset offsetting to that extent the current liability for accrued interest. To illustrate: On January 1st, following the date of a balance-sheet as at December 31st, interest upon bonds may be payable. To provide for such payment cash may have been set aside in a bank account before closing the books for the period. As a result the balance-sheet will display the accrued interest

among the current liabilities. The cash deposit to meet the obligation should therefore be classed as a current asset. The working capital, that is, the excess of current assets over current liabilities, should not be disturbed because of this liability which the organization is fully prepared to meet. Similarly, deposits of cash for other purposes may properly appear under current assets if the deposits are for the purpose of liquidating any current liability.

On the other hand, cash deposits for the purpose of liquidating permanent liabilities, or for any purpose other than payment of current liabilities, which can not be drawn upon for current operations, should not be grouped among the current assets but should be separately displayed upon the balance-sheet.

Overdrafts (Asset account on balance-sheets of banks)

6-4. Deposit accounts appear on balance-sheets of banks as current liabilities, as they represent amounts which are in the bank's possession subject to the orders of the depositors as represented by cheques drawn on the bank. Whenever a bank pays cheques drawn by a depositor to an amount in excess of the funds which such depositor has to his credit at the bank the result is an overdraft, which of course appears as a debit account. It is really an informal loan to the depositor. State laws against unsecured overdrafts are becoming more rigid, and bankers endeavor to keep such amounts at the minimum.

Bank Accounts — Foreign.

6-5. Any moneys belonging to an organization must be carried into the balance-sheet at their value in dollars or in whatever unit of value the balance-sheet itself is expressed. Money in foreign banks, therefore, or any other sums in foreign units of value must be converted into dollars at the rate applicable on the date of the balance-sheet.

Any profit or loss arising from such adjustment of cash items in normal times is carried to an account known as "reserve for foreign-exchange adjustments," which is frequently carried as a balance-sheet item on the theory that fluctuations at a particular date will probably be offset by other fluctuations at another date. However, during recent years when the fluctuations in exchanges have been so great, and when there is little certainty as to what future quotations will be, these adjustments preferably are considered as

gain or loss items and therefore are merged into the profit or loss of the period and do not appear on the balance-sheet. Some accountants advocate treating a debit balance in this exchange-adjustment account as an expense and treating a credit balance, not as a gain, but as a reserve appearing on the balance-sheet to be offset by possible future debits.

Specie

6-6. Specie is a term occasionally found in the balances of financial institutions covering the amount of coined metal money on hand. It does not include any paper money nor any item ordinarily included in cash other than actual coins. These may be of gold, silver, copper, nickel or other metal of which the money of the country in which the bank is situated may be legally coined.

Currency

6-7. The term "currency" generally refers to all forms of money metal and paper in circulation, but in some cases a more restricted application of the word indicates any form of legal tender other than specie. Its use in balance-sheets is limited to the statements of financial organizations.

Accounts Receivable

6-8. All amounts owed to an organization as the result of sales or other services rendered and for which no promissory note or similar document has been received may be classified as "accounts receivable." They are sometimes referred to as "open accounts." Upon the balance-sheet they may be classified as to source. Accounts receivable resulting from the ordinary operation of the business should be shown distinct from those resulting from other causes. Any accounts receivable from officers or employees should appear as a separate classification. Subdivisions may be shown by indention, carrying the total into a major column. From this total may be deducted an amount as reserve for possible loss in the collection of the accounts, usually designated "reserve for bad debts" or "reserve for accounts receivable," so that a net amount may be carried to the main asset column of the balance-sheet.

There is much difference of opinion as to whether or not the possible loss because of cash discount should also be deducted from the amount of accounts receivable for balance-sheet purposes. (See discussion of cash discount, Chapter XXIV.)

As an illustration, these items might appear on the asset side of a balance-sheet as follows:

ACCOUNTS RECEIVABLE:		
From Customers	$217,350.00	
From Officers and Employees	8,920.30	
From Other Sources	1,864.00	
	$228,134.30	
Less: Reserve for possible loss in collecting . .	2,900.00	$225,234.30

Open accounts with debtors are sometimes used by organizations as a security for current loans. When accounts are specifically pledged the fact must be made evident in the balance-sheet, the loan itself appearing among the liabilities. If only a portion of the accounts receivable be pledged, the item may appear upon the balance sheet as follows:

Accounts Receivable:	Pledged	$96,500	
	Unpledged	71,800	$168,300

Or the accounts receivable may be carried out at the full amount, and a line in parentheses beneath the classification may read "pledged to secure loans, $96,500."

Loans Receivable

6-9. In a commercial balance-sheet any receivable item representing loans should carry a title which will indicate the class of loan covered, for example "loans to employees." Also the accounts should show whether the loans are secured or unsecured. They will usually appear under the general head of "accounts receivable" or "notes receivable" instead of under the designation "loans." However, in the balance-sheet of a bank or other financial institution the term "loans" is frequently used to express the total of all amounts lent by the bank to its customers for which the customers' notes are held. (See ¶ 6-17.)

Notes Receivable
Bills Receivable

6-10. Negotiable instruments of a promissory nature payable to the organization should be carried under the designation "notes receivable" until they are settled. The term "bills receivable" is

also used for this classification. As the word "bill" is applied to many different kinds of accounting forms it is not so definite in its meaning as the term "note." American practice, therefore, leans toward the latter designation.

If a note receivable is discounted by the concern holding it, it should not be credited to this account but instead should be set up in an account called "notes receivable discounted." Such an account represents a liability of a contingent character. If the original signer of the note pays it when due, the liability on the part of the company which discounted it is eliminated. If such notes are not paid when due, they become true liabilities to the organization discounting them. In the latter case, it is preferable that the amount of the note be taken out of the notes-receivable account and charged back as an account receivable, so that the amount shown on the balance-sheet as notes receivable will equal the face value of all notes which will be payable to the organization but have *not yet matured* and are *still negotiable.* Notes which have been discounted and have been paid by their signers in due order should be eliminated from both the notes-receivable and notes-receivable-discounted accounts. This should be self-evident, but accountants often find that it has not been done.

Interest accrued on notes receivable should be set up under a different classification instead of merging the amount with the notes receivable.

Notes signed by officers or employees of the company should be displayed in the balance-sheet distinct from notes signed by others.

Any reserve which may have been withheld from profits to meet possible loss in the collection of notes receivable should be indented in the statement and deducted from the total of the notes. An amount which represents the accountant's opinion of the collectible value of this item should be carried to the asset column. Some organizations prefer to carry one reserve for all receivables. In such cases the accounts receivable, notes receivable and other receivables would be added in an indented column, the amount of the reserve would be deducted and one item representing all classes of receivables would be carried into the asset column.

Acceptances Receivable

6-11. Acceptances receivable are frequently merged with notes receivable but it is better practice to indicate them on the balance-

sheet under the distinct heading "acceptances receivable." Any acceptances which may be discounted should be credited to an account "acceptances receivable discounted." The treatment of this account is the same as that of notes receivable discounted. (See ¶ 6-10, 13-10).

Accounts with Consignors

6-12. Consignees frequently make payments, such as for inbound freight or for similar expenses, because of merchandise held on consignment. Such expenditures are in the nature of advances to the account of the consignor and are represented on the books of the consignee by accounts in the name of the individual consignors or possibly by accounts bearing the title "consignments inbound." These accounts may properly be listed on the balance-sheet of the consignee as accounts receivable. They are a more certain asset than trade accounts receivable because as a guarantee of their realization the consignee has a lien on all the property of the consignor held by him.

Advances

6-13. Advances appearing on a balance-sheet should be accompanied by qualifying words to indicate more definitely their character. The term is generally recognized as properly applying to moneys which have been advanced either to employees or to others, to be converted into expense items rather than to be returned in cash. For instance, money advanced to an employee for traveling expense might properly be classed under this heading until the employee accounts for it. When the traveling expenses are definitely ascertained and vouchers properly prepared, advances would be credited and the proper expense accounts debited. Any balance remaining after expenses might be refunded.

There is some difference of opinion as to the proper place on a balance-sheet for such items. Usually, however, they are classed as current assets. If at the time of the balance-sheet, the exact amount of advances which at that date have been converted into expenses is known, an adjustment should be made so that the item appearing among the assets would represent only the unexpended balance of advances. That which has been expended would, of course, be carried to the proper debit account. If this is a nominal account, that is, an expense account, the effect will be to reduce the profit for the period preceding the balance-sheet.

Advances on Purchase Contracts

6-14. Any advances which have been made on purchase contracts should not be subtracted from other liabilities but should appear on the asset side of the balance-sheet under a specific heading such as "advances on purchase contracts." To illustrate: An organization which posts such advances into the accounts-payable ledger may find that on a certain date this ledger will contain credit accounts totaling, say, $325,000, and debit balances resulting from such advances totaling, say, $40,000, giving a net total as shown on the trial balance of $285,000. Merely to show this net amount among the liabilities would be incorrect. It would violate the accounting rule against deducting assets from liabilities and showing a net amount on the balance-sheet. Instead, the $325,000 should be shown among the liabilities and the $40,000 among the assets.

Accrued Assets

6-15. There are certain assets which accumulate by the passage of time so that their value at any date is the result of an exact calculation. For instance, interest which a company may earn upon its loans accumulates day by day, and the amount accumulated or accrued up to the date of the balance-sheet, even though it is not due and payable, may readily be determined. This amount would appear under the title "accrued interest" or "interest accrued." Some accountants insist upon the use of one of these terms, while perhaps as many accountants prefer the other. There seems to be at present no uniformity in the matter. Since adjectives in English ordinarily precede the noun which they modify, there seems to be no very good reason why the rule should not be followed in this case.

The accumulating value set up under the head of accruals must not be confused with the increase in market value of assets which may take place with the passing of time. The latter is known as "appreciation." (See ¶ 10–11).

Subscribers to Capital Stock
Subscriptions to Capital Stock

6-16. Either "subscribers to capital stock" or "subscriptions to capital stock" may be used in the balance-sheet to indicate the amount of outstanding subscriptions which have been accepted

for capital stock. Such an account in the general ledger is debited when the subscriptions are received; the credit is to "capital stock subscribed," or some similar account. As the money is paid in, this account is credited and cash is debited. When the subscriptions are fully collected, the account is eliminated.

If the account represents money collectible at an early date, it may be classified among the current assets. If, however, the money to be received from subscription has been or is to be set apart for some specific purpose other than current financing, the item should not be grouped among the current assets but should be given a distinct heading to indicate the use to which it is to be applied. Instead of listing the account among the assets on a balance-sheet, it may appear as a deduction from the credit account showing the amount of capital stock subscribed. (See ¶ 17–21.)

Loans and Discounts

6-17. "Loans and discounts" on the balance-sheets of banks represent the total amounts due the bank because of loans it has made to customers covered by the notes payable of the customers or by the discounted notes receivable of the customers. This account may be subdivided as to time loans, demand loans, etc.

Time Loans

6-18. Moneys that banks have advanced to be repaid at specified dates are known as time loans. The time usually is from thirty to ninety days.

Demand Loans

6-19. Loans made by banks or brokers, the payment of which may be demanded at any date, appear on the balance-sheet as "demand loans." This item is more liquid, that is, more readily converted into cash in case of need, than the time loans.

Sight Exchange

6-20. Drafts or other forms of demand paper, payable "at sight" may be classified under the heading "sight exchange" on the balance-sheets of financial houses. It is somewhat analogous to demand loans in that it is quickly convertible into cash when desired.

Customers' Liability on Acceptances and Letters of Credit

6-21. The amounts due to banks because of sums advanced on the endorsement by customers of acceptances and letters of credit appear under appropriate heading on the banks' balance-sheets. The liquidity of the account depends upon the time that must elapse before maturity of the endorsed documents.

Exchanges for Clearing-house

6-22. At the close of a banking day all items which will be exchanged the following day through the clearing-house appear on the balance-sheet of the bank under the heading "exchanges for clearing-house." A bank cashes or accepts on deposit not only the cheques drawn upon itself but various cheques drawn upon other banks. These are exchanged daily with the clearing-house for the cheques drawn upon the bank and cashed by all other banks. Any excess one way or the other is covered by an actual transfer of cash or its equivalent between the bank and the clearing-house. In other words, to each bank the clearing-house represents all other banks save its own direct correspondents.

CHAPTER VII

INVENTORIES

WHAT INCLUDED — AS TO PURPOSE

7-1. While the term "inventories" may be applied to any list of items with values, its use in the balance-sheet is properly limited to those items which are owned by the organization and held for purpose of sale or those which are to be converted into commodities or services intended for sale. Such inventories may properly be classified under "current assets."

Current assets properly include only those items which are held for purpose of conversion into cash. It is evident, therefore, that it is incorrect to include in such inventories items which are neither for sale nor to be converted into items for sale. Inventories of supplies which are not in the nature of raw materials are often classified under the head of "deferred charges" or "prepaid expense" and not under the current-asset group. However, in practice, if such inventories are very small, they frequently are so included.

WHAT INCLUDED — AS TO OWNERSHIP

7-2. Inventories should include only items title to which is vested in the organization. They include purchases not received, if the purchase contract is such that title has been transferred to the organization. If goods have been purchased f.o.b. point of shipment, and have been delivered to the common carrier at that point they may properly be included in the inventories of the purchaser.

Orders for future delivery should not be included in inventory unless title has been acquired by the purchaser.

Consignments that have been sent out should be included in inventory, preferably under a separate heading, unless they have been converted into sales.

Merchandise sold but not shipped may be included in the inventory only if an offsetting reserve is shown either on the liability side of the balance-sheet or as a deduction from inventory

total. Otherwise an inflation of assets with a corresponding inflation of profits would result.

CLASSES OF INVENTORY

7-3. Commodities owned by an organization and properly included in inventories for balance-sheet purposes may fall under one or more of three broad classifications.

First, goods still in the same condition as when purchased from others.

Second, goods that have entered into the convertive stage but have not yet reached the form in which they are marketed by the owning organization.

Third, goods that have passed through the convertive changes of this organization and are completed ready for sale or delivery to purchasers.

7-4. Under the first heading the following sub-headings may appear:

Merchandise is a term which in its broadest sense may be used to embrace all commodities held by an organization for purpose of sale. An item which is a permanent asset to one organization may have been a merchandise item to another. Office furniture is classifiable as merchandise by an organization which deals in such furniture. Another organization which buys this furniture for its permanent use should consider it as a permanent asset, not as a current asset. Whether or not a particular item is properly classified as merchandise does not depend upon any element or characteristic of the item itself, but it depends instead upon the purpose of the owning organization with regard to it.

7-5. Raw Material is a term used by a manufacturing or other convertive industry to include those items which it expects to convert into its product or some element thereof. The thought expressed above with regard to merchandise may be applied also to raw materials. In other words, that which is the finished product of one organization may be classified properly as raw material by another organization. Leather fully treated and ready for sale may be the finished product of a tannery, but the same leather purchased by a shoe factory would be classified as raw material.

7-6. Factory Supplies include the various items which a factory may utilize or consume during the process of manufacturing but are not properly classified as raw materials. The line of demarcation between the two classes is not readily drawn. However, it may be stated generally that commodities which actually enter into and form a part of the finished product should be classified as raw materials, whereas items that are used up in the process incidentally but form no part of the finished product may appear as factory supplies. To illustrate: Lubricating oils would be classified by a factory under the head of supplies. They are used up in the manufacturing process, yet they do not form any part of the finished product.

7-7. The second group, as classified above—that is, goods that have entered into but have not completed the convertive operations of an organization—includes the following:

Finished Process

Where the convertive work performed by an organization consists of several processes, items that have finished one or more of these processes and are in a state of rest so far as the operations are concerned may be classified under this title. It indicates that these goods have still other processes to pass through before they are completed ready for sale or delivery to purchasers.

Completed Parts or Component Parts

7-8. Items manufactured by an organization to be assembled to form a complete product are usually classified under the head of "completed parts" or "component parts." As an illustration: A finished machine may consist of a number of different parts, cranks, wheels, shafts, frames, etc., all of which may be manufactured by the same organization. All these parts, having passed through the processes of manufacture and being ready for assembling, belong under such headings.

7-9. Work-in-process may properly be applied to work which has left the raw material stage but has not yet reached the completion of process or part. Work which has entered into a convertive process may be classified in this way until the process is finished.

Since the inventory which is classified as a current asset is supposed to include only items which are to be sold or converted into cash, care must be taken not to include therein items of con-

struction work which an organization may be carrying on for its own permanent use. To illustrate: A factory might be manufacturing for itself machinery or other equipment or might be constructing a new factory building. These jobs might appear on its records among other work in process. They should not so appear in the balance-sheet but should be separated and shown among the capital assets under some designation such as "construction in process" or "uncompleted construction work."

7-10. The third group into which we have classified commodities includes those that have passed through the convertive or assembling process of an organization and are completed ready for sale or delivery. These are usually referred to in inventories as **"finished goods."** The use of this term differs from that of the term "merchandise" previously discussed in that the latter usually signifies commodities held for the purpose of sale which have been acquired in the same state from other organizations; whereas "finished goods" usually indicates commodities that have passed through some convertive or assembling process by the organization now owning them.

It must again be noted that the classifications above discussed are not based upon any inherent element or characteristic of the goods so classified, but rather upon the use made of the commodities by the organization or its purpose with regard to them.

BASIS OF VALUATION

7-11. There are two generally accepted bases for valuing inventories; one is to value each item at cost and the other is to value each item at cost or market, whichever is the lower. In addition, special methods of valuing frequently have to be applied, as in the case of deteriorated merchandise or in cases where the above methods give a value in excess of selling price.

Cost as a Basis of Valuation

7-12. Since the term "inventories," as used in balance-sheets, applies strictly to items held directly or ultimately for purpose of sale, items listed therein may properly be valued at what it has cost the organization to render them available for sale. Such cost in the case of merchandise or of raw material may be expressed as follows:

Purchase Invoice Price
Less Trade Discount
Less Cash Discount (if a consistent plan be followed). (See ¶ 24-1)
Plus Transportation
Plus Duty and other importation cost (if any)
Plus any other costs directly applicable to the items and necessary for bringing them into condition for use or sale.

These several items will be discussed in their proper places in the ensuing chapters.

In the case of goods produced, either in finished form or in process, the elements of value may be expressed as follows:

Raw Material and Supplies (valued as above)
Plus Direct Labor of conversion
Plus Overhead costs necessary to bring the material to its present condition.

Cost or Market, as a Basis of Valuation

7-13. Some business men have construed the so called "cost-or-market" basis of valuation to mean that the whole inventory should be valued at cost and a total obtained and again valued at market and a total obtained, followed by adopting the lower of these totals. That is incorrect. Instead, both the cost price and the market price at the date of the balance-sheet for each item in the inventory should be determined and the lower amount for each item should be taken as the inventory valuation. It may be that in one inventory some items will appear at cost and other items at market price. In preparing an inventory for balance-sheet purposes by this method, it is desirable to use three unit-value columns. Each item tabulated should show in the first column the cost price and in the second column the market price at the date of the inventory. In the third column the lesser of these two amounts should be used in the extension.

The method of applying this base to goods-in-process and to other items in the inventory will be discussed under their respective headings.

Irregular Basis of Valuation

7-14. Where the application of the above methods results in

a value greater than can be obtained by realization it would be incorrect to use such values in the balance-sheet. It is a fundamental principle of accountancy that known losses should be taken at once and not postponed until later periods. No item, therefore, should be included in the inventory at an amount in excess of what it will bring when sold.

Using cost or market, whichever is lower, for an inventory is considered more conservative than using cost alone as the basis. There are times, however, when one should not insist upon this method. If, at the time when an inventory is taken, there is a general depression in market price and it seems probable that the depression is only temporary, great injustice might result to the organization from insistence by the accountant that the inventory must be written down to cost or market, whichever is lower. Such a method would result in throwing into the past period a loss which might never become a true loss. If the market should react there would also be shown in the following period an abnormal gain which was not a real gain. There are few rules indeed that must be applied inflexibly. Common sense and judgment must always have their proper influence.

Retail Method of Determining Inventories

7-15. The retail method of valuation does not differ radically from the methods previously discussed. It is nothing but a substitute for taking a physical inventory and valuing it at cost, and it deserves only brief mention in this book. It is used by organizations which have great quantities of merchandise of many kinds operated by departments. Under this heading would come department stores, large chain stores, etc.

Briefly, the method consists of recording on summary sheets all purchases by departments and indicating the expected retail price in a parallel column. At the end of each month the ratio of purchase price and marked retail price is obtained for each department. A separate record must be maintained carrying the total value of all "mark-ups" and all "mark-downs" of retail prices. At the end of any period the total of the opening inventory at retail value, plus purchases at retail value, plus "mark-ups," minus "mark-downs," minus sales equals the retail value of the closing inventory. This amount multiplied by the average ratio of purchase price to retail price gives the estimated cost of the inventory.

This method has its advantages where it is desirable to carry all inventory values at retail price so far as branch stores are concerned and further where it is impracticable to take complete physical inventories. The method, when properly applied, furnishes a good control over inventories of branch stores where the keeping of a continuous inventory proves too expensive. Retail-value inventories, however, for balance-sheet purposes must always be reduced to a cost basis or to the basis of cost or market, whichever is lower.

Valuing Raw Material

7-16. As previously stated, the method of valuing merchandise at cost or at market, whichever be the lower, is based upon the principle that known losses may be anticipated if the loss is reasonably sure to occur. If merchandise drops in market value the presumption is that the selling price will also drop so far as the owning organization is concerned, and this drop will either cause a net loss from sale or will reduce the net profit when the sale is made to a point below the normal figure. Therefore, many accountants consider that it is more desirable to throw this loss into the period in which the drop in market value occurred than into the period in which the sale is made.

It is not so probable that the owning organization will ultimately receive less for its product because of a drop in market price of a raw material as it is in the case of a drop in the price of merchandise. Therefore it is frequently correct to carry raw materials at cost, regardless of market fluctuations, unless the selling price of the finished article or service will be affected by such fluctuations.

7-17. The same rule holds when the organization produces some of its own materials — in other words, when an organization produces a commodity, usually a natural resource, such as oil, timber, minerals, etc., which it later converts into some other commodity. It is generally considered that organizations should be allowed to carry such items at the cost of production or at market price, if the latter be less, or at the cost without regard to market price until completion so long as the cost does not exceed the realizable value. Any loss in the early stages of operations may be overcome in later stages of the manufacturing process. To shrink the value of the elements entering into the manufacturing or convertive process would show an incorrect cost upon completion which might lead to incorrect conclusions or policies.

VALUING WORK-IN-PROCESS

7-18. Goods-in-process have incurred certain expenses additional to the value of the raw materials entering into them. These additional costs are usually divided into two groups, one of which includes direct labor, which with the cost of the raw material constitutes what is commonly referred to as "prime cost." The other group is known as "overhead" or "burden." It includes all expenses, other than material and direct labor, necessary to the carrying on of the convertive process.

These costs, being necessary to the convertive process, may properly be included in the value of the work in process as rapidly as they are incurred in the production of it, whether they be applied directly or indirectly. It is well recognized that the cost of a finished product may properly include all the various costs of performing the conversion, whatever they may be, including the cost of all raw materials or supplies utilized or consumed in the process.

To apportion to goods-in-process the exact amount of indirect expense applicable at the particular stage which they had reached at the inventory date is one of the problems of cost accounting. Goods so valued are evidently valued at cost. Market price is concerned only so far as the prices of various elements which enter into the goods have decreased at inventory time below actual cost to the organization. Usually this is applied only to raw material and labor, as the elements constituting overhead can not well have a recognized market value. To illustrate: If a certain job in process at an inventory date consists of the following:

Material Cost	$200.00
Direct Labor	120.00
Overhead	180.00
	$500.00

and if material has gone down, say 10% and labor of the kind used in this process has decreased, say 5%, market price upon this job in process might be considered as being:

Material Used	$180.00
Labor	114.00
Overhead	180.00
	$474.00

It may be mentioned that the writing down goods-in-process to market price as illustrated above is not common in practice. It is much more customary and perhaps as good accounting to treat goods in process at cost without regard to market price of the elements entering therein, except in unusual circumstances when an injustice would result from failing to give consideration to decrease in market price.

Valuing Finished Goods

7-19. Under preceding headings we have expressed the principles of valuation which apply to all products of convertive work. Finished goods may properly be valued on one of the following bases:

First, cost of all the elements which have entered into the product.

Second, the above value less whatever effect a decrease in market price at the date of inventory may have upon these elements.

Third, the selling price of the finished product, less the cost of selling, if such amount be less than either of the other two methods.

To illustrate: It may be found that the sum of the costs of material, labor and overhead of a finished item may be $1.00. If the material and the labor that entered into this article were rated at the market value at the date of inventory it might produce a lower value, say, 95 cents a unit. If the selling price of the finished article has dropped to, say, 97 cents, and selling expenses of the organization amount to 6 cents a unit, the value, 91 cents, should be used instead of either of the other values. This condition seldom appears. When it is found, it must govern the valuation, as it would be a violation of good accounting to value finished goods at an amount in excess of their receivable worth. This receivable worth is the sale value at that date, less the cost of obtaining such value — that is, the selling and collecting expense.

7-20. There is so much discussion as to what properly constitutes the *Costs of Manufactured Goods* that certain points should be emphasized here.

These costs include not only the material that entered into the product directly but perhaps other materials which are of necessity wasted in the process of conversion. The costs include not only that labor which applies directly to the items of product but also the labor of superintendence and management which has to be

distributed to the product upon some arbitrary basis. Other costs such as power, light, heat, rent, depreciation of equipment and all the other costs which are necessary in order to operate the factory must be borne by the finished product. This conclusion is based upon the theory that assets held for purpose of sale may be carried at what it has cost to obtain them or at market, whichever be lower.

Illustration: If a factory in order to produce a number of articles for sale has used raw materials which cost $1,000 and in the production of the finished article has employed labor costing another $1,000 and has incurred various other costs and expenses amounting to $500, the finished product has cost $2,500 and may be carried at that figure upon the books until it is sold or is converted into some other asset, unless the factory uses the method of adjusting to market price if that be lower. If at the expiration of the period when these costs were incurred some of the commodities are fully finished and others are not completed, the value of the completed goods and of the goods in process taken together equals $2,500. To determine how much of the value belongs to the finished product and how much to the product in process is a question of measurement. It is evident that accuracy in valuing factory products must depend upon the accuracy of the measurements of the various elements that enter into the cost of the products. Thoroughly to discuss the question of measurement of cost elements would involve a complete book upon cost accounting. Here one can mention only the essential principles; but emphasis should be laid upon the fact that since the inventory often embraces a large proportion of the asset values of a manufacturing enterprise, the worth of the balance-sheet will be greatly affected by the accuracy or inaccuracy of the cost-accounting system and its operation. Probably more business men have been deceived by incorrect values of manufactured products than by any other inaccuracies in accounting systems.

It is essential that nothing shall be included in the cost of goods in process or of finished goods that is not a true cost. Nothing should be included that does not represent value paid out or to be paid out by the organization. Some manufacturing enterprises own their own factory buildings but charge into cost a rental for the buildings, in addition to the depreciation thereof, holding that they are entitled to receive additional income because of the money

invested in plant. And there are manufacturing enterprises which charge in the factory cost interest upon all their investment, not only in the factory itself but in the materials and other cost necessary for its operation, holding that they are entitled to receive such interest on their investment, and that they should consider as profit only such sums as are received in excess of charges for interest and rental. If such organizations carry into their balance-sheets inventories of finished goods or of goods-in-process at values which include charges for interest and for rental, they are giving incorrect values to inventories and are inflating their assets by income which has not yet been earned. (See ¶ 5–9.)

After organizations have sold the goods which they manufacture they may separate the excess of selling price over true costs into whatever elements they choose, calling a portion of this "rental," if they wish, calling a portion "interest" and calling the remainder "profit." Accountants would probably allow them to make such division of earned profit without question; but to anticipate profits and to set up as an asset any value which has not yet accrued to them is to misstate asset value. By accrued value is meant a value realized or to which a legal claim has been established by contract.

Illustration: If an organization lends $100,000 and the recipient obligates himself to pay interest thereon, the organization has the right to accrue such interest as time passes. Or if this organization has $100,000 invested in a building and rents it to another organization which legally obligates itself to pay a periodic rental therefor, the first organization has the right to accrue the rental as income as time passes. But if the organization holds the $100,000 for its own use or holds the building for its own use it violates a fundamental principle of accounting and of good business if it sets up accrued interest on the investment or rental of the building among the assets in its balance-sheet. Yet that is what organizations do when they add to their inventory values interest on investment and rental upon the equipment owned, which was employed in production.

As the amounts of interest and of rental are largely questions of agreement between owner and user, evidently if both parties are the same, almost any amount of interest or of rental might be agreed upon and the inventory be inflated to a corresponding degree. If business men were allowed to set up on their balance-

sheets constantly increasing values because of interest which they thought they might have earned upon their assets, there would no longer be any definite foundation for balance-sheets. The inflation would soon cease to be limited to interest and rent, and could readily spread to a point where the absurdity would be manifest to every one.

If organizations wish to measure their results in order to see whether or not they are obtaining a profit in excess of any given rate of interest on investment or an arbitrary rental on property utilized, it is proper that such factors shall be computed for comparative and statistical purposes. With this accountants are in sympathy, but these factors must not enter into inventory valuation for balance-sheet purposes, nor must they enter into the surplus which appears upon the balance-sheets, until they are represented by realized assets or legal claims upon debtors.

Inventory—Imported Goods

7-21. There is difference of opinion as to what elements of cost other than purchase price shall be included for inventory purpose in the book cost of merchandise imported. Probably the most generally accepted rule is to include all ordinary costs necessary to bring the goods into the warehouse or place of business of the organization concerned. These include:

The inventory price abroad
Ship or other freight charges necessary to bring the goods into the country
Customs duty
Marine insurance, and perhaps
Other costs necessary for dockage and transportation from wharves to warehouse or place of business.

This is not a universally accepted rule but it seems to be logical and in keeping with accounting principles. Some organizations go further than this and include the cost of the receiving department as well as the cost of maintaining purchasing agents in other countries.

It would seem in accord with good accounting principles that cost of merchandise should be shown so that the relative advantages of purchasing in one country or in another could be revealed by comparison of costs. Any expenses that are necessary for the purpose of bringing merchandise to form and location ready for

sale would thus enter into the proper cost of that merchandise. (See Cost of Manufactured Goods, ¶ 7-20.)

The proper treatment of the foreign invoice price in valuing imported goods deserves special consideration.

Foreign Invoice Price

7-22. If merchandise be imported, the cost in this country is based upon the cost in dollars, because the inventory is to be valued in dollars. Frequently imported goods are received and the entry made upon the books before the foreign exchange is purchased with which to effect settlement. When foreign exchange fluctuates greatly these entries will have to be made at an arbitrary rate. When the exchange is purchased an adjustment must be made for any difference between the amount recorded and the cost of the exchange. These adjustments must apply not only to the debit on the purchase account but also to the inventory value, if any of these goods are on hand when the inventory is taken.

To illustrate: A certain importer bringing in goods from France in 1919 entered the purchase at the intrinsic value of the franc, 19.3 cents. The franc had depreciated heavily, and the draft to cover the purchases cost 7 cents a franc. The account payable was settled in full, so the difference of 12.3 cents per franc was carried to an account called "foreign-exchange adjustment." When the books were closed the foreign-exchange-adjustment account was offset against foreign purchases, thus bringing the latter account to its true condition. Any of these goods which remain in inventory should be listed at the cost of 7 cents per franc and not 19.3 cents. It is essential that all adjustments not only be made in the purchase account but also be carried into effect in the inventory, otherwise misstatement will result.

This principle of valuation sometimes involves many difficulties of calculation as it may not be easy to apply specific foreign exchange purchases to particular invoices of imported goods. Also it is difficult to identify specific goods remaining on hand at inventory dates with the invoices of the settlements correctly applying to them. However, so far as possible the exact cost in dollars of the goods on hand at the date of inventory should be calculated.

Some organizations keep records in the money of the country from which goods have been purchased so that at inventory

dates merchandise brought from France will be listed in francs, goods from England in pounds, etc. The rate of exchange applying to foreign money at the date of the balance-sheet is then used to convert the amounts into dollars. This method is not technically correct as the inventory is one of merchandise and not of foreign moneys. Changes that may have taken place in the rate of exchange since the goods were purchased should not be applied in determining the cost of the goods nor in determining their market value. It is entirely possible and often is true that the market price of commodities changes inversely to the variation in the exchange rate of the moneys in which they were invoiced.

To illustrate: Certain merchandise might be received from France invoiced at 10,000 francs, and settlement might be made for, say, 8 cents a franc. The purchase price of these goods in America is $800. At a later date when a balance-sheet is prepared the franc may be listed at 7 cents. If these goods were inventoried at that price a loss of $100 would appear which might not be an actual loss at all. It is entirely possible that the same amount of merchandise at the date of the balance-sheet would have a market value in France of, say, 12,000 francs, which at 7 cents would mean a cost in this country of $840. Therefore, these goods would be correctly listed in the inventory at cost — that is, $800 — and not at $700.

Firms are frequently under the necessity of listing their inventories of imported goods at cost, even though their inventories of domestic goods are taken at cost or market, whichever be lower. The reason for this is the practical difficulty of determining at an inventory date the correct figure to use as market price for many goods which are imported. This was especially true during the years immediately following the war when very little standardization of market price of exports from European countries was possible.

Imported goods, for which payment has not been made, on hand at the date of the balance-sheet may be valued (a) at the quoted price for the foreign money on that day or (b) at the number of dollars needed on that day to buy a foreign draft payable on the day when settlement for the imported goods is required by the terms of the invoice.

Merchandise out on Consignment

7-23. When one organization ships merchandise to another upon the consignment basis no transfer of title to the merchandise passes until the merchandise is sold by the consignee. Upon the books of the consignor this merchandise remains as an inventory asset, even though not on hand. It has not been converted into any chose in action. There seems to be little uniformity in the accounts used for recording consignment merchandise. Perhaps the most common method is to charge individual accounts of consignees with the merchandise sent to them, the credit being to some such account as "shipments" or "consignments outbound." The latter account is nominal in nature and at the end of the accounting period should be closed into the trading account. The debit accounts, however, unless they have been offset by sales, represent merchandise in the hands of agents and for balance-sheet purposes they should be accumulated under some heading such as "merchandise on consignment" or "consignee accounts."

Care must be exercised to see that these accounts are not incorrectly valued on the balance-sheet. If the consigned goods have been invoiced on memorandum bills or consignment bills at a figure in excess of the cost of the merchandise as carried on the books of the consignor, this inflation must be eliminated for balance-sheet purposes. It is a recognized fact that the sending of merchandise from the consignor to a consignee does not in itself create any profit. The profit can come into existence only when the consignment is turned into an actual sale and the title to the merchandise passes.

7-24. Consignment trading is an ancient form of commercial activity and many of the customs of earlier days still find effect in consignment records. One is the carrying, with regard to each group or lot of merchandise sent out, a single account very much like the old-fashioned merchandise account. To this account is charged, not only the cost of goods consigned, but all additional expenses related directly to this consignment, so that the total of this account at any time represents the accumulated investment in the particular merchandise. So long as these accounts are properly operated under this principle they find approval in the accounting world. Such accounts appearing on the balance-sheet represent merchandise at cost plus additional items of expense which have been incurred because of this merchandise. The

practical result is merely that certain expenses are treated as cost of merchandise, and therefore reduce gross profit when the merchandise is sold, instead of appearing as expenses deductible from the amount of gross profit during the period when the costs are incurred. The ultimate effect upon profit and loss is the same. As to just how far this idea can safely be carried, however, a reasonable doubt appears.

Illustration: "D," a consignor, ships merchandise costing $1,000 to "E," consignee. This results in a debit to an asset account which we may call "merchandise consigned." "D" also prepays freight amounting to $100 which he charges to the same account. In a balance-sheet this merchandise would now appear as $1,100. If one half is sold by "E" the proper asset would be debited, a credit of $550 would be made to "merchandise consigned account" and any difference would be treated as a profit or loss on this consignment. If "E" can sell no more of this merchandise the balance may be shipped at "D's" orders to "F" and an additional expense of, say, $50 may be incurred, so that the account will stand as an asset of $600. So far this treatment is generally accepted by accountants. Suppose, however, that "F" has no success in the sale of the article and returns it to "D" at a cost of, say, $60. Should this merchandise now appear on "D's" records at $600 or at $660, the total actually expended on this particular merchandise, or should it appear at $500 which was its cost before making its several journeys? Doubtless, a variety of replies to this question could be obtained, depending upon the viewpoint of the one making the reply. However, the point is evident that somewhere along the line we must cease adding to merchandise value the expenses needed to transport it from one consignee to another. Some hold that these expenses may be considered as cumulative so long as the merchandise is still in the hands of some consignee but must be eliminated when returned to the consignor. Others hold that when merchandise is transferred from one consignee to another expenses incurred must all be eliminated save those needed to place it in the hands of the latest consignee.

Merchandise Consignments on Hand

7-25. An organization should not include among its assets merchandise in its possession which belongs to other parties. This includes merchandise received on the consignment basis when no

title has passed to the consignee. It is held by him for purpose of sale or other disposition for the benefit of the consignor. Whatever records have been kept by the consignee relative to receipt and control of such merchandise are merely memoranda and do not form a part of the final records. Merchandise so held is not an asset of the consignee nor is the responsibility for it a liability. If the consignee makes any expenditures because of merchandise held on consignment such expenditures may properly be treated as assets. They do not belong under inventory classification, however, but are in the nature of accounts receivable and should be so classified upon his balance-sheet.

7-26. Whenever a consignee makes a sale of consigned merchandise any values received by him are properly recorded as assets. The true liability to the consignor thus created must be set up as such and whatever profit or loss results to the consignee must be properly displayed in his records. If the liability is credited to the asset accounts with the consignors the effect is either to reduce the amount of such assets or to convert the account into a liability. Illustration: If "H" receives on consignment merchandise from "J" and pays $80 for expenses, such as drayage, no financial entry appears upon "H's" books save the one for the payment. This will be debited to some account representing this consignment, such as an account with "'J,' consignor." If "H" then sells for $500 cash some of this merchandise, for which he is to receive $100 as his commission or profit, the entry will be debit cash or accounts receivable $500, credit commissions earned $100 and credit account with "'J,' consignor" $400. Prior to this sale the item of $80 would appear among the assets under some classification such as "accounts with consignors." After the sale the account with "H" has a credit balance of $320 which represents a liability to "J," the consignor, and should appear among the current liabilities as an account payable on the balance-sheet of "H."

Inventory Verifications

7-27. The public accountant before certifying to a balance-sheet may or may not make complete verification of the inventory as to count, classification and pricing. If he does not make such verification he should obtain from the organization a certificate in regard to these essential points signed by proper officers of the

organization and by those responsible for the accuracy of the inventory. A typical certificate of this character follows:

"We certify that the inventory as at December 31, 1922, totaling $876,921.34, was taken under our direction; the pricing was at cost or market, whichever was lower; the count, extensions and footings were double-checked; and to the best of our knowledge and belief this amount of $876,921.34 represents the true and correct value of merchandise on hand and owned by the Jones Mercantile Company at December 31, 1922.

(Signed).....................................
(Signed).....................................
(Signed)................................... "

If, on the other hand, the public accountant holds himself completely responsible for the count, pricing and completion of an inventory, very specific technical knowledge of the elements of such inventory will be required of him so that the classifications may be properly made. It is questionable whether the public accountant always has available the technical knowledge required for actual verification of inventory. Distinctions not always discernible to the layman may have great bearing upon values. An error in classification, even though the count were correct, might result in serious error in the total value. This phase of the matter is of such importance that in many cases the accountant much prefers to obtain such a certificate as was mentioned above and then to make such tests of count and pricing as he deems desirable. In all cases the accountant should verify extensions and footings.

CHAPTER VIII

Investments and Funds

8-1. The term "investments" is so broad that it might be construed to include all the assets of an organization. Its use in the balance-sheet, however, is usually limited to securities — such as mortgages, bonds and stocks — of other organizations owned by the one represented by the balance-sheet. This term should not be applied to securities issued by the owning corporation. When a company re-acquires its own bonds they should be classified under the heading of "treasury bonds" which on the balance-sheet would appear as a deduction from bonds outstanding. (See ¶ 15–4.) An exception to this sometimes is made when the re-acquired bonds form a part of a sinking fund or other specific fund in the hands or under the control of a trustee. Similarly if a corporation re-acquires its own stock it should be listed under the head of "treasury stock" and in the balance-sheet this item would appear as a deduction from capital stock issued. (See ¶ 8–13.) Treasury stock and treasury bonds are discussed in detail later in this chapter.

An organization having surplus funds may invest them temporarily in securities of various kinds so as to produce income until the funds are needed for other use. Similarly, investments may be made of a more or less permanent nature for the purpose of providing readily convertible assets to meet some far distant need, such as the paying off of a bond issue. In either of these cases the chief elements considered are the income-producing factor and the realizability of the investment.

8-2. Again investments may be made in the capital stock of other organizations for the purpose of control. If more than 50% of the voting stock of a corporation is acquired, that corporation becomes a subsidiary under the control of the investing company. Frequently in such cases, instead of placing the investment item on the balance-sheet of the owning company, a consolidated balance-sheet is prepared in which the actual assets and liabilities of the subsidiary are combined with those of the holding company. (See Chapter XXI.) If the character of the subsidiary, however, is

entirely different from that of the holding company, consolidation may not be desirable. As an illustration: A large factory having considerable trackage and motive equipment in its yards might find it advantageous to incorporate the latter as a railroad company. In that case the balance-sheet of the latter might have to be drawn in accordance with the public service commission requirements and a consolidated balance-sheet might not be as desirable as it would be to display among the permanent assets a single amount representing the investment in the railroad company.

Again, the element of control may apply even when one organization buys only a small proportion of the stock of another. If the stock so acquired is sufficient to enable the owners to have one or more directors upon the board of the second corporation it may be sufficient for the purpose. These directors may enable the owning company to influence the policy or at least to be kept posted as to probable policies of the second corporation. Illustration of such investment may be found in the case of manufacturing companies owning sufficient stock in corporations producing raw materials to enable profitable contracts to be made and to assure the manufacturing companies of constant supply of needed materials.

Place in the Balance-sheet

8-3. It is evident that investments may be in the nature of current assets representing items readily convertible into cash at will, such, for instance, as investment in government bonds. On the other hand, investments may belong properly under the permanent asset group as the investment may have been made in lieu of acquiring actual assets of a permanent nature. Under this head would come the investment in the railroad company mentioned above. In this case the factory shows an investment in the stock of a railroad company instead of displaying the actual trackage and equipment among other permanent assets. With regard to some investments there may be doubt as to whether they are current or permanent. Quite often accountants do not attempt to separate investments as to their current or permanent nature but instead display them all under a group heading in the balance-sheet. Such a group should usually appear between the current assets and the permanent assets.

Book Value of Investments

8-4. The value at which owned securities should properly appear on the balance-sheet depends to a certain extent upon the purpose for which they are held. Stocks or bonds representing merely a temporary investment to be re-sold if the market turns favorably or as need arises may be carried at cost. In case of sale the proceeds may be credited to the account representing the investment. The resulting balance in the account will show the profit or loss upon the transaction which must then be transferred to profit and loss account. Occasionally securities are acquired as a result of a settlement or compromise of indebtedness. In such cases it is usually desirable to carry them on the books at the same value as the asset which they replace unless it is evident that there will be an ultimate loss in their realization. It is always the practice of conservatism to anticipate such loss if it is reasonably certain. Therefore the expected realizability must govern the value at which such securities are carried.

Bonds Held for Investment

8-5. In the case of bonds held for long time investment — that is, held until maturity or redemption — the difference between the cost price and the amount ultimately to be received represents a profit or a loss which applies to the periods between those two events. Such a profit must not be taken in advance of its being earned. It may be deferred, however, until ultimate realization. In like manner, a loss from such a transaction might be carried at once to the profit-and-loss account. Neither of these procedures, however, is strictly correct and if the amounts be large they should be spread equitably over all the periods in which they accrue. In the case of a bond purchased, say ten years before maturity, the difference between its cost and its ultimate proceeds should be spread over the ten years rather than be applied to the profit-and-loss of one of those years. This apportioning of discount or premium over a number of periods is accomplished by a process called "amortization."

In determining the cost price of bonds purchased, care must be taken to make proper adjustment for accrued interest, as a certain amount of this may have been included in the price paid for the bond and is not an element of cost but is an offset to the interest received upon the bond at the next interest date.

8-6. The cost of the bond may be recorded in either of two ways. It may be recorded in one account as the asset value of the bond, which will be subject to periodic writing up or down as the case may be until it ultimately reaches par value or redemption value at the date of maturity. Or it may be recorded in an asset account at par or redemption value, the difference between this amount and cost being recorded in a different account called "discount on bonds purchased" or "premium on bonds purchased." Under this method the discount or premium account will represent the amount to be amortized over the life of the bond.

The simplest method of amortizing such an amount is to spread the difference between cost and redemption value equally over the intervening accounting periods. Illustration: If Corporation "A" acquires for $900 a 6% bond of Corporation "B," maturing ten years later and redeemable at that date at par value of $1,000, the difference between the cost, $900, and the redemption value, $1,000, may be spread equally over the ten years. (Note that this is practically the reverse of the treatment of depreciation previously discussed.) The $100 gain is a value received because of investment and therefore is classified as interest. Annual interest of $60 is also received according to the contract. Considered from the standpoint of simple amortization, Corporation "A" receives in the ten years a total of $700 interest which may be considered as $70 per annum. If the interest is received annually the effect upon the accounts will be a debit to cash of $60, a debit to bond-investment account of $10, and a credit to interest earned of $70. These annual debits would bring the bond-investment account to $1,000 at the date of the bond maturity, and the payment of the bond would eliminate this account.

8-7. Instead of recording the book value of the purchase in one account, the same result may be accomplished through two accounts. The investment account may be debited with par value of the bond $1,000 and an account called "reserve for discount on bonds purchased" (see ¶ 19–30) may be credited with $100. This reserve is in reality a deferred credit to the investment account. If two accounts be used the amortization will be applied to the "reserve for discount on bonds purchased" instead of to the "investment" account. As a result the reserve account, being reduced by $10 a year, will disappear at the end of the tenth year, leaving the investment account at the par value of $1,000. The result of the second method is therefore exactly the same as the first.

If the investment represent bonds purchased at a premium the amount of the purchase price in excess of the redemption value should be so spread over the periods that the book value of the investment will be equal to the redemption value at the maturity date.

Illustration: If Corporation "A" should purchase for $1,030 a 6% bond of Corporation "C" redeemable at par value of $1,000 five years later, the excess of cost over redemption value ($30), would be spread over the five years as a part offset against the interest received annually. In other words, Corporation "A" would receive during the five years a total of $300, plus the $1,000 principal of the bond. This $1,300 is the result of an investment of $1,030. The difference, $270, is classifiable as an interest earning which accrued by the simple method at the rate of $54 a year. Therefore if the interest be received annually the effects should be recorded as follows: cash debited $60, interest credited $54, and the investment account credited $6. Amortization would result at the end of the fifth year in reducing the investment account to the par value of $1,000. The redemption of the bond at the maturity date would eliminate this account.

8-8. The illustration above involves only the simple method of amortization, which consists of spreading equally over the intervening periods whatever net premium or discount may apply to the investment. A more accurate method of amortization should be applied if the amounts are sufficient to justify it. The amount of amortization applicable to each period under the more exact methods, such as effective-rate method, usually may be obtained from tables prepared for the purpose. Without such tables the amounts are obtainable only by intricate calculations.

The net results of these methods of amortization are the same at the end of the period involved. The difference lies in the apportionment of the amounts to be amortized in intervening periods. In the case cited the amortization is distributed equally to the periods. In exact amortization the amount applied to each period is based upon the net investment at the beginning of that period. As a result, the amount amortized during each accounting period is used either to increase or decrease the investment for the ensuing period and therefore increases or decreases the amount to be amortized in that period. The resulting effects upon interest each year bear a fixed ratio — known as the effective rate — to the net investment at the beginning of the year.

INVESTMENT IN STOCKS

8-9. Since capital stocks usually have no maturity date, the difference between the purchase price and the par value is not amortized, but the items presumably remain at cost until realization. For balance-sheet purposes, it is desirable that the par value be indicated but this may be done parenthetically without affecting the asset value.

The investment value may or may not agree with the net book value of stocks owned. There is sometimes little relation between market and book values. In some cases accountants have felt that the amount of investments should be written down to correspond with any decreases in the market value or the book value of the stocks represented. However, the value to the organization owning the stock may not be greatly affected by any such fluctuations. For instance, one corporation may own stock in another for purpose of control, and in that case the book value of the stock may have very little bearing on its value to the owning corporation.

INVESTMENTS BY FINANCIAL COMPANIES

8-10. Companies organized for the purpose of dealing in securities, such as stock and bond brokerage houses and other organizations of similar character, usually display securities periodically at market price, taking as profit or loss whatever differences may result. This is one generally recognized exception to the rule that profits should not be recorded on the books until they are realized in cash or in legally enforceable rights to property.

Securities Owned

8-11. The term "securities owned" is applied generally to documents representing ownership or indebtedness of a formal nature. It includes capital-stock certificates, bonds, mortgages and similar documents. As there is a great difference in the character of such documents they should usually be displayed separately unless they are all of a readily marketable nature, such as the stocks and bonds listed on established stock exchanges. (See discussion of specific items in this chapter.)

Treasury Bonds

8-12. The term "treasury bonds" is used to designate the par value of bonds that have been re-acquired by the organization

issuing them. It is occasionally used in a further sense to cover unissued bonds of a negotiable nature that have been signed and sealed and only await delivery. In either case the amount signifies merely a reduction of the offsetting liability. This item should not appear among the assets on a balance-sheet, but it should appear on the opposite side as a deduction from the liability for the bonds to which it applies. On the balance-sheet the essential thing to display is the net liability to creditors for the amount of bonds issued and outstanding. The re-acquiring of a bond correspondingly reduces this liability.

Many organizations and some accountants list treasury bonds as an asset instead of deducting them on the opposite side of the balance-sheet from the security to which they apply. The reason usually offered for this procedure is that the treasury bond is an asset which can perhaps be converted into cash by sale. The error of this opinion is that the treasury bond is not an asset. It is nothing more than an evidence of indebtedness to a creditor and a promise to repay. It is in the nature of a promissory note. When re-acquired by the issuing corporation the obligation involved in the contract has been completed. The creditor has been paid. There is no longer a liability. To call such a document an asset would be akin to calling an unissued promissory note or a re-acquired promissory note an asset. A signed promissory note might perhaps be turned into cash if the signer could induce someone to lend him the cash for the note. In the same manner the treasury bond may perhaps be converted into cash if the owner can find some one to lend cash upon it. "Selling" bonds is an excellent term for psychological effect but that does not alter the fact that it is merely borrowing money and giving a promissory note (the bond) as evidence therefor. A treasury bond does not represent any property nor any legal claim to any property or service not otherwise shown in the balance-sheet. Therefore, it does not possess the characteristics of an asset which would justify its appearance on a balance-sheet.

Treasury Stock

8-13. It is not desirable to include any unissued stock under the heading "treasury stock." Instead, the use of the term should be limited to capital stock issued and re-acquired. This account should be carried at par in the case of par value stocks, and on the

balance-sheet it should appear, not as an asset, but as a deduction from the capital stock account, resulting in the net amount of capital stock issued and outstanding.

For treasury stock of no par value there does not seem to be any uniformity of method adopted by the business world as to valuation. It is usually stated in one of the following ways:

1. At the amount paid for its re-acquirement.
2. At an amount equivalent to the original value at which the particular shares re-acquired were issued.
3. At an amount per share equal to the average book value of the no-par stock at the time when such stock was re-acquired. (See discussion of no par stock, ¶ 17–20.)

The reasons why treasury stock should not appear among the assets on a balance-sheet are similar to those applying in the case of treasury bonds. (See ¶ 8–12.)

Donated Stock

8-14. Financial needs sometimes induce corporations to call upon their stockholders for additional contributions. As the stockholders may not be in a position to contribute cash, the desired result is sometimes achieved by a donation by the stockholders of a portion of their stock to be re-sold to the public. Stock so received may be carried on the balance-sheet as donated stock. This account should appear at par value. Or the stock received may be included under the heading treasury stock. The rules for the treatment of treasury stock apply equally to donated stock. (See ¶ 17–7.)

Funds

8-15. A fund has been defined as an aggregate of assets set aside for a particular purpose. It will be noticed that there are three essential elements of a fund: first, that it consists of assets; second, that these assets are "set aside," that is, specifically separated from other assets; and, third, that they are so segregated to accomplish a specific purpose. The term is broad in its scope. For instance, all the assets of a corporation might be considered as a fund, as they are specifically set aside for the use of the corporation. However, the designation is usually limited to more specific groups of assets. As ordinarily used in business, the term "fund" suggests that the assets of which it consists are in the form of cash

or of something which may readily and without sacrifice be converted into cash when the purpose for which it is set aside demands. A mere resolve to use a certain sum of money in a certain way does not of itself constitute a fund. An amount of surplus formally withheld from distribution for a specific purpose does not constitute a fund, though the term is sometimes misused in such cases. If the action results in a specific setting aside of actual assets, a fund is created. Otherwise, the effect is no more than to create an item of appropriated surplus which appears on the liability side of the balance-sheet under some proper designation.

Sinking Fund

8-16. The term "sinking fund" is frequently applied to any fund periodically set aside for the purpose of liquidating specific liabilities. Such a fund consists either of cash or of securities which may readily be converted into cash when the need arises. The amounts periodically set aside are usually determined upon a basis of time, though occasionally some other basis is employed.

If it is the purpose of a sinking fund to meet a bond issue due, say, in twenty years, a sufficient amount should be set aside each year to equal the retirement value of the bonds at the date of their maturity. This may be accomplished by the so-called "straight-line method" in which the amount to be obtained, divided by the number of years, gives the amount to be set aside each year. Or it may be determined upon a basis of time and interest wherein the amounts set aside, together with interest earnings thereon, will equal the required amount at the proper date. A bond issue based upon some extractive industry such as mining or lumbering might be cared for by a sinking fund set aside periodically upon the basis of minerals or timber produced during that period.

Whatever the method of determining the amounts, the prime purpose of all sinking funds is to accumulate over the period of indebtedness an amount sufficient to liquidate the liability at its maturity and in a form which will be available for that purpose.

Sinking funds may remain under the control of the organization owning them, or they may be put in the hands of trustees under conditions limiting their use to the specific purposes for which they are intended. The latter unquestionably furnishes the better security for the creditor, for if the sinking fund remains among the available assets of the organization, it may become subject to lien

because of the claim of some other creditor than the one for whose protection it is intended. Usually, therefore, the purchasers of bonds of corporations will insist upon protection by the placing of sinking-fund payments in the hands of responsible trustees. Failure to set aside sinking-fund amounts in any period usually brings the whole bond issue to maturity in the same way as failure to pay interest when due.

Usually, a clause in the bond provides that sinking funds shall be set aside "out of profit." This, however, may not always be construed literally, as even when there are not sufficient profits out of which to set aside the funds the obligation remains and the funds must be provided from other sources. Even though such a clause may not be followed literally, its intention is excellent. It is to avoid paying out all the profits in dividends which would mean that the sinking fund would represent no more than a setting aside of a portion of the original assets. It is good accounting, as well as good business policy, to insist that the sinking fund be set up from assets produced by the corporation in addition to those existing prior to its inception. This purpose is accomplished by means of the combination of sinking fund and sinking fund reserve. (See ¶ 19–17.)

The total of a sinking fund at any time may consist of four classes of assets: (1) cash, (2) securities of the issue protected by the sinking fund, (3) other securities and (4) accrued interest.

It is seldom necessary to present an analysis of the sinking fund on the balance-sheet, but if such an analysis is made the amounts of the various elements as grouped above may be indicated by indention, carrying the total into the final asset column. It is sometimes desirable to display the amount of the sinking fund represented by the securities of the issue protected by the fund, even if no further analysis is made. This may be shown as already indicated, or the item may be brought over to the other side of the balance-sheet and deducted from the bond issue, as is done in the case of treasury bonds.

For instance, a sinking fund containing all the elements mentioned above might appear in any of the following ways:

(1) Bond Sinking Fund		$200,000
(2) Bond Sinking Fund:		
Treasury Bonds	$100,000	
Cash and other securities	100,000	$200,000

(3) Bond Sinking Fund	$200,000	
Less Treasury Bonds deducted contra	100,000	$100,000

But on the liability side would appear:

Bond Issue	$500,000	
Less Bonds re-acquired and held in Sinking Fund	100,000	$400,000

(4) Bond Sinking Fund:		
Cash	$ 49,000	
Accrued Interest	1,000	
Treasury Bonds	100,000	
Other Securities	50,000	$200,000

It will be noted that under the above methods the bonds will appear at the full amount on the liability side of the balance-sheet, except under the third method, in which the bonds re-acquired and held in sinking fund are deducted both from the sinking fund and from the bond issue.

8-17. Usually, the bonds which it is the purpose of the sinking fund to retire form the best security which may be carried as a part of the fund, as they will generally bear a higher rate of interest than any other investment which would be absolutely certain of realization without loss. To illustrate: The XY Manufacturing Company may have issued $500,000 of 7% bonds due in twenty years. The sinking fund may be set up at the rate of $25,000 a year. Evidently, if this sum is kept in the form of cash on deposit, it will yield only the income paid by banks for time deposits, which will be considerably less than 7%. In order to increase its earnings, the fund may be invested in bonds which will produce more than the interest on cash on deposit. The greater the safety of these bonds, the lower the rate of interest. The character of a bond yielding 7% would probably be such that there might be a doubt as to realization of the full amount of principal and interest at the time when the sinking fund would have to be applied to the retirement of the bonds for which it was created.

However, if some of these bonds were available for investment — in other words, if the trustee should find bondholders willing to dispose of their bonds at par or thereabouts — such bonds could

be held as a part of the sinking fund and the full 7% earned thereon could be added to the sinking-fund earnings without any possibility of loss, as the retiring of the bonds — that is, the re-acquiring of them by the corporation for the purpose of retirement — would already have been accomplished so far as these bonds were concerned. In other words, for every bond acquired there is a saving to the corporation, from the date of purchase onward, of the amount of interest on that bond, which in almost all cases is higher than could be obtained by the corporation for its sinking fund in cash form or in the form of securities other than its own which would comply with the restrictions upon investment of the fund.

Sinking-fund Reserve

8-18. There is much confusion between the terms sinking fund and sinking-fund reserve. They are sometimes used more or less interchangeably, although they differ entirely in character.

A sinking fund is an aggregate of assets specifically accumulated for the purpose of sinking, that is reducing, a certain liability. A sinking-fund reserve, on the other hand, is not an asset but is a credit account properly used to measure the amount of profit or surplus which has been set aside for meeting the liability. Instead of being alike, the two terms are opposite in character. The term sinking fund should not be used for an item on the liability side of the balance-sheet, nor should the term sinking-fund reserve be used to designate an asset on a balance-sheet.

The entries on the accounting records for these accounts are as follows:

Sinking Fund	$000,000	
To Cash		$000,000
For amount of cash set aside in hands of trustee for sinking fund for retirement of 7% bonds due 19— as per contract.		
Surplus	$000,000	
To Sinking-fund Reserve		$000,000
To record appropriation of surplus profits equal to amount set aside in sinking fund as authorized by Board of Directors at meeting of (date). Minute book page 00.		

Sinking-fund Revenue

8-19. If the revenue earned by the sinking fund were added to the amount in the hands of the trustee, the journal entry on the books of a corporation would be:

Sinking Fund	$000,000	
To Sinking-fund Revenue		$000,000
For interest earned on sinking fund in the hands of the trustee during period —.		

The sinking-fund-revenue account is usually current in its nature and closed at the end of each year. Generally, it is used to reduce the amount transferred from other profits to the sinking-fund reserve. For instance, the entry might be:

Surplus	$000,000	
Sinking-fund Revenue	000,000	
To Sinking-fund Reserve		$000,000

Under this method each credit to the sinking-fund reserve is the same as in the preceding period, but the amount debited against surplus profits is reduced by the amount which the sinking fund itself has earned during the period.

As was stated under "sinking funds," there are many different methods of determining the amount of the periodic charge to sinking fund and credit to reserve. However, the above usage is common.

Sinking-fund Trustee — Cash
Sinking-fund Trustee — Securities

8-20. Instead of displaying the sinking fund in a single account it is sometimes carried in two or more accounts. One such account may represent the amount of cash in the hands of the trustee. The other may represent all securities held as part of the fund. Or the latter may be divided, one account carrying the amount invested in the bonds which it is intended to retire, and one account carrying other securities in which the fund may have been invested. These accounts may be combined on the balance-sheet or may be listed in detail as explained in ¶ 8–16. When the trustee converts any cash into securities, or vice versa, he should notify the corporation so that it may embody his transactions in the accounts.

It is sometimes held that, so long as the corporation has placed in the hands of the trustee designated in the indenture the full

amount of the sinking fund required, it is of no financial interest in what form the trustee may carry such funds, and that it is not necessary to record on the books of the corporation the various sub-classifications of the fund. Against this contention it is argued that since the revenue on the sinking fund is an item in which not only the bondholders but the corporation also will be vitally interested, it is essential that the corporation should carry on its records sufficient data to enable it to check the accuracy of the periodic sinking-fund revenue as reported by the trustee.

Redemption Fund

8-21. The term "redemption fund" may be given to any fund set aside for the purpose of redeeming an obligation. Such a fund is similar in character to a sinking fund though it may be more variable in its use. If bonds are issued with a stipulation that certain numbers or proportions of them may be redeemed periodically at the option of the bondholder, the fund set aside for this purpose is more properly called a redemption fund than a sinking fund, though the terms are frequently used interchangeably.

Redemption funds may also be set up for other purposes. For instance, organizations issuing premium certificates may carry under the name of redemption fund the amounts which they set aside for the purpose of settling the periodic claims of the premium companies for certificates redeemed. This is usually only a small percentage of the value of the certificates given out. The amount depends upon what experience shows for a particular type of premium scrip.

Redemption funds appearing in balance-sheets should have sufficient description to indicate the purposes for which they are set up.

Investment in Life Insurance

8-22. It is a constantly increasing practice in modern business to insure the lives of officers in favor of the organization. The premiums paid upon such policies result in the creation of an asset of the organization. The question frequently arises as to the value at which such an asset should be carried. There is not as yet complete agreement among accountants as to how the value should be determined. There are three plans chiefly in use, as follows:

First method: To charge to an account "investment in life in-

surance" the full premiums paid. The argument in favor of this method is that the account should show the total amount expended in the creation of the asset. It is further supported by the idea that if the policy is maintained until the death of the insured, the amount obtainable will always be greater than the amount of this account. Some advocates of this method go even further and add annually an amount for interest calculated upon the preceding balance at the rate used for accumulation by the insurance company, usually about 3% or 3½%. This addition of interest, however, is not justified in good accounting as it results in setting up a book profit which is not supported by any legally enforceable claim, as at no particular instant could the amount so set up be claimed from the insurance company or from anyone else, except on the death of the insured or at the maturing of the policy. Such a profit, therefore, being only contingent, is not justifiably included in the profit-and-loss account for the period.

Second method: The method approved by more conservative accounting is to record as an asset only so much of the annual premium as represents cash-surrender value according to the terms of the policy. This has the advantage of expressing an amount realizable at any time by surrendering the policy. The excess of premium over cash-surrender-value increase is charged to expense. The objection offered to this method is that the carrying of a policy ought not to result in a charge to expense, and also, since there is no cash surrender value for the first two years, that no asset would be built up during that length of time. If this method be followed, it seems desirable on the balance-sheet to qualify the classification with the words "at cash-surrender value."

Third method: Some organizations charge the excess of premium paid over cash-surrender values to a deferred asset account. By this plan the cash-surrender value is carried as an asset under investments, as in the second method, but the amounts which under the second method would be charged to expense are capitalized as deferred assets. The total of the two asset accounts is the total paid out in premiums and equals the amount carried as investment under the first method.

CHAPTER IX

Investments in Leased Property

Leaseholds

9-1. Instead of buying real estate, that is, purchasing title to it, organizations frequently rent real estate for their operations. Any amount which may be paid in advance for such use of real estate is legitimately listed as an asset which is reduced as the time for which it prepays passes, reaching zero at the expiration of the prepaid period. To illustrate: If in January an organization paid $6,000 rental for the use and occupancy of certain land and buildings for the current year, this $6,000 would be legitimately set up as an asset under the head of "prepaid rent." As each month passes this asset would be reduced by $500 (using the straight-line method) which would be charged to the operating expenses of that month. At the end of the year the asset account would be reduced to zero. Such an item on the balance-sheet should be stated as a "prepaid expense." (See ¶ 13–1.)

The Lessor's Position

9-2. There are times when organizations find it desirable to prepay their rent for a period longer than one year. Sometimes such payments cover all or a part of the rental for the entire period of the lease. Any amounts so paid may properly be set up under the term "leaseholds." The amounts thus prepaid usually are in lieu of certain annual rentals over the period of the lease, and represent the cost of an annuity of as many terms as there are years in the lease at some agreed rate of interest.

To illustrate: If "A" leases property from "B" for a period of five years at an annual rental of $1,000, they may mutually agree that "A" shall make one payment in the beginning instead of the annual payments of $1,000 each. If they agree upon a 5% interest rate, and if the annual payments are due at the beginning of each year, then "A" should make a prepayment of $4,545.95. If "B" puts this sum out at interest at 5% and at the end of each year deducts from the amount of principal and interest $1,000 the total will be exactly exhausted at the beginning of the fifth year. In other

words this would have exactly the same result as if "B" had received the $1,000 annually. The following table illustrates "B's" position:

	Annual rental deduction	Remaining principal	Interest at 5%	Balance, principal and interest
		$4,545.95		
1st year	$1,000.00	3,545.95	$177.30	$3,723.25
2nd year	1,000.00	2,723.25	136.16	2,859.41
3rd year	1,000.00	1,859.41	92.97	1,952.38
4th year	1,000.00	952.38	47.62	1,000.00
5th year	1,000.00	none	none	none
	$5,000.00		$454.05	

During the four years the total interest earned, amounting to $454.05, added to the prepayment of $4,545.95 makes a total of $5,000. Evidently if "B" earns less than 5% on the money, he loses under this prepaid-leasehold plan, but on the other hand he gains by it if the money is worth more than 5% per annum to him.

9-3. When "B" receives the prepayment indicated above it would be incorrect to consider it as income of the year in which received. Instead the entry should be to debit cash and to credit reserve for prepaid leasehold $4,545.95. Another entry debiting the same reserve and crediting rental $1,000 may be made bringing into the gain accounts the $1,000 received for that year. At the end of the year an entry should be made debiting interest $177.30 and crediting the same amount to the reserve. These entries, whereby $1,000 is credited annually to the income account called "rental" and proper credits for interest are made to the reserve, will result during the five years in crediting $1,000 a year or a total of $5,000 to rental and in charging interest with a total of $454.05. If the amounts of money represented by the principal during each year were actually invested at 5% the interest earned would be credited to the interest account and would offset the above charges. Periodic writing down of the reserve for prepaid leasehold is known as amortization on the compound-interest method.

9-4. Instead of using the annuity method of amortization "B" could amortize the amount by making an equal distribution over the years involved. Under this simple method of amortization, when the prepayment was received the following entry could be made:

Cash	$4,545.95	
To Rental		$ 909.19
Reserve for Prepaid Leasehold .		3,636.76

Each year thereafter the amortization would be set up by the entry:

Reserve for Prepaid Leasehold . . .	$909.19	
To Rental		$909.19

These entries in the fifth year reduce the reserve for prepaid leasehold to zero. This method has the advantage of simplicity, as the amount to be amortized is found by dividing the amount of the prepayment by the number of years of the service. It does not, however, recognize the interest element. During the first year the organization has the use of $3,636.76 in addition to the amount allotted as rental revenue for that year from the property owned, whereas in the fifth year there is no such amount available for use, yet the various years have been credited with the same amount of revenue.

In practice this method is usually adopted, however, unless the amounts involved are large.

The Lessee's Position

9-5. When "A," the lessee, prepays an amount as in the foregoing illustration, he will debit an asset account called leasehold or prepaid leasehold, $4,545.95. This amount is to be amortized over the periods of the lease. The amortization may be on the straight-line method or on the compound-interest or annuity method. Under the first, equal amounts ($909.19) would be transferred each year from the leasehold account to an expense account representing rent. Under the second method, the determination of the periodic entries is somewhat more complicated.

9-6. In practice one frequently finds erroneous methods of setting up amortization. One very common method is incorrect. It is probably desirable to illustrate it.

Incorrect Method

The prepayment under this method is set up as follows:

Rent	$1,000.00	
Leasehold	3,545.95	
To Cash		$4,545.95

Thereafter, at the beginning of each year, the following entries are made:

(Second year)		
Rent	$1,000.00	
To Interest		$177.30
Leasehold		822.70
(Third year)		
Rent	$1,000.00	
To Interest		$136.16
Leasehold		863.84
(Fourth year)		
Rent	$1,000.00	
To Interest		$ 92.97
Leasehold		907.03
(Fifth year)		
Rent	$1,000.00	
To Interest		$ 47.62
Leasehold		952.38

It will be noticed that this method gives the following amortizations of the prepayment and credits for interest:

	Amortization	Interest credit
First year	$1,000.00	
Second year	822.70	$177.30
Third year	863.84	136.16
Fourth year	907.03	92.97
Fifth year	952.38	47.62
	$4,545.95	$454.05

The error is self-evident when displayed in this manner. The year in which the greatest amount of investment in leasehold is outstanding receives no credit for interest. Further, the amounts of amortization should be on a constantly ascending schedule and therefore the $1,000 charge should be in the fifth year and not the first. These points are so evident that we would not be justified in giving space to them, were it not that the method is so frequently approved without realizing that it is illogical.

Corrected Method

9-7. The error in the above entry lies in the fact that an attempt is made to journalize the debit against rent and the credits to interest and to leasehold by one entry for each year. According to the theory on which this illustration is based the rental for each year is presumed to be paid in advance. Therefore, the leasehold account should be amortized by that amount on the first day of each year. The interest, however, does not accrue to the leasehold until the end of the year and therefore should appear as a separate entry on that date. As a result, the item, interest on the balance of $3,545.95 the first year, amounting to $177.30, should be debited *at the end* of the first year instead of at the *beginning* of the second. As a result, it partly offsets the rental charge of $1,000 made at the beginning of the year, resulting in a net amortization of the principal sum for the first year of $822.70.

The following schedule shows the correct application of the theory to the leasehold account:

Year	At First of Year		At End of Year	
	Credit by rental	Remaining balance	Debit by interest at 5%	Debit balances
1	$1,000.00	$3,545.95	$177.30	$3,723.25
2	1,000.00	2,723.25	136.16	2,859.41
3	1,000.00	1,859.41	92.97	1,952.38
4	1,000.00	952.38	47.62	1,000.00
5	1,000.00			
Total	$5,000.00		$454.05	

It will be noticed that by this method the interest credited to the respective years is equal to 5% of the book value of the investment in the leasehold at the beginning of the year; also that the amortization of the leasehold increases in exactly the same ratio as that in which the book value decreases. In other words, the amount of amortization each year increases by 5% of the amount amortized in the preceding year. This may be shown by the following table and is in keeping with the annuity theory:

	Amortization	5% of same
First year	$ 822.70	$41.14
Second year	863.84	43.19
Third year	907.03	45.35
Fourth year	952.38	47.62
Fifth year	1,000.00	

The net effect on the profit-and-loss account is evidently the amount of amortization for each year shown in the above table.

9-8. It will further be noted that by this method the amounts outstanding at the end of each year, that is, the balance-sheet amounts, differ considerably from those shown in the first illustration. This is shown in the following comparison:

BALANCES ON THE LEASEHOLD ACCOUNT AT CLOSE OF YEAR

	First method	Second method
First year	$3,545.95	$3,723.25
Second year	2,723.25	2,859.41
Third year	1,859.41	1,952.38
Fourth year	952.38	1,000.00
Fifth year	———	———

From the lessee's point of view the compound-interest method rests on the idea that the prepayment of a leasehold is in reality lending a sum at interest so that annual deductions from the cumulative amount of principal and interest will reduce the amount to zero in the final year. In other words, of the prepaid amount, $1,000 is supposed to represent the rental for the first year. The remainder, $3,545.95, at 5% interest would earn $177.30 the first year. This added to the principal would amount to $3,723.25. From this at the beginning of the second year, $1,000 would be deducted for rental and the remainder would again earn interest. This process continued would result during the five years in a total charge of $5,000 to rental and a credit of $545.05 to interest.

9-9. Under the annuity method of amortization the charges to rent are uniform but the deductions from the prepaid-leasehold account differ with the years. Also in each year the expense account for rent is partly offset by a credit to interest. It will be noticed, therefore, that the net effect on the profit-and-loss account of each year exactly equals the deduction from leasehold for that year. Shifting a certain amount as a credit to one nominal account (interest) and at the same time transferring a debit to another account (rent) is no more than a fiction. Some accountants and many industrial engineers, however, take great pride in this fiction and rejoice in the discovery they have made. Since these nominal entries offset each other, no effect is evident in the balance-sheet results unless a portion or all of one of these nominal elements be carried into an asset account.

To illustrate: If the rent amount were considered a manufacturing expense and therefore an element of cost of merchandise, the inventory of such merchandise in the balance-sheet would contain an element which was not a true cost but was offset by a credit to a nominal account (interest). This would be a violation of the principles of valuation as laid down in Chapter IV. It is evident that if an organization is justified in crediting profit with interest upon an amount which it has paid out as prepaid rent it would be justified in crediting profit with interest on any other amounts which it has invested in machinery, merchandise, receivables, or in any other asset. If such fictitious credits are used to inflate the assets themselves, the organization would merely be chasing itself around a vicious circle and would be misstating the amounts which it had actually invested in its assets.

Leasehold Improvements

9-10. Permanent fixtures which are installed in leased properties may be of such a character that they will pass out of the possession and ownership of the lessee with the expiration of the lease. Evidently such amounts set up on the balance-sheet of the lessee should be amortized over a period not to exceed the remaining years of the lease. Usually this amortization is on the straight-line method — that is, the amount to be amortized is distributed equally over the accounting periods involved. If the amount is large, the annuity method described in preceding paragraphs may be used.

Before expiration a lease may be renewed and thus the number of periods over which the balance of the account is to be spread may be greatly increased. One result of such a condition will be a smaller charge for amortization of leasehold fixtures in the later than the early years. This seems like incorrect accounting practice, but these apparent inaccuracies are unavoidable. It would be incorrect to charge off the fixtures during the period of the first lease at a rate based on the assumption that the lease would be renewed, unless there were some binding agreement whereby such continuance of occupancy was assured. Otherwise, if the lease were not renewed, it would be apparent that the fixtures had not been sufficiently depreciated. Such treatment would not be conservative.

Another complication arises when the period of useful life of the fixtures is less than the period of the lease. This frequently occurs

as in the case of the finishing and decoration of leased retail store buildings. Improvements which, it is estimated, will be exhausted before expiration of the lease must be amortized or depreciated on the basis of their estimated life, whereas improvements that will outlast the lease must be amortized on the remaining life of the lease.

9-11. Improvements of a fixed nature made on leased lands are usually held to belong to and at once become a part of the real estate so leased. Legally, therefore, they belong to the owner of the land rather than to the lessee of the property. The possession, however, of the property during the period of the lease belongs to the lessee, and this includes the possession of the improvements. It is entirely correct, therefore, for the lessee to include such improvements among his assets at cost, to be charged off to expense during the period of the lease or during the period of the life of the improvements if that be less than the life of the lease.

On the books of the lessor of property upon which fixed improvements have been made, it is usually desirable to give effect only to such asset value as will become his through possession at the expiration of the lease.

To illustrate: If "C" owns a piece of real estate which he leases to "D," and, twenty years before the expiration of the lease, "D" erects upon the land a building costing $100,000, "D" is really prepaying $100,000 as an expense over twenty years, and this $100,000 should be apportioned to his expenses over the twenty-year period. This may be done at the rate of $5,000 a year or according to any other proper method of amortization.

Let us assume, however, that this building is estimated to have a value of $50,000 at the expiration of the twenty years. "C," at the expiration of the lease, will come into possession of an asset of $50,000. It would be proper for him to build up such an asset during the twenty-year period, which might be done by writing up even amounts each year or by some other method of cumulation on a compound-interest basis. The accumulation would be credited to his income account and would be the equivalent of additional rental upon the leased property.

CHAPTER X

Fixed or Permanent Assets

10-1. "Fixed" or "permanent" assets are frequently referred to as "capital" assets. The terms are practically synonymous. The group embraces assets held for use of the organization in carrying on its activities rather than for purpose of conversion. It includes both tangible and intangible assets of this character. For convenience, intangibles are discussed in a separate chapter.

Property

10-2. This term "property" often appears as a single item on a balance-sheet, embracing all the physical property with which an organization operates. If it is so used, care must be taken in preparing the balance-sheet to see that intangibles such as goodwill are not included under the heading. It should include no more than real estate, machinery, equipment and such other tangible items as properly are related to the operation of the business. Since even when so restricted it includes a group of assets varying greatly in their essential elements and in their depreciation, it should be accompanied by a schedule in which a more complete analysis is made.

Real Estate

10-3. Real Estate is legally understood to include not only land but also buildings erected thereon. In accounting records however, their treatment must be distinct. The decrease between the cost of a service asset and the amount estimated as recoverable therefrom at a later date constitutes a cost which must be spread over the intervening periods of service. (See ¶ 5–3.) This distributable cost varies greatly between buildings and the land on which the buildings stand.

Land

10-4. All land owned by an organization — that is, land to which it has title — may properly be listed under this heading "land." Leaseholds or other assets which merely involve the right

to use land or to derive certain elements from it should be listed under distinct headings. Land owned essentially for the use of the organization, such as the land on which its factory stands, or land which is necessary for the proper operation of its factory should be indicated apart from other lands owned which could be sold without interfering with the operation of the factory. Land held for speculation or investment purposes differs in its bearing on the financial status of a company from land which is essential to the company's operation.

In the case of a partnership, real estate title to which is vested in one of the partners should not appear as an asset on the balance-sheet of the partnership unless the title holder is acting as trustee for the partnership and the trusteeship is evidenced by proper documents. This introduces another point which it is difficult to reduce to absolute rules. In preparing a balance-sheet for a sole proprietorship how much of the land owned by the proprietor may properly be included? (See sole proprietorship, ¶ 1–5, 16–9.)

Land should be carried on the balance-sheet at cost, unless there is some definite reason for using a different valuation. If there is such a reason, and an appraisal by properly qualified experts indicates that the land is worth more than cost, it may be recorded at this appraised amount. The excess over the cost price, however, must be represented by a credit account called "surplus from land appreciation," or with a similar title, which will indicate clearly its source, so that it will not be confused with surplus arising from earnings or from contributions. Writing up of the value of an asset is contrary to the fundamental asset theory as explained in Chapter IV. (See appreciation of developed properties.) It is not conservative and should not be approved, except in cases where the customary treatment would be unjust to the organization or to other parties. For instance, if an organization whose land has increased greatly in value since the date of its purchase desires to issue bonds, it is right and proper that the bond purchasers should know the full value of the land which may form the chief asset for their protection. To treat such appreciation as profit or to allow it to be merged with earned surplus would be erroneous and could not be approved by accountants. An account on the liability side of the balance-sheet showing distinctly appreciation as a factor in valuation serves notice that while the land is carried at a figure estimated to be its present value, the organization did not pay that amount for it.

On the other hand it is not usually necessary to depreciate values of land. There are times, however, when this also must be done. The value of land sometimes reaches a high figure and then, because of general movements of commerce, perhaps, that value is not maintained. Holders of such land who have paid high prices for it are justified in writing off depreciation as they would in the case of any other asset whose recoverable value will eventually be less than its cost price.

Land Development Assets

10-5. If a tract of land is bought and developed as a whole with the expectation of selling it in smaller units, the principle of depletion must be applied to the accounts controlling it. (See ¶ 5–2.) The term "depletion" is usually limited in practice to values produced from land, such as minerals and timber. But the principle is broader. Costs necessary to development should be added to the original cost of the property, and the total cost should be prorated over the units to be sold. As each unit is sold the operating accounts will be debited with the cost that has been apportioned to this unit, and a corresponding credit will be made to the cost of the developed property. When the last unit is sold, the cost apportioned to it, if the principle has been properly applied, should reduce the developed-land asset to zero.

For example, this principle should be applied, but is frequently overlooked, as in the case of cemeteries, where lots are sold outright but under a guaranty of maintenance over a period of time. Here the total cost of the property, plus proper development expenses, constitutes an asset or a group of assets which form the real subject matter of the corporation. Theoretically when all the lots are sold these assets will have disappeared. However, there will still be upon the company the burden of maintaining the lots and grounds in a certain condition for the time agreed upon in the contract with purchasers. If the contract be perpetual, assets sufficient in amount to provide an annual income which will defray the cost of maintenance must be reserved. If the contract is for a limited period, say fifty years, the fund must be large enough to produce income which, with the annual amortization of the fund itself, will cover the cost of maintenance during the period.

10-6. Therefore, from the sales of all the lots there must be

reserved an amount sufficient to cover the original cost and to provide a maintenance fund. The excess of selling price over this amount is the gross profit from which selling expenses and other expenses not included in maintenance must be deducted before net profit can be ascertained. The cost and maintenance fund should be prorated to each lot so that as each lot is sold the proper accounting adjustments may be made. The determination of the amount of a maintenance fund involves many difficulties. First, there is the difficulty of determining how much may be needed periodically for maintenance purposes. The years 1914 to 1921 proved how difficult it is to estimate in advance the payroll requirements for a given amount of work. Second, there is similar difficulty in calculating in advance the amount of income which a given investment will continually produce. As a result this fund must be made large enough to provide with certainty for such contingencies as may arise. (See reserve for maintenance of sold property, ¶ 19-11.)

Buildings

10-7. Buildings erected on owned land should be carried in the balance-sheet at cost, less the portion of that cost which has been charged to service in the past. The rate of depreciation — that is, the rate at which the cost of buildings less ultimate recoverable value is spread over the intervening periods — will vary according to the character of the building and the use to which it is put. Brick or stone buildings will last longer than frame buildings. Buildings housing vibrating machinery will deteriorate more rapidly than buildings not subjected to such a strain. These and kindred elements must be taken into consideration in determining the length of service which a building will render so that the net cost may be properly spread. Occasionally some unusual element has a marked bearing upon the apportionment of depreciation to the various periods. During 1918 and 1919 concerns producing war supplies were frequently compelled to construct additional buildings to increase their capacity. Because of conditions then prevalent these buildings cost a great deal more than they would cost in normal times, and they were mostly of inferior construction. Such conditions often justify charging off the excess cost of buildings over a very brief space of time, allowing the remainder of the cost to be spread over the estimated life of the buildings. Such additional

charge to earlier periods has been called "amortization" instead of depreciation. Specific rulings were issued by the government in regard to income and excess-profits taxes under the general heading "Amortization of wartime facilities."

Illustration: If a building which normally would cost $200,000 was built during an abnormal period at a cost of, say, $300,000, the excess cost of $100,000 was amortized in the first four years, and the remaining cost was spread over the estimated life of the building. Suppose that this normal depreciation was at the rate of 5%. Three years after the building was constructed it would appear on the balance-sheet in one of the following forms:

Buildings		$300,000	
Less: Three years amortization	$75,000		
Reserve for depreciation	30,000	105,000	$195,000

If the amortization was credited directly to the building account it would appear as follows:

Buildings	$225,000	
Less: Reserve for depreciation	30,000	$195,000

By the latter method, the building account at the end of the fourth year would have been reduced to $200,000, which was determined as the proper first cost for a building of this type, instead of carrying it at the unusually high cost due to its construction in time of emergency.

Buildings that are directly employed in the operations of an organization should be shown distinct from other buildings owned by the organization but not indispensable to its operations. The reason for this separation is that the latter constitute an asset which might be sold without handicapping the activities of the organization.

10-8. Buildings in course of construction, which when completed will constitute permanent assets of the company, must be classified as such in the balance-sheet and must not be classified as current assets. A factory organization may decide to erect some of its own buildings instead of having them constructed by others. During construction they may be grouped with other work in process, which is a current asset. For balance-sheet purposes a separation should be made and the construction work should be listed among the permanent assets.

The book cost of a building properly includes every expense necessitated because of its construction or acquisition. This may comprise not only the cost of materials, labor and overhead applicable to the construction, but also the cost of razing a preceding building or otherwise preparing the ground for construction. These costs, however, may be added to the cost of the land instead of to the cost of the buildings erected thereon. If money has been borrowed in order to construct a building, most accountants consider it legitimate to include interest paid upon such money during the construction of the building as a legitimate part of the cost. It is an oft-repeated accounting principle that the cost of any service asset may properly include all expenses incurred in bringing that asset to such a condition that it may render the service for which it was intended. This cost less any recoverable value is the true cost of the service during the period of its use. (See ¶ 5-3.)

Buildings on Leased Land

10-9. A man or an organization may erect a building on land which he or it does not own but has leased for a certain number of years. Since the building will pass to the lessor at the expiration of the lease, its cost must be spread over the period of the lease instead of over the period of its estimated life. This is in agreement with the theory stated in ¶ 5-1. The cost of the building to the lessee is a prepaid expense somewhat similar to rental of the real estate. At the expiration of the lease there may be no recoverable value to the lessee; therefore, this prepaid expense — that is, the cost of the building — is apportioned to the years during which it renders service to the lessee. If there is a contract whereby the lessee receives from the lessor a return of value in any form, this reduces the net expense to the lessee and should be taken into consideration in calculating the cost of service applicable to each intervening period. As to the method of apportioning this cost, see discussion of leasehold, Chapter IX.

If the lease is of such long duration that the building as a usable asset will expire before the expiration of the lease, the cost of the building must be apportioned over the shorter period. If a building whose normal life would be thirty years is erected on land leased for a longer period, say for ninety-nine years, the building cost must be apportioned to the estimated thirty years of service without any regard to the length of the lease. In other words, the building cost

should be apportioned over the length of life of the building or the remaining life of the lease, whichever is the shorter.

It has been contended that a building upon leased land is never the property of the lessee; that title to it is not in his name, and therefore that it should not appear among his assets, as it immediately becomes an asset of the owner of the property at the time of its construction. This argument was in fact once advanced by some officers of the Bureau of Internal Revenue in attempting to exclude such property from the invested capital of certain lessees. The contention was futile and was immediately overruled by higher officers of the department. The reason for mentioning the argument here is that the same opinion seems to be held by some people in business. While it is legally true that the lessee does not hold title to buildings erected upon leased land, nevertheless the cost of such buildings represents a prepaid investment for service. It is akin to a prepayment of additional rental and is therefore properly chargeable — not to the period in which the building was erected, as an expense item — but equitably to the various periods which will obtain the benefit of the use of the building. It is, therefore, a legitimate asset of the lessee during the period of its usefulness to him.

Depleting Assets

10-10. There is a kind of asset which differs somewhat from the permanent assets already discussed and also from the current asset "merchandise." Such assets are associated with fixed property, such as real estate, but are either sold directly or at least enter into and become a part of the commodity or service sold by an organization. To an extent they are like merchandise. Merchandise, however, is a term usually given to all commodities which are continually being bought to be sold. Merchandise is something which the organization is continually restocking. The assets which are the subject of this paragraph are sometimes called "wasting assets" and are usually acquired en bloc. They may form a part of the assets with which the organization begins business. Among the most common examples of such assets are timber lands and oil and other mineral lands. Real-estate development properties also may be placed in this group.

Prices paid for timber lands usually include the real estate itself and all the timber growing on it. As the latter is worked and sold,

a portion of the value of the initial purchase is properly applicable to the sale as a cost of the thing sold. At the end of each accounting period the proportions of the cost of the land applicable to the quantity of timber cut during the period is added to other factors of cost and subtracted from the cost of the property retained as a permanent asset. The deduction is usually made by crediting an account called "reserve for depletion of timber land," rather than by crediting the amount directly to the asset account. In the balance-sheet, the timber lands are carried in an indented column at cost, and from this the amount of reserve for depletion is deducted. The net amount representing remaining value is carried into the asset column.

Since the amount of timber that will be obtained from such land cannot be known positively in advance, it has to be estimated as nearly as may be by expert appraisal. The estimate is used as the basis for calculating the amount of depletion per unit of lumber cut. If a piece of land costs $25,000 and it be estimated that 1,000,000 feet of lumber can be cut from it, after which the land will be worth $15,000, the decrease in the value of the land, $10,000, must be apportioned over the lumber cut, which would be at the rate of $10 per 1,000 feet. If during the first year 200,000 feet of lumber be cut, these items will appear upon the asset side of the balance-sheet as follows:

Timber lands	$25,000	
Less: Reserve for Depletion	2,000	$23,000

Similarly, in the case of oil and other mineral lands experts calculate the probable amount of oil or other mineral reserve. The total cost of the land or its value fixed after discovery of minerals, less its remaining value after exhaustion of minerals is the amount of total depletion. This divided by the number of estimated units in the property gives the ratio of depletion to be applied to the periodic output of the wells or mines. (See ¶ 5–2.)

Appreciation of Developed Properties

10-11. Certain properties such as those containing coal, metal, oil or gas, acquire a greatly increased value because of development. It has been conceded that the owners of such properties have the right to display appreciated values on their balance-sheets, pro-

vided the proprietorship accounts are not diverted from their true function. A special item representing the estimated amount of the appreciation, based upon the estimated probable production of minerals, may be introduced among the asset accounts. The offsetting credit to this asset would appear as "unrealized appreciation," "surplus from re-valuation," or under some similar title. (See ¶ 18–21.)

Many methods of determining the amount of appreciation are in use, but it is not the author's intention to discuss them in this book. They are essentially engineering problems, but the federal revenue acts and treasury rulings offer to the accountant valuable information on the subject.

The total value fixed for property less its remaining value after exhaustion gives the amount of depletion to be spread over the products of operation. This is usually accomplished on the unit basis. At the end of each accounting period the number of units produced multiplied by the amount of depletion applicable to each is credited to a reserve for depletion and debited to the production cost. So much of this amount as represents a depletion of the appreciation — that is, of the excess of the re-valuation amount over the cost — is debited to the reserve which was set up at the time of appreciation and is credited to "realized appreciation." The latter is a part of surplus. As an illustration, assume that certain property has been appraised at an amount representing twice the cost price, the excess being credited to "unrealized appreciation." If the amount of depletion due to production of a certain period is $1,000, it is evident that half of this amount represents a return of investment and half represents a conversion of appreciation into true surplus. Therefore the second journal entry discussed above would debit "unrealized appreciation" $500 and would credit "realized appreciation" $500, thereby adding that amount to true surplus. If the estimates as to production have been correctly made, at the time of the exhaustion of the product all of the amount originally credited to "unrealized appreciation" will have been transferred to surplus through this method. Meanwhile the balance of the unrealized appreciation account is kept distinct from true proprietorship. It is not surplus in the strict sense of the word, as it is not available for dividends or other use. It is no more than the amount which it is estimated will be converted into realized profit during the life of the appreciated asset.

10-12. It may appear to the reader that this procedure is somewhat in violation of the principles of accountancy. A careful study, however, will show that it is in strict keeping with those principles. To illustrate: A man, familiar with the oil industry, decides that a certain tract of land possesses great possibilities of oil production and acquires a lease to the property. It requires a good deal of money to develop the property by the sinking of wells, etc., and this investment is entirely worthless unless oil in paying quantities is reached. Assume that these experimental wells strike a rich flow of oil which it is estimated by engineers, will produce a certain number of thousands or millions of barrels. The property is no longer an experiment and the formerly hidden resources are now manifest. In a sense, they are tangible. It would be a violation of accounting principles, rather than conformity thereto, to restrict the asset value of this property to the cost of obtaining the lease and of development. The oil is there and it has a recognized market value. It should be capitalized at what engineers have found to be a fair value. When this is properly expressed by the account "appreciation of developed leases," the balance-sheet will display a true valuation of assets for purposes of capitalization or sale.

The value may be ten times the actual investment in the lease. It would not be correct to add this excess over the investment to true surplus. As has been said above, it does not represent any amount which has yet been realized and it has not been converted into any assets which could be used for the paying of dividends or for any other purpose for which surplus may be legitimately used. To merge it with the earned surplus would result in distorting that account and in giving a false impression. The excess is therefore carried, as already described, in a special account indicating its nature. "Unrealized appreciation" or "surplus from revaluation" seem to be the most common titles for such an account. As these values are converted into usable assets by production and sale, the proper portion of appreciation applicable to them may legitimately be added to true surplus by an entry such as the one previously indicated.

Perhaps a further illustration will make this point clearer. For the sake of brevity, all items other than those directly involved

will be grouped under the fewest possible headings. The balance-sheet might be expressed briefly as follows:

ASSETS

Other assets	$ 400,000
Developed Leases	900,000
Total	$1,300,000

LIABILITIES AND CAPITAL

Liabilities	$ 300,000
Capital Stock	1,000,000
Total	$1,300,000

Assume that 5,000,000 units will be recoverable at a value of $1 each. Further assume that in a certain period 500,000 units are produced and sold for $2 each, the expenses being $300,000. Disregarding other possible transactions the balance-sheet at the end of the period would be:

ASSETS

Other assets (in detail)		$1,100,000
Developed Leases	$ 900,000	
Appreciation of Developed Leases	5,000,000	
	$5,900,000	
Less Reserve for Depletion	500,000	
		5,400,000
		$6,500,000

LIABILITIES AND CAPITAL

Liabilities			$ 300,000
Capital Stock		$1,000,000	
Surplus:			
Net Profit	$200,000		
Realized Appreciation	500,000	700,000	1,700,000
Surplus from re-valuation			4,500,000
			$6,500,000

In this instance the value of the developed lease is not depreciated as it is not the purpose to illustrate this item here. Such depreciation would result in an increase of the reserve for depre-

ciation on the one hand and a decrease of the net profit on the other hand.

Machinery and Plant Equipment

10-13. The implements or equipment of a more or less fixed and durable nature in a factory are usually grouped under the heading "machinery" or "plant equipment." They should be carried on the books as an asset at cost and a reserve for depreciation should be set up to care for that portion of the decrease in asset value which is transferred to expense account in the operating periods. The principle of valuation involves three elements: first, cost; second, recoverable value; third, period of use or service. These are discussed fully in Chapter IV. The machinery cost, less the recoverable value, is the total cost of machinery service in the periods of usefulness. The amount of this cost apportioned to each period is known as depreciation. Various methods of distributing this cost are discussed under the head of "Depreciation," Chapter V. The cost of machinery properly includes not only the original purchase price but all other costs necessary to bring the asset to a state of usefulness. These additional costs may include inbound freight, trucking and all expenses incidental to installation and testing.

10-14. Machinery manufactured by the factory itself should be placed on the books as an asset at cost only. The cost includes not only material and direct labor but so much of the overhead as properly applies to it. It should not, however, include interest on investment, theoretical rental on an owned plant, nor any other element that is not a true cost. Occasionally companies will put such machinery on their books at the price which they would have had to pay some other company had they purchased it complete instead of manufacturing it themselves. This may be an amount in excess of cost. They attempt to justify this action by saying not only that if they had not manufactured it themselves they would have had to pay such a price but also that their factory forces could have been utilized in making a profit on other work. The contention is of course erroneous. Accounting records must show what is — not what might have been. Also they overlook the fact that if they have manufactured anything for less than it could have cost elsewhere they have saved the difference and have it either in the form of cash or some other asset. To list the manufactured machine at an inflated price would be to show the saving twice.

Illustration: Suppose an organization has $100,000 in cash and needs a machine which would cost $60,000. After buying this and paying for it, omitting all other transactions, the concern would have:

Cash	$ 40,000
Machine	60,000
	$100,000

Instead of purchasing the machine suppose the concern manufactured it at a total cost, paid in cash, of $55,000. After this transaction the records would show:

Cash	$ 45,000
Machine	55,000
	$100,000

The organization has saved $5,000 by manufacturing the machine and this saving is shown by the actual cash which it has in addition to the cash it would have had if it had purchased the machine from others. This is a legitimate showing. On the other hand, suppose this machine were listed on the books at $60,000 even though it had cost only $55,000 to produce. It would result as follows:

Cash	$ 45,000
Machine	60,000
	$105,000

Such a statement would be a violation of the principles of accounting. It would misrepresent facts. It may be given as a general principle that profits are made when values are transferred to others. They are not made directly by purchasing. Efficient purchasing may be essential to profit making, but the profit is not made at the time of the purchase, however advantageous. It is made when the thing purchased has been converted into a greater value in money or right to collect money.

Whatever amount is paid for a machine is in reality a pre-payment for the service which the machine is expected to render. The cost of this service is deducted periodically in the form of depre-

ciation from the gross income of the periods receiving the service. The profit of each period is decreased by the amount of depreciation charged to that period. Let us assume the machine to have a recoverable value of $5,000 after ten years of service. If it be listed at a cost of $55,000 there will be a total service cost of $50,000 to be apportioned to the ten years — that is, the income of the ten years will be reduced by $50,000 which represents the cost of this machine. On the other hand, if the machine be listed at $60,000 its recoverable value, $5,000, leaves $55,000 as the amount to be charged against the income of the ten years. As a result, if the machine, which actually cost only $55,000, is listed at $60,000 it will mean that a $5,000 profit will be taken at the beginning and that the profit for the ensuing ten years will show $500 less for each year, a total of $5,000. The final result will be the same, and the ultimate net profit of the company at the expiration of the ten years will be identical; but in the first year a fictitious profit of $5,000 will be shown which finally will be offset by a fictitious loss of $500 a year for ten years. (See ¶ 4-4.)

Small Tools

10-15. The designation "small tools" usually refers to those smaller implements of a factory which are not durable in their nature or may readily be lost or carried away by workmen. Since the life of these tools is uncertain and depends more upon the use to which they are put and the skill of the operator than upon their inherent characteristics, it is considered better to write down the asset periodically than to attempt to carry it at cost and to set up a reserve for depreciation. If one attempts to follow the latter plan it will require great care to prevent overstatement of the asset on the balance-sheet. An excellent method is to charge all tools to the tool account at cost; at the end of the fiscal year to take a physical inventory of the tools, valued according to their estimated depreciated worth, and to adjust the asset account to this figure charging the difference to expense of the period.

Patterns

10-16. In every factory where the product has to be shaped from metal it is customary to have patterns from which to make the molds. In the case of job foundries, however, the cost of making patterns is usually charged to the customer for whom they are

made, and in that case they should not appear on the balance-sheet of the foundry, even though they are kept on hand for the convenience of customers. There is an income-producing value attached to the possession of these patterns by a foundry, as such possession practically assures future work for which these patterns are to be used. However, like other service assets they should be carried on the books only at what they have cost, and if this cost or any portion of it has been charged to the customer, the book value of the asset should be correspondingly decreased.

Such patterns become the property, and therefore true assets, of the company for which they have been made and to which they have been charged. Such companies may justly carry them upon their books as assets at cost price. As this cost is small there is usually no reserve for depreciation. After a pattern has served its purpose, that is, when it is no longer used in manufacture, its value should be written off. The value on the books should represent only the cost of patterns still useful to the organization.

Tracings, Drawings and Models

10-17. The manufacture of some products is preceded by the making of models of the things to be produced; and these models are usually preceded by drawings showing the things to be produced and the relation of all their parts. These models and drawings are a valuable part of the factory equipment. It is justifiable to list them as assets at cost. Their asset value generally ends when the factory ceases to manufacture the articles for which they were required or when changes and improvements necessitate new drawings and models. The account on the balance-sheet should appear at the cost price of models, etc., related to or useful in current manufacture. Those related to articles no longer produced have no place in this account. As the cost of these items is relatively small no reserve for their depreciation need be established.

Furniture and Fixtures
Office Equipment

10-18. Desks, chairs, filing cabinets, typewriters, adding machines and other equipment required for the administrative purposes as distinct from directly productive activities are represented by the account "furniture and fixture" or "office equipment." The asset will be carried in the books at cost and a reserve for depre-

ciation will be set up by a periodic credit, offset by a debit to depreciation, which is an expense element. As the rate used is often higher than actual depreciation, the reserve sometimes reaches the amount of the cost before the equipment reaches the end of its usefulness. The reserve must never exceed the cost. When the reserve reaches that point no further charges can be made to depreciation. This merely means that the total cost of service as represented by this asset has been distributed too rapidly.

Some organizations, especially those of a financial character such as banks, carry furniture and fixtures into the balance-sheet at $1. This is merely for the purpose of showing that they have invested money in such equipment but that it has all been charged to the expense of past periods, save the amount of $1, which permits the item to be displayed on the balance-sheet.

Delivery Equipment

10-19. "Delivery equipment" is a general term applied to all equipment used by an organization for the purpose of delivering merchandise to customers or delivering purchases to its own warehouses or stockrooms. Instead of this general term, more specific phraseology may be used, such as "horses and wagons," "auto trucks," etc. One reason for separating this class of assets from other classes is that it is not as a rule directly productive. Depreciation rates applicable to it deserve special consideration. Motor trucks, for instance, depreciate much more rapidly than ordinary machinery equipment. Liability to accident with resultant losses and claims for damages is much greater than with many other kinds of equipment.

CHAPTER XI

INTANGIBLES

11-1. The term "intangibles," used not only in business accounting but also in the income-tax law, refers to asset values which have not a tangible, that is, a physical existence; or, rather, to values not limited to physical entity. A trademark may have a physical existence, yet its value does not lie in such existence but in the right to its exclusive use. The value would not be lost through the destruction of any existing physical trademark, but it would be lost if the right to reproduce and use the trademark should pass to others or if its use should be no longer productive.

The term "intangibles" includes franchises, formulas, trademarks, patent-rights, copyrights, goodwill and other similar assets which may be created or acquired by an organization. Some of the more important are discussed in detail in this chapter. Goodwill, perhaps the most important of the group, is discussed in Chapter XII.

Formulas

11-2. Secret formulas for processes or for compounding products are often indispensable. If these formulas are owned by the corporation or if it has a contract involving the right to use them they become assets of the corporation, which, like other assets, it may record on its books at the amount expended to acquire them. Ordinarily it is not necessary to depreciate their book value.

An example may be given here of an erroneous method sometimes used by organizations in regard to such items. A corporation obtained the right to use a specific formula on a royalty basis — that is, the corporation agreed to pay the owner of the formula a stipulated amount for each unit of product manufactured according to the formula. These amounts were set up on the books as an asset under the heading "cost of formulas." As each period passed the amount of royalty paid during that period was added to this account. This was incorrect, as the amounts paid were expenses of the period in which they were incurred and they did not give to the corporation any rights other than those held previously. In other

words, these amounts did not create a right or an asset of the company. Instead, they represented payments for the rent or use of the formula and should have been treated as cost of product. No accumulating asset was acquired.

Formula rights may be acquired by an organization on the payment-and-royalty basis — that is, the organization may pay a specific sum for the right to use a formula and in addition may pay a royalty based on production. The original sum paid for the right may properly be capitalized, but the royalty should be treated as an expense of the period in which it is incurred.

If the formula is a secret one and the organization does not acquire the secret but only the service of the one who knows the secret, amounts paid to him should be treated as expense unless they give additional rights not otherwise owned, which may be capitalized. If a large amount is expended to acquire rights it would be conservative to provide an offsetting reserve. At any time death or accident may cause the secret to be lost and in such case the value would disappear with effects which might be disastrous to the business. Arrangements should be made in any such case for the full protection of the organization. For instance, the secret might be fully recorded, sealed and placed in the hands of a trust company to be delivered to the corporation on conditions specified in the agreement between the parties concerned. This would prevent the loss of the secret through the death or disability of one knowing it.

Patents

11-3. A patent is an exclusive privilege granted to an inventor to make and sell his invention for a certain number of years. Since this privilege is supposed to be granted by the government for the purpose of encouraging and promoting discovery, only nominal fees are demanded for this grant. The inventor frequently has to employ attorneys and is put to other expenses for drawings and patterns. He therefore has a right to list as an asset all costs which were necessary in order to obtain the privilege. Patent rights are transferable and the organization acquiring them may list them as assets for whatever amount it may pay for them in cash or its equivalent or the obligation to pay cash, which may be in the form of a true liability or of capital stock issued. Generally the largest item entering into the original cost of patents is the experimental work

required to perfect the article or process. These costs may legitimately be included in the amount at which the patent is recorded on the books of the inventor. (See ¶ 11-6.)

A patent in the United States at present is little more than an official certificate of registration of what purports to be the discovery or origin of the thing patented. Others may produce a similar thing and sell it without opposition by the government. The burden of fighting infringements lies with the holder of the patent, who must appeal to the courts for protection. As a rule a patent is of little value until its priority has been established by infringement suits. It is, therefore, considered proper to add the cost of such suits to the asset value of the patent rather than to treat it as current expense. The benefits of a suit usually accrue to future periods rather than to the periods in which the cost is incurred.

Appreciation of Patents

11-4. In the excitement of obtaining a new patent and in keeping with the high hopes of fortune it may represent and also with the apparently worthy desire of building up an asset, holders of patents sometimes write them up on their books at a value greatly in excess of cost. This is not in accord with sound accounting policy for balance-sheet purposes although for purpose of sale the capitalization of probable future earnings would ultimately be one of the factors to be considered. If the patents are appreciated — that is, are written up to a value in excess of the amount actually expended — it would result in a credit to an account which might be confused with profit. This might lead to disastrous consequences such as have followed the payment of dividends out of such appreciation.

To illustrate: If an organization has expended a total of $20,000 in perfecting a device and securing a patent, it may legitimately be recorded as an asset of that amount. However, if in enthusiasm it is decided that the patent is worth $100,000 and it should be so recorded, there would result a credit entry of $80,000 which might become confused with surplus, and a surplus account is always a temptation to a board of directors. Careful thought will make it clear that this $80,000 is not profit nor anything akin to profit and has no more real tangibility than the thinnest of thin air.

Depreciation of Patents

11-5. Since the exclusive privilege conferred by a patent expires in this country at the end of seventeen years, it is generally considered desirable to spread depreciation of a patent over that period of time — in other words, to transfer from the asset value to an expense account each year one seventeenth of the cost of the patent as carried on the books. Thus at the expiration of the patent the asset value and the reserve for depreciation would equal each other and the book value would be reduced to zero.

On the other hand, it is often held that operation of an exclusive right for a period of years builds up a goodwill equal at least to the patent value itself and that, therefore, the patent need not be written off. This is based on the theory that in seventeen years the organization will have built up such a reputation and such facilities for producing and marketing the patented product that any other organization attempting to produce it would be handicapped, and that the value thus created gives the organization an advantage even after the expiration of the patent equal at least to the asset value at which the patent was carried. There are probably cases in which this is strictly true, but in the absence of evidence in its favor it is much more conservative and desirable to depreciate the book value of the patent during the life of the grant.

Instead of depreciating for a period of seventeen years, the cost may be spread over the number of years remaining after the patented product has been brought to a profitable stage of development. If such a stage were not reached until the fourth year of the patent, the cost would be apportioned on a thirteen-year basis.

Experimental Expenses

11-6. Many organizations spend a great deal of money in experimental work, hoping to develop new processes or formulas or to better old ones. If these experiments prove successful the new discovery may legitimately be capitalized for the full amount of its cost. Such costs are usually carried under "experimental expenses" or a similar heading until the final result is determined. If experimenting be unsuccessful the total costs of such work should not be capitalized, but should be written off. The account "experimental expenses" in a balance-sheet indicates costs which may eventually be capitalized or may be written off as losses, depending

upon results. It is, therefore, an uncertain asset and is usually given little weight for credit purposes. (See ¶ 13-15.)

Trademarks

11-7. A trademark is a special distinguishing design, picture or device, by which certain products of a merchant or manufacturer may be readily identified or distinguished from the products or merchandise of others. To prevent the use of this trademark by anyone other than the owner, the latter usually registers it with the government.

Trademarks may become very valuable because of the goodwill associated with their use. They are therefore frequently merged with the item "goodwill" on the books of a company. If set up separately they should be valued only at cost, which usually is only a nominal amount.

Some organizations make a practice of charging to "trademarks" all or a part of the cost of the advertising used for the purpose of developing a demand for trademarked articles. Naturally the effect of this is to increase profits above what they would have been if the advertising outlay had been charged as expense. It is recognized in accountancy that the cost of bringing any service asset up to the proper condition and position to render service is a legitimate asset value at that moment, which must be apportioned to the later periods of use. Whether this theory can also be correctly applied to intangible assets, such as the value attaching to a trademark, is another question. All accountants admit that it may be done to a certain extent and that expenses incurred in the organization of a company may be carried as assets to be written off during the early years of operation. Some believe that the cost of developing a trademark name may be capitalized. If so, apparently this amount also should be written off during the early years against the profits resulting from the demand created by such advertising.

On the other hand, the true value of a trademark does not usually decrease from year to year, but rather, like goodwill, it should increase with the passing of time, and should not be depreciated. The more conservative accountants prefer to apply advertising expenses to the periods in which they are incurred unless they are abnormal in amount and in that event to carry them as a deferred charge to be written off as quickly as profits will allow and not at any time to add them to the permanent asset called "trademark." (See ¶ 13-1.)

Copyrights

11-8. A copyright is a grant by the government conferring exclusive rights to original compositions such as literature, music and products of art. The owner of copyrights may list them on his books as assets at cost. In most cases this amount is written off over the life of the copyright which in this country is twenty-eight years. Occasionally the value of a copyright based upon its royalties for a period of years is set up as an asset. This method is discussed under the subject "goodwill," ¶ 12-4. Most accountants deprecate this method of valuing copyrights for the balance-sheet. If it is used the offsetting credit entry should be to a reserve account, such as "reserve for appreciation of copyright," and this reserve must be transferred to profit during the life of the copyright, the amount so transferred being a partial offset to the annual depreciation of the copyright.

Franchises

11-9. The term "franchises" on the balance-sheet represents the asset value of some special right or privilege granted by a state or community to a private corporation, firm or individual. In return for this special right or privilege the granting power retains certain control over the operations, rates and policies of the company to which the franchise is granted. A city may grant to a corporation the exclusive right to operate cars on certain streets belonging to the municipality. It may grant to a corporation the exclusive privilege of supplying gas or electricity to the citizens or industries in the city. Governments may grant franchises giving the right to develop power from water falls or to develop other properties, the control of which lies with the granting government.

The rules of valuation which apply to other intangibles discussed in this chapter apply to franchises. There are times when it is desirable to set up a franchise at an appraised valuation. In such cases the entry would be offset by a corresponding credit under some explanatory designation such as "government grant." Public-service corporations to which such franchises are granted are usually under the control of public-service commissions which dictate how the accounts shall be kept. The rules so laid down may or may not be in accord with good accounting principles, but they must be followed by the controlled corporations.

CHAPTER XII

Goodwill

12-1. One of the well-recognized laws of physics is that stationary objects tend to remain stationary until some force is applied to move them, but once set in motion they tend to continue forever in a straight line. This continuing is only theoretical, for, practically, there are many things to stop this movement, which is known as momentum, and therefore force is required to keep physical objects in motion. However, this force is much less than the force required initially to overcome the static inertia. It is very much the same in business. It requires a great deal of expense to set a business in motion, but when the business has begun to roll along smoothly, it accumulates what might be called "momentum," and the expense or effort necessary to keep it in motion is not so great as that needed to start it. Therefore an organization desiring to enter certain activities sometimes prefers to buy a going business — that is, one which has already acquired momentum — and is willing to pay for such a business an amount in excess of the net book value of its assets.

In accounting this amount is termed "goodwill." It is that value more or less intangible and undefinable which causes any business to be considered worth more than the investment which it represents. Many attempts at definition have been made, and the definitions have varied greatly not only in their wording but in their intent. Lord Elton's definition made in an English court long ago was to the effect that goodwill is nothing more than the probability that the old customer will return to the old stand.

In those days trade was dependent largely on location and goodwill was presumed to be built up about that location. The classification of such a value as goodwill was upheld by the courts of that day. If people acquired the habit of dropping into a shop for their tobacco, they would probably continue that habit at least to some extent, even though the tobacco shop changed ownership. Presumably the purchaser of such a well-established stand would pay more for its possession than the mere stock and fixtures justified. This investment based upon a capitalization of the habit of the old customers was known as "goodwill."

12-2. Sometimes the reputation of the owner rather than the location is the cause of goodwill. For instance, a certain restaurant might become famous for the excellence of its service, a reputation which would probably draw not only the old customers but new ones who had been told of its qualities, even though it moved across the street or a few blocks away. Even in this case the location would play a part but the name would be a greater factor. The purchaser, therefore, would be more anxious to retain the name and the equipment than merely to obtain the location. There have been many cases in which large sums in excess of the actual value of the assets were paid for the right to continue the name of a famous restaurant. The purchaser in setting up the assets of his investment would list this amount quite properly under the name "goodwill." Nowadays, so far as most great businesses are concerned, location is a minor element. The name has become of increasing importance and bears directly on goodwill. There are two fundamental elements which must still apply to goodwill in order to justify its inclusion among the assets. These elements are well expressed by Dicksee when he states: "The only necessary elements appear to be these: a positive element, enabling the person who acquires it to represent himself as the successor to the business of the person from whom he acquired it; and a negative element entitling him to restrain the transferror of the goodwill from soliciting the old customers of the business which has been transferred."

This view of goodwill assumes a transfer in order to justify the setting up of goodwill as an asset and that is a view widely held by American accountants. The accounting rule to conform to this opinion is that the purchaser may list as an asset the amount which the goodwill costs him. This may be the result of an actual payment of value or the obligation to pay value whether in the form of a true liability or, according to the law of most states, by capital stock issued.

12-3. In addition to goodwill acquired because of a transfer, accountants recognize the right of a partnership to enter goodwill as an asset for the purpose of equalizing investments of the partners, provided this value is represented by a contribution by one or more partners. To illustrate: "A" may have built up a business whose net investment is $20,000. "B" desires to go into partnership with him and is willing to put in $25,000 for one-half interest. "A," therefore, is presumed to contribute assets worth $20,000 and goodwill

$5,000 which the partnership of "A" and "B" is justified in listing as an asset.

Some organizations, believing or alleging that they have built up goodwill which is salable, desire to write this item on their books without making a sale to anyone. Such anticipation of amounts which they think they might possibly obtain by sale is a violation of the principle of asset valuation which has been elaborated in this book and generally accepted in the business world.

12-4. There is a theory, which is widely accepted in some countries and has a certain following among the business men and accountants of America, that an organization may calculate the amount of goodwill by capitalizing at a certain rate the amount by which the net profits for a term of years exceed a given percentage of the net investment. It will be noted in this calculation that there are three arbitrary factors: first, the percentage used for capitalization; second, the period of time to be considered, and, third, the percentage of investment to be allowed as a deduction before capitalization.

To illustrate: Assume that an organization agrees upon 15%, five years, and 8%, respectively, for the three factors mentioned. If the average investment for five years is $100,000, 8% thereon gives $8,000 as a deduction from the average profit before capitalization. If the average profit for the five years has been $15,500 there is an excess of $7,500, which capitalized at 15% gives a value of $50,000 for the goodwill.

Such a calculation may be justified for purposes of determining an amount which a company might ask for its goodwill in case of sale but it does not offer any logical reason for adding $50,000 of goodwill to the assets for balance-sheet purposes. General accounting practice in America at the present time would not sanction such action. A balance-sheet containing such figures would indicate that the company had invested $50,000 in acquiring the element of goodwill. It is doubtful if the financial or credit standing would be helped in the slightest degree by any such entry if the actual facts were disclosed. If accountants adopted generally such a principle it would open a wide field for manipulation, and organizations would be tempted to compete with each other in building up a doubtful asset. Either goodwill set up on the books aids the credit standing of the firm or it does not. If it does not, why include it? If it does aid, why not make it as great as possible?

Suppose the above organization decided to use 7% instead of 8% and 12% instead of 15% — this would result in a capitalization of goodwill at $70,833.33. Or if 7% and 10% were used the goodwill would then appear to be worth $85,000. Evidently such a method cannot be adopted unless uniform percentages and periods are also adopted. Even then the results would be very questionable. Suppose that two companies had the same average investment and the same average income — their goodwill would be calculated as identical. In one the profits may have been continually decreasing during the five years, whereas in the other they may have been continually increasing. Who would say that their goodwill assets were of equal worth?

There is the constant temptation before business men and accountants to leave the conservative ways of determining asset value and to follow specious arguments along a thousand by-ways. Sometimes this is done in all good faith without looking far enough ahead to see that the path leads only to absurdity.

Purchase of a Group of Mixed Assets

12-5. One important element in valuing goodwill is frequently overlooked by both business men and accountants. It is the result of an erroneous idea, that the purchaser must carry into his books all tangible assets at the same book value as that at which they appear on the books of the seller. Illustration: Assume that Corporation "A" agrees to pay $1,000,000 for the plant and business of Corporation "B." The assets acquired appear as a net value on the books of Corporation "B" at that date as follows:

Accounts Receivable	$ 50,000
Notes Receivable	50,000
Inventories	200,000
Equipment	100,000
Land and Building	200,000
Total	$600,000

These assets might be brought on the books of Corporation "A" at the same figure and an additional asset called "goodwill" might be recorded at $400,000, thus making up the purchase price of $1,000,000. This might or might not be a true record of the pur-

chase as intended by the directors of Corporation "A." It may be considered as an acceptable rule that the purchaser of a group of mixed assets for a single aggregate price is entitled to distribute that aggregate sum over the assets purchased as he sees fit, subject to two restrictions: first, that in the distribution no accountancy principle be violated; and, second, that the sum total of the values assigned to the assets shall not exceed the aggregate purchase price.

Corporation "B" may have built up a valuable goodwill which would pass to Corporation "A," and this may have been the deciding factor in the purchase. If so, the entry quoted may have been correct. On the other hand some element other than goodwill may have made Corporation "A" feel justified in paying more than the book-value for the assets. For instance, the real estate may have been acquired many years before and may still be carried at its cost price, whereas it may now be worth three times the book-value to Corporation "A" and the latter may have felt justified in paying $600,000 for it. If so, Corporation "A" is entitled to record it on the books at that price. If the other assets are recorded as on the books of "B," this would exactly equal the purchase price and the element of goodwill would not appear as an asset purchased by Corporation "A."

12-6. The statement has sometimes been made that, if the purchaser pays more for a group of assets than their net value on the books of the seller, goodwill must be recorded to account for the difference. This is an erroneous statement. In the illustration above it might readily have been that Corporation "B" had no goodwill or having it, it might have been of no value to Corporation "A," as the latter might utilize the plant and equipment for an entirely different kind of work and not attempt to use name or product or any other element which had been recognized as goodwill of the old company. The sole reason for the purchase might have been to acquire the real estate because it was of special value to Corporation "A" for certain reasons.

Or, again, even if the directors of Corporation "A" consider goodwill as an element of the value they may not consider it worth $400,000. It may be that the equipment is of a type well adapted to "A's" needs and may be worth several hundred thousand dollars to "A," and it may have been depreciated on the books of "B" to a far greater extent than its efficiency justified. If so, Corporation

"A" may feel that of the purchase price, say, $200,000 or $300,000 may apply to the equipment, and the amount applicable to good-will is correspondingly reduced.

If the receivables are good and collectible, Corporation "A" should record them at their face value or at their face value less a small amount for possible loss in realization.

Great care must be exercised by Corporation "A" in deciding the amount at which the inventory shall be recorded. If it consists of articles that Corporation "A" is continually purchasing or producing and if it is of the same standard and in reasonable quantity, it would be advisable to record it on the books at the price which it would normally cost if acquired otherwise. If it is carried at a greater amount it will lessen the normal profits of the periods in which it is sold. If it is carried at a lower price it will increase the normal profits of the periods in which it is sold. In either case the profit and loss would be arbitrarily increased or diminished by a transaction which cannot be expected to be repeated period after period. Current profit or loss should not be allowed to fluctuate unnecessarily as the result of such transactions as this.

To illustrate: If Corporation "A" decided to bring inventory values on the books at $100,000 less than their current worth and added that $100,000 to some permanent asset, the profit of the ensuing periods in which the articles were sold would be increased by $100,000 and, as a result, the assets at the end of that period would stand at an inflated figure. This manipulation would show for such a period a result far more favorable than the facts. Since distribution of aggregate purchase price among mixed assets acquired is a more or less arbitrary affair on the part of the purchaser, it should never be utilized as an expedient for either inflating or deflating current profit-and-loss results.

The same reasoning must be applied to the valuing of such items as equipment, which will be depreciated during succeeding operating periods. If equipment is set up at too high a value it will result in an excess charge for depreciation to the following accounting periods, and if set up at too low a value it will result in a correspondingly low charge for depreciation in the ensuing periods. All these factors must be given careful consideration by the purchaser in determining the respective amounts to be assigned to the various groups of assets acquired for an aggregate price.

12-7. To summarize, the principles to be kept definitely in mind are:

First: the purchaser of a group of mixed assets for an agreed aggregate sum may distribute that sum to the assets acquired without regard to the value at which they were carried on the books of the seller. Under the laws of most states the board of directors has the right to apportion the values for the purchasing corporation.

Second: the total of the amounts assigned to acquired assets should not exceed the aggregate sum paid.

Third: the distribution should be such that the profit-and-loss results of the current and ensuing periods will be disturbed as little as possible.

Fourth: if the aggregate purchase price exceeds the proper value of the other assets acquired the difference may be recorded upon the books of the purchasing company as the value of goodwill acquired.

Appreciation of Goodwill

12-8. In the preceding chapter reference was made to the tendency of some organizations to increase book value of trade-marks as a result of expenditures for advertising. In like manner some companies add to the asset values of their goodwill accounts all or portions of their periodic costs of advertising and of promotion expense. This is done on the theory that the publicity brought about by these measures increases the goodwill. In many cases this is undeniably true. It is equally true, however, that this plan has been followed by organizations when there was little increase in the value of goodwill resulting from advertising effort. Instances could be cited in which the book value of goodwill showed a constant increase during periods immediately preceding bankruptcy or receivership. No capitalization of advertising costs should be approved by the accountant unless the increased asset value is unquestionable or unless any other treatment would work an injustice to anyone or present unfair records of operating results of various accounting periods.

It must be noted that whenever items are capitalized that would otherwise be charged to expense, the profits of the period are correspondingly increased. The apparent increase in profit is represented by an increased valuation of an intangible asset. This is

a condition that must always be watched with care as it is likely to represent an inflation both of profits and of asset value.

Depreciation of Goodwill

12-9. The question whether or not goodwill legitimately entered on the books need be depreciated or written off over a period of time is frequently discussed. Ordinarily it need not be depreciated, especially if the organization makes reasonable efforts to maintain its good name among its customers. However, there are organizations which have apparently depended upon a good name previously created rather than upon present service for success. In such cases the goodwill is doomed to early extinction and depreciation would be properly chargeable against the profits of the periods to take the place of some of the expense for service which should have been but was not rendered.

Since goodwill has little value in a financial statement for credit purposes, as bankers almost invariably eliminate it from consideration, many organizations which have built up sufficient surplus to justify it prefer to write off goodwill against surplus even though goodwill represents a true investment. The accountant does not insist upon this treatment nor does he discourage it unless it seems unwarranted.

Evidently it would not be desirable to write down the asset goodwill if a deficit would be created thereby or if such procedure would prevent the paying of ordinary dividends to stockholders. If the earnings of an organization are sufficient only to meet the regular demands for reserves and dividends that condition casts doubt upon the value of the goodwill and therefore would seem to justify reduction of the asset. However, in such circumstances there would be no excess profits and a reduction of asset value would involve impairment of capital. On the other hand, if earnings are sufficiently in excess of dividend demands to create an amount to offset a reduction of goodwill, that fact itself implies that the value of the goodwill is justified and that there is no reason for reducing it. To put it briefly, if you can write it down, you need not; if you cannot, you should! It is self evident that only in a profitable business can the element of goodwill be rightfully claimed to exist.

Position of Goodwill on Balance-sheet

12-10. If goodwill is listed among the assets of an organization it is usually shown as the last item in that group on the balance-

sheet. In balance-sheets prepared for credit purposes, however, the item is sometimes omitted from the asset side and is brought over to the other side as a deduction from the proprietorship or net worth. That method is suggested in the treatise on the preparation of balance-sheet statements issued by the Federal Reserve Board.

Goodwill in Consolidated Balance-sheets

12-11. Sometimes one organization instead of buying the assets of another buys a controlling interest in the capital stock of the latter. If the purchase price is in excess of the book value of the stock at date of purchase an element of goodwill is acquired. This will not appear on the balance-sheet of the purchasing corporation so long as the investment in the subsidiary is carried as a single asset, but it will appear on a consolidated balance-sheet merging the assets of the two corporations.

To illustrate: If Corporation "X" pays $140,000 for the capital stock of Corporation "Y" and at that date the books of Corporation "Y" show capital stock $100,000 and net surplus $25,000, an element of goodwill amounting to $15,000 is acquired by the purchase. So long as Corporation "X" carries this investment at $140,000 among its assets the element of goodwill is not manifest. In the case of consolidation, however, the actual assets and liabilities of Corporation "Y" are combined with the assets and the liabilities of Corporation "X." The net value of the assets so combined at that date amounts to $125,000. If these be substituted for the investment item of $140,000 there will result an apparent deficit of $15,000. It is contrary to accounting principles to create a deficit as a direct result of a purchase. Therefore, it is evident that on the consolidated balance-sheet an item of goodwill, $15,000, must be displayed to equalize the purchase price of $140,000. This is in strict conformity to the principles relative to the acquisition of goodwill discussed earlier in this chapter. The question is considered further in the chapter on consolidated balance-sheets. (See ¶ 21-5.)

CHAPTER XIII

Prepaid Expenses and Deferred Charges

13-1. In Chapter III the distinction between prepaid expenses and deferred charges was discussed and illustrated. (See ¶ 3–8.) Under "prepaid expenses" should be classified those items which represent service not yet received but for which settlement has been made. They represent in all cases legally enforceable claims for service. "Deferred charges," on the other hand, represent costs incurred and services already received, which are not charged to the periods when they were received, but instead are held as assets, even though they have no tangible existence nor any enforceable right at law. (See ¶ 3–8.)

A characteristic of the group known as "prepaid expenses" is that the period of prepayment is definite and the amount should be amortized over a period accurately determinable; whereas "deferred charges" include those costs which, if amortized at all, must be amortized upon a purely arbitrary basis.

13-2. Since the terms "deferred assets" and "deferred charges" are construed sometimes to include any item carried as an asset which is to be charged to the expense of subsequent periods, some accountants extend the designation to include tangible assets such as inventory, not only of materials and supplies, but also of merchandise. While it is permissible in condensed balance-sheets to reduce the assets to as few classifications as possible, it is not desirable in detailed balance-sheets. In the latter, assets should be classified as nearly as may be under group headings which display their essential characteristics. The more accurately these classifications are made the more worth while the information obtainable from study of a balance-sheet. Best accounting practice either limits the term "deferred assets" to such items as are intangible or, at the most, includes only such tangible assets as materials and supplies which are chargeable properly to expense accounts in subsequent periods and do not enter either directly or indirectly into sales. It should be noted that even when materials and supplies are included under deferred assets as mentioned above, this classification should not include the materials and supplies of a manu-

facturing organization which enter into the factory product and are properly chargeable to its cost.

The matter may be summarized by saying that deferred assets should not ordinarily include any tangible items which later find their way into the cost of goods produced or sold by the organization. Such tangibles are preferably carried under the balance-sheet heading "inventories." (See Chapter VII.)

13-3. Authorities differ greatly as to the position of these groups on the balance-sheet. Many accountants make no distinction between prepaid expenses and deferred charges but group all such items under the latter heading, which they usually place last on the asset side of the balance-sheet. In the case of items properly belonging under the head of deferred charges this seems to be the logical order, whether the balance-sheet follow the current arrangement or the capital arrangement discussed in Chapter I.

13-4. The logical position of prepaid expenses is next to current assets. Some accountants go further and include them in current assets. There is an advantage in limiting the term current assets to those which have a probability of conversion into cash within the current financing period or, say, within one year. As prepaid expenses are not to be converted directly into cash but rather into service, some authorities hold that they should appear next to rather than among the current assets. In the case of a manufacturing enterprise, however, it is evident that prepaid expenses, so far as they relate to manufacturing process, will be converted into product and thereafter into cash, like the raw materials or other inventory items of similar nature which are included among current assets. The distinction, therefore, seems to be one of individual choice, there being no serious objection to either method of treatment.

There are no definite rules as to the order in which the various items should be arranged under "prepaid expenses" or "deferred charges." It is left to the judgment of the one preparing the statement. The order of discussion followed in this chapter is not intended as a guide to proper arrangement upon the balance-sheet.

Prepaid Interest

13-5. If at the date of the balance-sheet interest has been prepaid by an organization, so much of it as applies to the use of money for periods subsequent to the balance-sheet date must be

determined and displayed on the balance-sheet. It is an asset representing the right to receive service in the form of the use of money. It is therefore properly classified as a prepaid expense. It must not however be confused with accrued interest, discussed in ¶ 6–15. Accrued interest represents a service that has been given by the organization, payment for which is receivable in the form of money. Prepaid interest represents money that has been paid by the organization for service yet to be received. Both items are assets but are very different in character.

Prepaid Rent

13-6. At the date of the balance-sheet any amount of rent which has been paid by the organization for periods subsequent to the date of the balance-sheet should be determined and the amount should appear on the balance-sheet under "prepaid expenses."

Prepaid Taxes

13-7. If taxes are paid in advance of the period to which they apply, they may be set up in an account with the heading "prepaid taxes" and the amount may be distributed to expense for the proper period. Care must be exercised, however, to see that no taxes are included save those which really are paid in advance of the periods to which they are chargeable. Such items are rare.

Unexpired Insurance

13-8. The account "unexpired insurance" represents the amount which has been paid as premiums on insurance providing future protection. When an insurance policy becomes effective, the premium thereon is debited to this account and represents a prepaid asset. The amount of the premium is distributed over the life of the policy on a pro-rata basis, that is, an equal amount is charged to the expense of each month during the life of the policy. The charge to expense is offset by a credit to the unexpired-insurance account, the balance of which is thus constantly reduced. It is eliminated of course at the expiration of the policy.

It is sometimes said that this asset in the balance-sheet should be carried at the amount which would be realized if the insurance policy were cancelled, which would always be an amount less than that obtained by the above method. The answer to this argument is that it is not the function of the balance-sheet to carry assets

at their realizable value. This matter is discussed in Chapter IV.

Unexpired-insurance account must be limited to the calculated values of the unexpired portions of insurance premiums and must not be offset by any liabilities because of other types of insurance. For instance, liability-insurance premiums accrued on the basis of payrolls should be set up in a distinct account, should appear among the liabilities and should not be used to reduce the amount of the asset appearing under the term "unexpired insurance."

Prepaid Expenses

13-9. Instead of displaying in detail prepaid items such as prepaid interest, prepaid salaries, etc., they may all appear under one heading, "prepaid expense" in the balance-sheet. The term has already been defined.

The rule that a liability and an asset must not be deducted the one from the other with the difference shown as a net amount on the balance-sheet is frequently violated in regard to prepaid expenses. Accountants find that many organizations carry one account for accrued interest, debiting it with accrued interest receivable and crediting it with accrued interest payable. The net balance of the account is shown on the balance-sheet as an asset or a liability, depending upon whether the account has a debit or a credit balance. This is a violation of the rule. Accrued interest receivable is an asset. Accrued interest payable is a liability. The same rule applies to all other prepaid items. Taxes paid in advance should not be deducted from any liability on account of taxes payable. A liability because of insurance payable must not be reduced for balance-sheet purposes by any amount representing unexpired insurance. The ratio of liabilities to assets is of great importance for credit and managerial purposes. It can be properly revealed only by including under each heading all the items that belong there. The ratio would be seriously distorted if assets were subtracted from liabilities or if liabilities were subtracted from assets and net amounts were shown. It is not a violation of this rule however to offset a receivable from a certain person or unit and a payable of the same kind to the same person or unit.

Discount on Bonds Issued

13-10. The difference between the face value of bonds issued and the proceeds received therefrom may be set up under the head-

ing "discount on bonds issued." This amount should be amortized during the remaining life of the bonds. The amount, if small, may be amortized by charging equal amounts to the periods involved or the more accurate principle of effective-interest rate may be made the basis of amortization.

Premium on Bonds Purchased

13-11. If bonds are purchased for an amount in excess of their face value or retirement value, this excess may be set up under the head "premium on bonds purchased" and be amortized in the period between the purchase and the maturity or retirement date. If the amount of this account be small it may be charged equally to the various accounting periods concerned. Otherwise it may be amortized on the basis of effective-interest rate.

Stores

13-12. The item "stores" among the assets of a balance-sheet usually indicates the amount of supplies on hand that are to be used in the ordinary course of business but are not to be converted into sales. In an office it may include stationery, printing and other items of a general character which will be converted into expense as they are consumed. In other cases, it may include items of larger amounts such as fuel, repair materials, etc. It should not include items held for purpose of sale, nor should it include items that are to be converted into commodities to be sold. If it be so used some qualifying words must be added, such as "stores of raw material" or "inventories." With such explanatory qualification the item has a totally different meaning and should be included among current assets.

The purpose of carrying an account such as "stores" is that items included in it may be charged as expense of the period in which they are used, rather than of the period in which they are purchased. When the supplies are acquired, the stores account is debited and the liability is credited. As the stores are used, proper expense accounts are debited and the stores account is credited. As a result a debit balance on the stores account measures the value of supplies acquired but not yet consumed. On the balance-sheet, such an item may be classified under "prepaid expenses."

Organization Expense

13-13. When any organization is formed, it is necessary to incur expenses before it reaches a revenue-producing condition. Apparently, this would result in an immediate deficit, unless the organization had sufficient paid-in surplus to cover it. However, it would not be good business policy to treat such costs in that way. Instead, it is an accounting fundamental quite generally recognized that a new organization need not report a deficit during its process of formation. Instead, all costs necessary to bring the business to a revenue-producing stage may properly be capitalized, that is, treated as assets, to be written off as expense during a reasonable time if desired. Such cost, commonly known as organization expense, or by some other name intended to indicate clearly its character, may properly be displayed upon the balance-sheet as an asset.

Whether or not organization expense should be later charged off — that is, apportioned to operating costs of subsequent periods — is open to doubt. Only a comparatively few years ago it was the custom to charge off organization expense during the first few years following the formation of a corporation. Now there is a tendency to consider that whatever it has cost to establish a corporation and to get it under way may justly be treated as an asset during the life of the corporation. However, if a corporation dissolves, this account having no further value would serve as a decrease of surplus. It is therefore proper to anticipate such reduction of surplus if no deficit is created thereby and if no rights of individuals are jeopardized.

Organization expense may include, not only various fees to officers, attorneys and accountants, but also the cost of original financing, such as the promotion and sale of capital stock. It should not include any costs other than those associated with organizing, establishing and financing the corporation. It should not include the costs of developing the business, nor of developing patents or processes, nor of sales promotion campaigns other than for capital stock or bonds. (See development expense, ¶ 13–14.)

Development Expense

13-14. Under "development expense" may appear those costs incurred by a concern in developing its business after organization. The development may consist of extensive advertising campaigns

for its products or of other forms of publicity but it should not include any costs chargeable to permanent tangible assets. "Development expense" should not be used to cover items properly chargeable to organization expense, discussed in ¶ 13-13. The latter applies to the costs of forming the organization, whereas development expense applies to the creation of a demand for the products or service or the developing of such intangible assets as formulas or trademarks.

Development expense may rightfully be written off against the operating income of periods subsequent to its incurrence, the number of such periods being a question for arbitrary decision by the management or by the accountants. It is not conservative to allow this account to be built up to too large an amount. It is always an asset of doubtful value except in most unusual circumstances and there is always danger that it will be over-stated rather than understated. It does not often rank high as an asset for credit purposes.

Experiment Cost

13-15. Many organizations conduct laboratories or other experimental departments for the purpose of developing or improving formulas or patents. Cost as incurred may properly be chargeable to the patents or formulas produced if they are successful. This question is discussed in Chapter XI. Much of such experimental work may not result in any successful product. All such costs therefore may be carried as a deferred charge until they can be transferred to a permanent asset account resulting from the work or until other disposition can be made of them. (See ¶ 11-6.)

Discount on Capital Stock, Original Issue

13-16. In some states original issues of capital stock with par value may be sold at a discount. Since the account representing par-value capital stock must always appear at the full amount of the par value, it is necessary to set up a separate account to represent the discount on such an issue. This item is sometimes merged with organization expense and is included in that account on the balance-sheet. Wherever carried, it is not an amount subject to depreciation — that is, it cannot be charged as an expense against profits. It can be written off against surplus direct, if that seems desirable. Some accountants record discount on capital stock as a deduction from the capital items in the balance-sheet. Ordinarily, however, it is displayed on the asset side among deferred charges.

Discount on Capital Stock, Re-issue

13-17. When capital stock has been re-acquired by the issuing organization, either for value received or as donation, it may be re-sold below par value. Such a discount should be kept distinct from discount on the original issue, as it is not an organization expense but an offset to the credit account set up when the issued stock was re-acquired. As an illustration: If stock with a par value of $100,000 is donated to a corporation by its stockholders, the entry may be:

Donated Stock	$100,000	
To Stock Donation		$100,000

If this stock be sold later to net $80,000 cash, the effect will be:

Cash	$80,000	
Discount on Donated Stock	20,000	
To Donated Stock		$100,000

This treatment eliminates the donated-stock account. The amount of the discount should then be carried to the stock-donation account, reducing the amount of that account to $80,000 which is the real measure of the donation.

Deferred Assets (On Balance-sheets of Railroads)

13-18. In the classification prescribed by the Interstate Commerce Commission the heading "deferred assets" is used to cover amounts advanced to agents or others as working funds, from which expenditures are to be made and reported, and amounts advanced to demurrage and other bureaus. It also includes funds raised and set aside for insurance, employees' pensions, savings, relief, hospitals and other similar purposes. Note that this use of the term "deferred assets" has no relation whatever to the term "deferred charges" as used by other commercial organizations.

Unadjusted Debits

13-19. "Unadjusted debits" is the name of an account appearing on the balance-sheets prescribed by the Interstate Commerce Commission. It is seldom used elsewhere. It is practically the equivalent of the prepaid-expenses and deferred-charges accounts discussed in this chapter. It includes expenses such as rents paid in advance, discount on capital stock, discount on funded debt and various items which are to be charged later against operating expenses.

CHAPTER XIV

Current Liabilities

14-1. In Chapter III the distinction between current liabilities and permanent or fixed liabilities was described and illustrated. The distinction depends largely upon length of time before maturity of the liability. There is very little uniformity in practice as to arrangement of the various items which come under the liability classification in the balance-sheet. Some accountants hold that the liabilities should be listed in the order of their legal priority as established by the various bankruptcy acts. Such an arrangement would place first any claims of the federal government, followed by claims of state governments, of other governmental subdivisions, claims of employees for salary and wages, secured creditors, unsecured creditors, etc. This order is desirable in preparing statements for receivership or in bankruptcy, but there seems to be no reason why it should be followed by organizations which are not facing such contingencies.

Many accountants attempt to arrange liabilities in the order of their security, placing those that are covered by specific mortgage at one end of the list and unsecured obligations at the other. This is a simple arrangement in the case of some liabilities, but it involves much uncertainty with regard to the proper position of others.

Some accountants attempt to tabulate liabilities in the general order of their probable liquidation, listing first items that are most apt to be paid first, such as current trade accounts, followed by items whose payment will probably be longer deferred, such as notes payable, and so on. Still others tabulate current liabilities in the order of their importance as to amount, putting first those items which are largest.

In the following discussion of items found under "current liabilities," no attempt is made to follow the order in which such items should logically appear on the balance-sheet.

Accounts Payable

14-2. Amounts which an organization owes as the result of purchases or of expenses incurred, and for which no promissory note or similar document has been given, may be classified as "accounts payable." As these payables frequently arise from a variety of sources, it may be desirable to classify them upon the balance-sheet. This is particularly true in regard to classes which might rank differently in case of insolvency.

Instead of grouping them under accounts payable, it is usually desirable to display expense payable items, such as for interest, for payroll, and for other expenses, under separate headings, as explained later.

There is some difference of opinion among accountants with regard to cash discounts on purchases. A few hold that since the term "accounts payable" is presumed to measure the amount of money needed to pay such liabilities, a deduction may be allowed for cash discounts which are certain to be taken. This is based upon the theory that if you reduce the accounts receivable because of expected discounts to be taken by customers, it is only logical to reduce the accounts payable in a similar way. If customers pay their accounts with sufficient promptness to take a discount, it will enable the organization to pay the accounts payable with sufficient promptness to deduct the purchase discount. On the other hand, if the customers do not pay promptly, they will not be entitled to their discounts and therefore more money will be collected from the accounts receivable than is indicated upon the balance-sheet, and this additional money will pay the additional amounts of the accounts payable caused by failure to deduct the purchase discounts. Such reasoning, however, is very faulty and opposed to the principle of conservatism. While it is true that the chief desire of the accountant is properly to express the values of all assets and liabilities, yet in case of doubt as to which of two values is correct, the rule of conservatism is to use the lower of the values for assets but the higher for liabilities. More progressive business methods regarding cash discounts are sometimes approved. These are discussed in Chapter XXIV.

In the preparation of a balance-sheet, great care must be exercised to see that everything is included in accounts payable which should be and that nothing is included which should not be. On the very date of the balance-sheet there may be a variety of

conditions. Merchandise may have been received but for some reason the invoice may not have been fully approved, and therefore no entry may have been made upon the books. If the merchandise has been accepted, it must be included in the inventory and the liability therefor must be included in the payables. On the other hand, accountants sometimes find invoices approved and recorded when the goods have not been received and therefore are not in the inventory. Such a condition will result in distorting the financial records unless proper adjustment is made. If title to the goods purchased has passed, the merchandise should be included in the inventory and the liability should be included in the payables, but if title has not passed to the organization the amount should not be included either in the inventory or in the payables.

If goods were ordered f. o. b. point of shipment and were delivered to the common carrier so that title had passed at the date of the balance-sheet, the amount should be included in the inventory and in the payables.

An error is sometimes made in regard to goods received on consignment. If goods are so received, but the consignor still has title to them, they should not be included in inventory nor should any liability be set up therefor unless the organization has committed itself to a liability for sale of the goods or under contract.

Briefly summarized, the principle is that any merchandise, title to which is in the hands of an organization, should be included in its inventory under a heading which will indicate its true status, and any obligation which has been incurred by the organization and is unsettled at the date of the balance-sheet should be displayed among the payables.

Accounts Payable Contracts
Purchase Contracts

14-3. Organizations sometimes enter into contracts for the future purchase of merchandise in order to take advantage of what they consider a favorable price or to insure prompt receipt of merchandise when needed, in case there is a scarcity in the market. Usually it is not necessary to enter anticipatory contracts in the balance-sheet as there should be no liability in such a case without a corresponding asset in the form of merchandise, and the asset should not be shown until title is obtained to the merchandise either by actual receipt or by constructive receipt. However,

there may be times when the price of merchandise under contract has dropped to such an extent that the merchandise when received will not be equal in balance-sheet value to the liability which will result. Under such conditions the balance-sheet should show a reserve set up to care for loss on purchases.

Purchase Commitments

14-4. During the period preceding a balance-sheet, an organization may have entered into contracts for the purchase of merchandise which it may not be able to fulfill. This inability may have resulted from such a drop in market price as to make the completion of the purchase contracts disastrous, or it may have resulted from some other inability. In such instances, the amount of definite liability because of these commitments must be displayed in the balance-sheet. If the contracts are of an optional character and can be cancelled without penalization no liability need be shown; but if there is a penalty indicated in the contract, or if in any other manner the amount of the liability is calculable, it constitutes a liability which should be displayed. Frequently this liability is the difference between the contract price and the market price of the date of the balance-sheet. If the amount can not be accurately computed, it should be estimated as nearly as possible, and the amount should be set up under the heading "estimated liability on purchase commitments" or "reserve for purchase commitments."

Warrants Payable

14-5. The term "warrants payable" is limited almost entirely to municipal accounting, and here its usage varies in different sections of the country. Ordinarily, it is the equivalent of vouchers payable, except that in the case of warrants payable authorization has been given by the proper municipal officer for payment of the vouchers. In other words, a city may use a voucher system, like any commercial house. When the proper officer of the city — who may be the treasurer, the comptroller or some other officer or group of officers — has authorized the payment for a particular voucher, a warrant is issued therefor, which immediately becomes a warrant payable until it is actually paid.

In some cities, however, the drawing of a warrant is considered the equivalent of the drawing of a cheque by a commercial house, and the cash funds in the general ledger are reduced immediately by the amount of warrants drawn. In such cases, unpaid warrants

would be the equivalent of outstanding cheques of a commercial house, and the item would not appear on the balance-sheet.

Accounts Payable in Foreign Moneys

14-6. When organizations import goods from other countries, a question frequently arises as to the amount at which the goods should be set upon the books and the amount which should be shown as a liability for them. This question is discussed under the head "inventories," ¶ 1-22. At this place, it is probably sufficient to say that liabilities of this nature may be carried on the balance-sheet at the amount which it would cost to settle them at the date of the balance-sheet. For instance, if a bill payable in London for £1,000 may be settled at any date, it may appear on the balance-sheet at the value of a £1,000 draft on the date of the balance-sheet. However, if the £1,000 is not due for ninety days after the date of the balance-sheet, it may properly be set up at the cost on the date of the balance-sheet of a ninety-day draft for £1,000. This will be less than the cost of a sight draft for the same amount, unless unusual conditions offset the ordinary consideration of interest in the calculation of long-tenor drafts.

Vouchers Payable

14-7. Business firms which use the voucher system for recording current liabilities frequently dispense with accounts-payable ledgers. On the general ledger, an account, usually known as "vouchers payable," "unpaid vouchers" or "audited vouchers," is credited periodically with the total of all items approved for current payment and is debited with all payments or other settlements made. As a result, the balance always equals the amount of items on the books which remain unpaid. The detail is represented by individual documents known as vouchers, one for each liability, to which are attached all papers validating the obligation.

In passing, it may be well to call attention to the purpose of the voucher system. Business men sometimes have the idea that its purpose is only to eliminate the accounts-payable ledger. It is true that this result is often accomplished by use of the voucher system, but that is not by any means the primary purpose. The purpose of the system is to bring together into one place, in a form convenient for handling, all of the evidences of liability. These include evidences of the fact that the goods or services were

ordered; that they were received; that the qualities and the prices are acceptable; that the quantities and the mechanical calculations are correct. These documents may be copies of purchase request, copies of purchase order, copies of receiving tickets, the bills of lading, receipts of stockkeeper, O.K. of purchasing agent and of other parties concerned and of clerks who have verified extensions and footings.

The voucher with its attached papers may supply all or any part of this evidence, and additional information may be given. Such data could not be advantageously recorded in an accounts-payable ledger. The voucher may also show terms, date of payment, and may have attached to it the cheque used in payment or a copy of the cheque. The system provides a complete history of a transaction in convenient form for filing and reference.

On the balance-sheet, the term "vouchers payable" or any of its equivalents presumably takes the place of the term "accounts payable."

Notes Payable
Bills Payable

14-8. Negotiable instruments of a promissory nature signed by an organization should be carried upon its records as "notes payable" until they are liquidated. If the notes are of a particular nature involving liens upon specific assets they should be carried in an account which clearly indicates the facts. To illustrate: Serial notes for the purchase of equipment will be carried as "equipment notes payable." Notes supported by mortgage on certain properties should be carried under the head "mortgage payable."

Generally speaking, the term "notes payable" indicates notes signed by the organization on whose balance-sheet they appear but not involving specific liens on any property. As liabilities they evidently rank second to all specific liens so far as the enforcement of payment is concerned. The amount appearing under the heading should be the face value of the notes — that is, the principal sum expressed therein. Interest which may accrue upon such notes should be carried in a distinct account, not merged with the notes themselves.

Some organizations include in notes payable their acceptances payable and also the amounts of any notes receivable which they may have discounted. It is a better practice, however, to separate

these classes of liabilities, especially notes receivable discounted. Whether the term be "notes payable" or "bills payable" is purely a question of choice, not of principle. In America, the word "notes" is gradually superseding the word "bills." Consistency naturally dictates that whichever term is used for the receivables upon a balance-sheet will also be applied to the payables.

Acceptances Payable

14-9. The use of acceptances instead of open accounts is a method of finance which has much to recommend it. By this method, instead of merely charging the purchaser in the accounts and carrying the item as an account receivable, the seller requests the purchaser to sign an instrument known as an "acceptance." By his endorsement upon this instrument, the purchaser formally accepts the obligation of settling the account at the date stipulated, which is usually a certain number of days after sight or acceptance.

The seller should carry such items as "acceptances receivable." They are worth more to him than the open account would be, because they may be converted more readily into cash. He may discount them at a bank on approximately the same terms as those on which notes receivable would be discounted. Since the document itself states that it is a settlement of a trade transaction, it is frequently given preference in re-discounting. The use of acceptances enables selling organizations to carry on larger operations with the same working capital. The purchaser who has signed the acceptance should make a record of the amount and the due date, carrying these amounts under the head "acceptances payable." They should not be allowed to appear as accounts payable, which ordinarily do not have to be met at a particular date. An acceptance has a definite maturity date, like a note payable, and is a negotiable instrument. To fail to pay an acceptance at its due date would affect more or less seriously the credit standing of any organization.

Notes Receivable Discounted

14-10. Instead of giving their own original notes to a bank for loans, organizations frequently endorse notes receivable which they are holding, and the bank allows them to anticipate the payment of such notes. To illustrate: Assume that Corporation "A"

is the payee of a note for $1,000 signed by "B" and bearing, say, 8% interest for three months. When this note matures, the amount due to Corporation "A" will be $1,020. If the corporation desires the money in advance of that due date, it may endorse the note and present it to the bank, which will credit the corporation's account with $1,020, less the bank discount for the number of days between the date of discount and the date of maturity. Corporation "A" at the date of discount will not make an entry on the notes-receivable account, but instead will set up a credit for $1,000 to an account called "notes receivable discounted." The $20 and the bank discount will be offsetting entries affecting the element of interest.

At times organizations credit discounted notes to the notes-receivable account instead of setting up the account "notes receivable discounted." This is on the assumption that they have sold assets to the bank and that there is no liability resulting. This is incorrect, however, for if the signer of the note does not pay the bank at maturity, the bank will look to the endorser for payment, and the liability will have to be met as if the note had been an original note payable given by the endorser. The true state of the case may be indicated by continuing the above illustration:

After discounting the note, Corporation "A" owes the bank $1,000 and accrued interest. This liability appears under the head "notes receivable discounted." Offsetting this, Corporation "A" has an asset in the form of a note receivable from "B." If "B" pays the note at maturity, Corporation "A" is relieved of liability and has no longer any interest in the note receivable. Therefore, Corporation "A" at that time should remove the $1,000 from both the notes-receivable and the notes-receivable-discounted accounts.

The notes-receivable-discounted account therefore should always equal the face value of the notes which have been endorsed by the organization and have not yet been paid by the signers.

Accommodation Paper

14-11. When a business organization endorses a note which has not been received in the ordinary course of trade but is endorsed purely to aid the credit standing of some other party this transaction does not always appear on the balance-sheet or other records of the endorsing company. However, it is an item which

may have an effect upon the financial standing of the concern, which may be called upon to pay if the paper is dishonored by its maker. If the existence of such paper is known to the maker of the balance-sheet it should appear at least as a footnote thereon. If placed among the actual balance-sheet classifications it should be recorded upon both asset and liability sides in equal amount as it embraces a contingent asset consequent upon a contingent liability — that is, if the endorsing company is called upon to pay, that fact gives it a right to collect a similar amount from the person accommodated. As such paper does not owe its existence to a transaction in the ordinary course of business bankers and accountants frown upon it, and its existence reduces the credit standing of the endorsing company because a liability which may become real is offset by an asset of doubtful worth. A paper which has been dishonored by its maker is of questionable asset value to the endorser who has redeemed it.

Accrued Liabilities

14-12. There are liabilities which increase in amount from day to day without the occurrence of any specific transaction or as a result of transactions chiefly affecting other things. For instance, interest upon promissory notes accumulates merely with the passing of time. Commissions may accumulate as the result of sales or other primary transactions. At the date of a balance-sheet such accrued items should be accurately determined and displayed under suitable terms. It is not necessary to use a sub-title under liabilities specifically for such items. Rather the accounts representing them should be displayed under current liabilities, unless they are of a nature which does not permit such classification. The names used should indicate the character of the liability, as for example "accrued interest" or "interest payable," "accrued taxes," "accrued payroll," etc.

Bond Interest Accrued

14-13. The item "bond interest accrued" on a balance-sheet represents the amount of interest upon all outstanding bond issues accrued up to and including the date of the balance-sheet, whether paid directly by the corporation or to be paid through a trustee or other agent. For example, in the case of a bond issue having interest coupons payable January 1st and July 1st, a balance-

sheet as at December 31st would show under the head "bond interest accrued" the total interest upon the bonds outstanding which would be due and payable the following day, that is January 1st. In other words, it would be the total of six months' interest upon the bonds outstanding for that period of time together with interest for fractional periods upon any bonds issued during the six months' period. When bonds are not coupon-bearing, cheques for the interest are usually drawn the last day of the period in which the interest accrues. Such cheques debited to the accrued-interest account will eliminate it, and no such item will appear upon the balance-sheet prepared at that date. Coupon bonds are usually made payable at some designated depository. Prior to their presentation a deposit is to be made sufficient to meet all coupon requirements at date of maturity. Therefore, on December 31st all interest due on coupons maturing January 1st would appear as a liability. And on the asset side of the balance-sheet would appear the deposit for exactly the same amount. Some accountants prefer to offset one of these items against the other so that neither the asset nor the liability appears on the balance-sheet. However, to show both the asset and the liability gives a true presentation of the facts. At December 31st the coupons are still unpaid and are therefore liabilities of the corporation. The deposit is at that moment an asset of the corporation, even though upon the following business day the coupons will actually be redeemed by this asset.

In the case of bonds maturing at a date other than that of the balance-sheet, all interest upon outstanding bonds accruing from the last interest payment must be determined and set up as a liability under "bond interest accrued."

Matured Interest Coupons Unpaid

14-14. The account on the balance-sheet which represents the total of interest coupons past due but not presented for payment is headed "matured interest coupons unpaid." As payment for coupons can not be made until they are presented by holders the organization can not liquidate this liability of its own accord. Usually this account in the balance-sheet is offset by an asset account of the same amount representing funds deposited for the purpose of redeeming the coupons.

Corporations use either one of two methods for handling matured coupons. By the first method, when a coupon matures, interest as an expense is debited and accrued interest payable is credited. If payment is made through a disbursing agent a cheque is drawn to the agent for the full amount of coupons maturing. This is debited to accrued interest payable and credited to cash. There remains upon the records of the corporation no account showing whether or not the disbursing agent has paid all of such funds to coupon holders.

By the second method, the value of maturing coupons is credited to an account called "matured interest coupons." When payment is made to a disbursing agent, an account, such as "deposit covering matured interest coupons," is debited, and cash is credited. After the paid coupons are received from the disbursing agent, credit is given to the account representing the deposit and "matured interest coupons" is debited. By this method the value of coupons unpaid appears as a credit balance on the balance-sheet, and the amount still in the hands of the disbursing agent appears as an offsetting debit among the assets.

Royalties Payable

14-15. A royalty is a sum paid for the use, either exclusive or limited, of some patented or copyrighted process, machine, article or production, or for the right to the products of oil or gas lands, mines or timber lands.

A company which agrees to pay royalty may periodically set up its liability and offset it as payments are made to the owner of the patent or copyright or land. Any credit balance in this account represents the accrued liability.

Dividends Payable

14-16. When a dividend has been declared by formal action of the board of directors of a corporation, the amount of the dividend should be set up as a liability under the head "dividend on preferred stock payable January 15, 1923," or similar descriptive heading. In the balance-sheet such an item would be classed as a current liability. Dividends which have not been declared should not be set up as liabilities.

It is apparent that many men, even business men, think that a preferred-stock dividend which is of a cumulative nature constitutes a true liability in itself, without action by the board of direct-

ors. This is not true. A cumulative dividend which has been passed does not constitute a liability and should not appear under the head "dividends payable" until it has been formally voted by the board of directors. It may, however, be mentioned on the balance-sheet either in footnote or otherwise, so that people studying the balance-sheet will know that there are dividends upon preferred stock which must be paid before dividends can be declared upon the common stock. Such notations, however, do not affect the amount of the liabilities on the balance-sheet.

Guaranteed Dividends

14-17. A corporation can not guarantee dividends upon its own stock. To attempt to guarantee such dividends would be futile, as dividends can not be legally declared unless sufficient available net profits or surplus has been accumulated from which they may be paid. A corporation attempting to guarantee its own dividends would be equivalent to guaranteeing that it will make a profit of a certain amount — which, of course, would be absurd.

However, one corporation may guarantee dividends upon the stock of another corporation. In that case the dividends would become a true liability of the guaranteeing company if they were not paid by the company whose dividends were so guaranteed. Illustration: The "X" Railway in absorbing the "Y" Railroad guaranteed dividends at a stipulated rate upon certain stock of the "Y" Railroad. On a balance-sheet of the "X" Railway at the expiration of a year in which the "Y" Railroad had not earned sufficient to pay the stipulated dividend, it would be proper to set up the amount among the liabilities under the designation "dividends guaranteed upon stock of 'Y' Railroad."

Customers' Accounts

14-18. The term "customers' accounts" on the books of stock-brokers has a significance slightly different from that understood by other commercial organizations. As used in trading concerns "customers' accounts" merely means accounts receivable — that is, amounts due from customers. In the case of stock-brokers, however, these accounts include two distinct classes, "long" accounts and "short" accounts.

Long accounts are those with customers who have purchased securities on margin, the broker still holding the securities. The

value of such securities, displayed on the liability side of the broker's balance-sheet, less the balance upon the long accounts, gives an amount representing the "customers' margins" which is carried out into the liability column. Short accounts are those with customers who have sold securities in advance of their purchase, the broker being protected by a margin advanced by the customer. The excess of the balance upon a "short" customer's account over the value of the securities which he must purchase indicates the amount of his margin. As the broker is liable for both the securities and the margin, the total of the balances upon the short customers' accounts should appear as a liability upon the books of the broker. It may be displayed as the sum of two items, one being the market value of the securities concerned and the other being the customers' margins.

Bank Overdrafts

14-19. Bank overdrafts sometimes appear on the balance-sheet of organizations, even though the bank's books at the given date would not show such an overdraft by the organization. This difference is due to cheques drawn by the organization against the bank account before the date of the balance-sheet, which have not reached the bank at that date.

If the organization has a number of bank accounts, it is correct for the balance-sheet to display a single net total. In other words, asset balances in certain banks may be reduced by overdrafts on other banks, and the net asset total may be shown. However, if the net result is an overdraft, it must be displayed among the liabilities and should rank first in the current group. To illustrate: The "X" Manufacturing Company on December 31, 1922, might have the following balances on its accounts with banks:

First National Bank	Debit Balance . .	$20,000
Second National Bank	Overdraft	5,000
Importers & Traders Bank	Debit Balance . .	10,000

This might very properly appear on the asset side of the balance-sheet under current assets as

Cash in Bank $25,000

It would not be necessary to display the $30,000 on the asset side and the $5,000 on the liability side, as a cheque from one bank to

the Second National for $5,000 would reduce the total to a debit balance of $25,000. This is, apparently, an exception to the rule that a liability must not be deducted from an asset and a net amount be shown unless both the asset and the liability attach to the same party. The purpose back of the rule is that assets are subject to shrinkage, whereas liabilities are not, and to make such a display would distort the ratio between assets and liabilities. That reasoning scarcely applies to the subject of this paragraph, as the asset "cash in bank" is not ordinarily subject to shrinkage, and it is considered conservative to deduct the overdraft at once from the cash in other banks rather than to display it among the liabilities.

Unfunded Debt

14-20. In the balance-sheets of public service corporations the term "unfunded debt" is sometimes used as the equivalent of current liabilities. It is a group name and the various classes of payables, accruals, etc., are classified under it.

CHAPTER XV

FUNDED OR LONG-TIME LIABILITIES

15-1. Funded or long-time liabilities are frequently referred to as "permanent liabilities," "fixed liabilities" or "capital liabilities." (See ¶ 3–12.) These terms embrace liabilities which do not mature during the current financial period and those which, because of their character, are presumed to be readily renewable. It is evident that for the protection of creditors such liabilities must be represented by more formal documents than would be necessary for liabilities of a current nature.

Since some of the obligations in this class do not mature for many years after the date of their incurrence it is desirable that documents representing such obligations should be specific as to all terms, method of payment, both of principal and of interest, and protection that is offered to creditors. This is especially true of corporations or other organizations in which individual liability is limited.

The financial condition of the borrowing company may change greatly during the life of the obligation. Therefore to avoid dissipation of assets prior to the maturity of such obligations the creditors are usually safeguarded by a lien upon certain definite assets of which no disposition can be made by the organization without giving recognition to the claims of the creditors.

To avoid any dispute which might result from changes in official personnel before the maturity of the obligations, documents in evidence of long-term liabilities of corporations usually bear the corporate seals.

Selling of a bond issue for cash is the equivalent of borrowing that amount of money and giving the bonds as evidence of the loan and as promise of repayment. However, as a bond issue is generally for a large sum of money it nearly always involves borrowing from a great number of people. If a corporation desires to borrow $1,000,000 it may be difficult to find an individual or an organization that will lend that sum, but there may be two hundred people who will lend $5,000 each or one thousand people who will lend $1,000 each. The bond issue, therefore, instead of being a single

note, is made up of a series of notes identical in all essential terms and characteristics, each being given a distinct number for purposes of record and of identification.

Each lender will have to be protected, and if a mortgage be demanded to protect the loan, no one creditor should be given preference over any other. Therefore a blanket mortgage will have to be prepared to safeguard equally the rights of all lenders — that is, bondholders of this particular issue. An impartial third party, known as a trustee, must be appointed who will hold the mortgage for the benefit of all persons interested. The contract should be such that the corporation can not dispose of the mortgaged property until all the claims protected thereby have been settled by the corporation. In order that a bond may be protected under such a contract it must be registered by the trustee, who keeps a record of all registrations and will not release the mortgage until all obligations of the corporation so registered have been liquidated and proper proof of such liquidation has been presented to him.

To summarize: A long-time obligation of an individual or of a partnership is usually in the form of a mortgage or a bond and mortgage. Long-time obligations of corporations are in the form of mortgages or of promissory documents, such as long-time notes or bonds, issued in series, usually under seal and secured by mortgages and bearing on their face detailed stipulations as to terms. Some specific types of documents of this class are discussed below.

Mortgages Payable

15-2. Mortgages are obligations constituting specific liens upon real estate or upon personal property. Until these obligations are paid they must appear among the liabilities of the individual or organization owning the property so mortgaged. The property must be displayed at proper value among the assets. Some men in business subtract the amount of the mortgage from the value of the land upon the asset side of the balance-sheet, carrying only the net equity into the total column. Such a display does not correctly present the facts. It must be kept in mind that if the mortgage is signed by the individual or organization it constitutes a general lien as well as a specific lien. In other words, if under foreclosure proceedings the property specifically mortgaged fails to realize a sufficient amount to liquidate the mortgage any balance remaining unpaid on the mortgage would constitute a lien against the other

assets of the individual or organization. In addition to this fact, if the mortgage is not included among the liabilities, notice is not given that it will be necessary to meet the amount of this mortgage and that interest upon the mortgage must also be taken into consideration. These are vital facts which the liabilities shown on the balance-sheet must reveal. A fundamental principle of accountancy frequently repeated in this book is that a liability must not be deducted from an asset and the net amount be shown on the balance-sheet. Such a display fails to disclose the proper relation between total assets and total liabilities.

If the organization has acquired only an equity in the land without assuming a previously existing mortgage it is then permissible to display the item by showing the amount of the mortgage as a deduction from the cost of the property, extending the net difference or equity as an asset. This may only be done where the organization making such display is not liable for the amount of the mortgage.

In nearly all states mortgages may be placed upon personal property as well as on real estate. These are called "chattel mortgages," and as they are almost always of short duration or are payable on demand they are classed among the current liabilities.

The term mortgage appears more frequently on the balance-sheets of sole proprietors or of partnerships than on those of corporations. In case of corporations if a mortgage exists at all it will nearly always be associated with a bond issue and will appear under that designation on the balance-sheet. In certain states the term "bond and mortgage" is used instead of "mortgage." The term bond so used is entirely different in significance from bond issues discussed later in this chapter.

BONDS

15-3. The word "bond" has many different usages in law and business. As used in the balance-sheet it is limited to a certain type of document which is in the nature of a promissory note but usually has certain additional characteristics. It is generally issued in series, is protected by lien on certain properties, is usually under seal, does not mature for a number of years from date of issue, and is formal and complete in its expression of terms. The reasons for these various characteristics have been discussed in preceding paragraphs.

Bond issues are ordinarily authorized for an even amount, such as $200,000, $500,000, $1,000,000. The issue consists of a number of bonds of the same class, identical as to date, rate of interest, interest maturity, principal maturity, terms and denomination. A bond issue, however, may contain two or more series, usually identical in all particulars except face value. For instance, one series may have a face value of $1,000 each, another of $500 each and another of $100 each, the three series making up the one bond issue.

People often assume that the term "bond" used in the balance-sheets of various corporations always signifies the same form of security. There are many classes of bonds differing greatly from each other, ranging all the way from bond issues that are no more than series of glorified promissory notes up to bond issues protected by direct lien on all assets of the corporation. Some bonds are protected by sinking funds; some are not. Some that are so protected contain provisions that sinking funds shall be placed periodically in the hands of a third party known as a trustee; in other cases sinking funds may continue under the control of the corporations. These facts must be kept in mind when preparing a balance-sheet so that factors which vitally affect the rights of bondholders may be shown. When it is difficult to display these facts on the balance-sheet proper they may be disclosed by comments accompanying the balance-sheet.

Whether a bond issue is registered or coupon-bearing is not of vital importance in a balance-sheet, but it is quite important to indicate an income bond or a debenture by specific wording. The name in the balance-sheet may also indicate the maturity date, the interest rate and perhaps other characteristics as for example "Bonds, General Mortgage 5's of 1930." Most bonds provide that if the interest is not paid at the due dates the whole issue becomes due and payable. Protection by mortgage usually applies not only to the face of the bond but to the interest as well.

15-4. Mere authorization of a bond issue does not justify an entry on the financial records. However, as soon as bonds are duly signed and sealed by the corporation, even though they have not yet been delivered to any purchaser, they may be set up on the books of the company, the bond issue being credited and an account called "unsold bonds" debited. This is for the purpose of fixing responsibility upon the treasurer.

In the balance-sheet, unsold bonds would be shown as a deduction from the bond issue. The net amount would indicate the face value of the bonds outstanding in the hands of creditors. To illustrate: A bond issue for $1,000,000 might have been authorized, of which, say, one-half has been signed, sealed and delivered to purchasers, and an additional $50,000 may have been signed and sealed but not yet delivered. On the balance-sheet this should appear as follows:

Bonds issued (authorized $1,000,000) . . .	$550,000	
Less: held in treasury	50,000	
Bonds outstanding		$500,000

After bonds are issued and delivered they may at times be re-acquired by the corporation without cancellation. When so re-acquired they are debited to treasury bonds. This account appears as a debit on the trial balance and is sometimes carried into the balance-sheet as an asset. This is incorrect treatment. (See Treasury Bonds, ¶ 8–12.) It should be deducted from the bonds issued, showing a net amount outstanding. Re-acquirement of bonds is in reality a liquidation of a certain amount of indebtedness, and this reduction of indebtedness should be made evident on the liability side of the balance-sheet. It is true that the bonds may be resold but that would be no more than incurring a new liability. When that time comes it will be soon enough to set up the new asset received and display the resulting liability. To argue otherwise is equivalent to saying that a payment to a creditor should not be deducted from the liability because one might borrow from him again.

15-5. There are many categories of bonds the names of which relate to the protection offered to the bondholders, such as debenture bonds, mortgage bonds, collateral-trust bonds, sinking-fund bonds and guaranteed bonds. Other names refer to the method of evidencing ownership, such as registered bonds or bearer bonds. Still others refer to unusual characteristics, such as income bonds and profit-sharing bonds. These classes are discussed below.

Debenture Bonds

15-6. Debenture bonds as the term is used in America are not secured by a mortgage upon any particular property or group of

assets. They may contain all the other elements common to bonds, such as issuance in series; they may be registered or bearer bonds, and very formal in appearance; but they are only a sort of notes payable "de luxe." As a rule they rank no higher than other notes payable.

Mortgage Bonds

15-7. Mortgage bonds are protected by mortgage upon specific property. They take precedence over other types of obligations excepting those given priority by statute, such as debts due to governments, etc. The mortgage protecting the bond issue may be upon all the assets of the corporation or it may be upon some assets only. A corporation may authorize more than one issue of bonds protected by mortgage upon the same property. In such a case the earlier issue will be known as first-mortgage bonds, a later issue second-mortgage bonds. If first-mortgage bonds be redeemed the issue that has been second-mortgage bonds automatically becomes a first-mortgage bond issue. Frequently the phrase "junior bond issue" is applied to second-mortgage bonds, indicating that the bonds are junior in rank or secondary to another issue frequently referred to as the "underlying" issue.

Collateral-trust Bonds

15-8. Collateral-trust bonds are secured by specific collateral in the form of securities and notes signed by parties other than the corporation issuing the collateral-trust bonds. The value of this protection evidently depends upon the character of the collateral security.

Sinking-fund Bonds

15-9. Bond issues are usually large in amount and the complete issue usually matures at a given date. It is essential to the protection of the bondholders that the corporation shall be able to redeem in cash the complete issue at the date of its maturity. To accomplish this, corporations generally set aside each year during the life of the bonds cash or assets of an equivalent nature so that the total will equal the amount of the bond issue at the required date. Such assets constitute a sinking fund. (See ¶ 8-16.) In order that this may be obligatory upon a corporation, bonds often contain a clause stipulating the amount which must be added an-

nually to the sinking fund and the conditions governing the fund. Bonds with such provisions may be known as "sinking-fund bonds." (See discussion of Sinking Funds, Chapter VIII.)

Serial Redemption Bonds

15-10. A bond issue, instead of maturing in entirety at one date, may be issued in series maturing at different dates. For instance, a bond issue of $300,000, running a maximum of twenty years might be divided into fifteen series. The first series might mature at the end of the sixth year, the second at the end of the seventh year, and so on, the last series maturing at the end of the twentieth year. In such a case, instead of setting up a sinking fund each year for the ultimate redemption of the bond issue, fixed numbers of bonds are actually redeemed year by year. The serial plan of bond redemption offers some advantages over the sinking-fund plan to the issuing corporation. Under the latter plan it is seldom that the sinking fund set aside annually can earn an interest rate as great as that paid upon the outstanding bonds, unless these bonds themselves are acquired as a part of the sinking fund. (See ¶ 8–18.) It is seldom that a sufficient number of such bonds can be acquired without paying a premium.

In case of serial redemption bonds each issue stipulates the date when it may be re-acquired at par or at a fixed premium, almost always moderate in amount.

Gold Bonds

15-11. Any bond which stipulates within the body of its contract that it is redeemable in gold coin may be referred to as a gold bond. The term, however, is not frequently used. Such a bond is not in a class distinct from others. The gold redemption clause may be inserted in any type of bond already discussed.

Convertible Bonds

15-12. Convertible bonds contain provisions whereby they may be exchanged in certain circumstances for other securities of the issuing corporation or of some affiliated corporation. Such bonds do not necessarily constitute an issue separate from other bonds described. The convertible privilege may be added to any type of bond.

Guaranteed Bonds

15-13. Guaranteed bonds are those issued by one corporation but guaranteed as to payment of principal or interest or both by another organization.

Registered Bonds

15-14. Proof of the ownership of a bond, that is, evidence of the right to receive interest when due, and at maturity date the face value or redemption value of the bond, may be accomplished by having the name of the owner registered on the books of the issuing corporation or of some agent thereof, or such evidence may lie in the mere possession and presentation of the bond itself.

Registered bonds are recorded in the name of the owner either on the books of the issuing corporation or on records kept for that purpose by an agent of the corporation known as the "registrar" of the bonds. When ownership of such a bond is transferred the bond is sent to the corporation or to the registrar for cancellation. In its stead a new bond, identical in all particulars save as to number and name of owner, is issued and the name and address of the new owner are duly registered. A bond may be registered as to principal only or it may be registered as to both principal and interest. In the latter case cheques for the amount of interest due to each registered holder are sent by the corporation at interest dates to the persons whose names and addresses appear upon the records. If bonds are registered as to principal only they will be issued with interest coupons attached. Cheques for interest are not sent to holders of such bonds, but the interest is paid either by the corporation or by the disbursing agent upon presentation of the interest coupons at the proper interest dates.

Coupon-bearer Bonds

15-15. Coupon-bearer bonds may pass from one owner to another without record of any change of ownership on the books of the corporation issuing the bonds. Possession of the bond or of the coupon is presumed to be evidence of ownership. Interest on coupon-bearer bonds is payable upon presentation (at the proper dates) of the interest coupons attached to the bonds at date of issuance. On the face of each coupon is printed the number of the bond to which it is attached, the amount of the interest, the date when payable and the name and address of the disbursing agent.

Usually the coupon contains within itself all the essential elements of a promissory note and is a negotiable instrument.

15-16. Classification of bonds as registered or as bearer has no effect upon the other characteristics that have been discussed. In other words, registered bonds and coupon bonds are not classes distinct from the other kinds of bonds which have been mentioned in this chapter. A mortgage bond may be in registered or coupon form — the distinction does not affect the mortgage characteristic in any sense. Bond indentures often provide that bonds may be of either form. Part of the issue may be registered; part may be coupon-bearer; and any bond of one class may be exchanged for a bond of the other class upon request of the owner.

15-17. Income Bonds are a sort of hybrid between bonds and preferred stock. The principal sum has practically the same characteristics and protection as the principal sum of any other bond. The interest, however, does not accrue and become payable unless the issuing corporation has made net profits from which the interest may be paid. Interest may be either cumulative or non-cumulative and usually ranks before the dividends upon preferred stock of the corporation.

15-18. Profit-sharing Bonds contain the ordinary provisions as to definitely accruing interest rate and, in addition, give to the bondholders the right to participate in the net profits of the issuing corporation.

Matured Bonds Unredeemed

15-19. When bond issues mature owners do not always present the bonds for redemption, even though no further interest accrues to their benefit. In the case of registered bonds, the owners can be reached, but in the case of bearer bonds the corporation has no way of knowing the owners or the whereabouts of bonds that are not presented for redemption. Why owners of such bonds should fail to present them is a matter for psychologists, not for accountants. The fact remains that unpaid bonds frequently remain outstanding for years after the date of their maturity. Such bonds should not be carried after maturity date in the account with bonds that have not matured. They should appear on the balance-sheet under some heading such as "matured bonds unredeemed."

When a bond issue is protected by a blanket mortgage in the hands of a trustee covering all the registered bonds, the mortgage may not be released until all the bonds so registered have been redeemed. However, if a bond has not been presented for redemption at the maturity date this fact would prevent the organization from relieving itself of the mortgage even though it were fully prepared to redeem the bond and had deposited money sufficient for that purpose in the hands of trustees. Provision may usually be made to overcome this difficulty by a special bond by the issuing corporation (usually for twice the face value of the unredeemed bonds) which may be held by the trustee as security, thus allowing the mortgage to be released. Were it not for such a relief measure as this, corporations might be seriously handicapped in their financing by the failure of a single bondholder to present at maturity date a bond registered under a blanket mortgage.

Long-time Notes

15-20. Corporations frequently issue long-time notes instead of bonds. These notes when issued in series are similar to debenture bonds. They usually run for periods of three, five or possibly ten years. As a rule they are not secured by any mortgage on specific property, but they may contain stipulations regarding sinking funds for their redemption.

Collateral Trust Notes

15-21. Collateral trust notes are similar to long-time notes but are secured by certain collateral. This collateral may be in the form of securities of other organizations or securities of a different class of the same corporation.

Equipment Obligations

15-22. Equipment obligations in the form of either notes or bonds are secured by lien on specific equipment, such as railroad cars, etc. These notes are usually issued by transportation companies or by other organizations, such as oil refineries, which operate their own railroad cars.

Coupon-bearer Notes
Registered Notes

15-23. Long-time notes issued in series may be either registered or bearer as to principal sum and registered or coupon-bearing as to interest. (See ¶ 15–14, 15–15.)

Funded Debt

15-24. The term "funded debt" as used in the balance-sheets of public-service corporations in America applies to indebtedness maturing more than one year after the date of its incurrence. In other lands the term "funded" has a quite different meaning, but apparently in America it involves no more than is covered in the above definition. It must be noted that in the balance-sheet it appears as a long-time liability and is so classified even though it may mature soon after the date of the balance-sheet. The presumption apparently is that funded debt can be renewed or a new and equivalent funded debt be created to care for the payment of the old. Therefore it is never classified as a current obligation.

CHAPTER XVI

CAPITAL

16-1. There is a deplorable tendency to use one word or term for many different meanings instead of devising a new term when occasion arises. In this respect accountancy sins as greatly as any of the other arts or sciences. One of the most abused and overworked words in business is "capital." It is applied to so many different things of such marked dissimilarity that it is necessary for one to know quite definitely in which sense it is used in order to avoid serious misinterpretation. It is not the purpose here to indicate all these usages but rather to discuss the word as an abbreviation of the more technical term "accounting capital." Accounting capital may be defined as the excess of the asset value over the liabilities of any commercial entity. It is used synonymously with the terms "net worth," "proprietorship" and "owner's equity." It is a broad term expressing the net investment of the proprietors. This investment may have been put into the business by the proprietors or may have accrued to them within the business.

16-2. To all the assets of a business there are legal claims or rights that can be enforced in certain circumstances to obtain complete and free title to the assets. These legal claims consist of two broad groups: claims of creditors, known as liabilities, and claims of owners, known as accounting capital. These two groups differ from each other as to priority of legal rights to the assets involved and their presentation on the balance-sheet should be such as to separate them distinctly.

The dividing line between the two groups is not always easy to draw. One may merge into the other so that even the courts sometimes find it difficult to determine whether relationship be that of creditor or of proprietor. When doubt exists as to a particular obligation of an organization there must be careful consideration to determine whether there is a preponderance of the characteristics associated with creditorship or of those associated with proprietorship. The chief items thus to be considered are:

1. Control;
2. Periodic return;
3. Risk;
4. Maturity and certainty of claim.

It must not be understood that all these elements are sharply differentiated in business. No one of them alone is sufficient definitely to determine the status of any relationship. The discussion of these elements is not an attempt to fix inflexible rules. It is undertaken in the hope that it will aid those who are conscientiously striving to make the proper classification in particular instances.

Control

16-3. The element of control is essentially one of proprietorship, whether it be exercised directly, as in the case of a sole proprietorship, or indirectly, through the representatives of the stockholders of a corporation. The proprietors of an enterprise exercise operative control not only over the values which they have advanced and the values which have accrued to them, but also over the values advanced by creditors. All the assets of an organization constitute a fund under the control of the proprietors so long as they comply with the regulations laid down by law and by business practice. Failing in these the priority of creditors' rights may become effective, certain rights of the proprietors may be temporarily taken away from them and the business may be operated by the courts until creditors' claims are satisfied. In other words, proprietors presumably contribute values to an organization and retain control over those values. Creditors in advancing values to an organization put those values out of their own control and into the control of the proprietors. In return for this creditors are allowed special rights. If the proprietors fail to comply with rules of law and of practice, creditors may appeal to the courts for aid in recovering control of the values advanced to the organization or accrued to them within the organization.

To illustrate: In the case of a corporation the control of all assets and the selection of methods and policies rest with the proprietors (the stockholders), who operate through a board of directors and officers appointed or elected thereby. Bondholders, although they have advanced assets to the corporation, have no vote nor any power in the determination of corporate policy so

long as the contract in the bond is fulfilled by the corporation. However, if the corporation fails to pay interest on the bonds when it is due or disregards other stipulations of the bonds, action may be taken whereby proprietary rights, such as the right of control, may be temporarily taken away from the proprietors and may pass under the jurisdiction of a court which will appoint agents to exercise the proprietary rights for the benefit of creditors. After obligations to creditors are fulfilled control of the remaining assets may pass back to the stockholders.

16-4. The element of return upon values advanced, as applicable to creditorship, is definite as to amount and maturity. Proprietorship, on the other hand, does not have a fixed return but must be content with whatever amount the business may produce above the claims of creditors.

Bonds constitute a definite liability to creditors and interest upon them ordinarily is at a fixed percentage per annum payable whether the organization makes a profit or not. It is possible that this relationship may be modified, as in the case of "income bonds," the interest on which depends upon the earnings of the corporation. To this extent the relationship of the bondholder resembles that of a proprietor, but this is not sufficient to classify him as a proprietor in the absence of other proprietorship functions.

The return to the proprietor — such as the stockholder of a corporation — is indefinite as to rate, amount and time and depends upon the available profits of the organization. This relationship also may be modified, as in the case of a preferred stockholder whose return is fixed as to rate. His status is somewhat like that of a creditor. This resemblance however is not sufficient to give creditorship rights to the preferred stockholder. He can not, therefore, demand a dividend unless it be voted by the directors of the corporation.

Risk

16-5. An element of risk is assumed to a certain extent by anyone advancing values to a business. There is always the possibility that the sum advanced may never be fully recovered or that no income or profit may be received. This is a primary risk in proprietorship but is presumably secondary in creditorship. If a business makes a loss, it must be borne by the proprietorship. It does not reduce the rights of creditors to their principal sum or to

their fixed return. However great the loss made by a business there is no loss to creditors until after the values of the proprietorship are completely exhausted. In return for the primary element of risk any profits of the business add to proprietorship. However great these profits may be there is no increase in the fixed return to creditors, except by special agreement. An example of special arrangement is found in "profit-sharing bonds" wherein this essential element of proprietorship is made a part of the agreement with the bondholders.

Maturity

16-6. Maturity of a fixed amount at a fixed date is a characteristic of the claims of creditors rather than of those of proprietors. Values advanced by creditors or accruing to creditors are to be paid at certain determinable dates and are definite in amount. Advances by proprietors have no such definite maturity, save with the dissolution of the organization, and are with few exceptions indefinite in amount. After an organization has paid all claims of creditors all assets remaining belong to the proprietors. When these are fully and rightly distributed the proprietors have no further claim against anyone even if the amounts so distributed are less than the original values advanced.

It is possible to have a maturity date for advances by proprietors, as in the case of some preferred stocks redeemable at fixed dates under special conditions. Such stock has in this respect an element of creditorship. Similarly when a dividend upon capital stock has been lawfully authorized by the board of directors it becomes definite both as to amount and maturity date and should be classed among the liabilities. Stockholders are also creditors so far as this amount is concerned. They are secondary to other creditors, however, and can not press their claim if the rights of other creditors are jeopardized.

Summary

16-7. The proper presentation of the financial condition of an organization on a balance-sheet necessitates separation of the liabilities and the proprietorship. This is becoming increasingly necessary as business makes progress in accuracy of classification and in accurate determination of amounts belonging to these classifications. There was a time when the items of liabilities and

those of proprietorship were listed on the balance-sheet without attempt to separate them. This was when a balance-sheet was no more than a list of the balances of the accounts in the general ledger. All debit balances were displayed on one side; all credit balances upon the other side. Business long ago outgrew such a balance-sheet. Whether an item is a debit or a credit is of little importance compared with the question whether it represents a true asset, a liability or a capital item. Unfortunately some leading accountants still hesitate about changing from the ancient method. The tendency, however, of balance-sheet development lies along the lines indicated in this book.

In order to make proper segregation of liabilities and of capital items, the character of each such item must be determined. They may be combined in such a way that it is difficult to decide to which group the items belong. No one characteristic is sufficient of itself to determine classification. Consideration must be given to all.

A person may act in dual relation to an organization, being both a creditor and a proprietor at the same time. One of the partners may lend a sum of money to a partnership with the understanding that the sum is not to be considered as a part of his capital investment. In such a case the individual is a proprietor and also a sort of creditor, so far as the other partners are concerned. The sum lent to the partnership should be displayed on the balance-sheet following the liabilities to other creditors but preceding the statement of the capital accounts of the partners. In case of liquidation it ranks in that order. After other creditors are paid in full this partner has first claim upon the assets for the sum lent before any distribution may be made to proprietary interests.

Similarly, in the case of a corporation a person may be both a stockholder and a bondholder. In the latter capacity he ranks with other bondholders. This relationship has no bearing whatever upon his status as a stockholder. In the case of corporations it is seldom necessary to separate from other creditors those who are also proprietors.

CLASSES OF PROPRIETORSHIP

16-8. Three classes of proprietorship are recognized in America: sole proprietorship, in which the proprietary functions are centered in one person; partnerships, in which the proprietary functions of

an enterprise are vested in two or more persons; corporations, in which the proprietary function is centered in an artificial person created by state law. This artificial entity, the corporation, has a legal existence separate from that of the individuals composing it; yet from the operative point of view this is a fiction, as the responsibility of proprietorship ultimately must rest upon persons. In a corporation these persons are known as stockholders. They exercise proprietary rights by means of authority delegated by them to a limited group known as directors and to certain chosen officers. Technically the corporation itself is the proprietor. The functions of proprietorship are exercised by stockholders with limitations upon their rights and their responsibility prescribed by law.

Sole Proprietorship

16-9. In the accounting records monetary extent of the sole proprietorship is shown by a capital account in the name of the proprietor. This account is credited first with the net book value of all assets contributed by the proprietor and later with all additions thereto either by contributions or from net profit. It is debited with all amounts withdrawn by the proprietor and with all net losses. As a result the balance of this account at any time after proper adjustment must represent the net book value of the assets less the amount of liabilities to creditors.

On the balance-sheet this amount appears with the designation "capital" or with the name of the proprietor or both. The amount may appear as a single item or it may be analyzed in any manner that conveys suitable information about it. As an illustration, this account might appear on a balance-sheet as at December 31, 1922, as follows:

Jonathan Jones, Capital:		
Balance, January 1, 1922	$ 6,000	
Profit during year	5,000	
	$11,000	
Less: Withdrawals during year	4,000	$7,000

If Mr. Jones does not desire all this information upon the balance-sheet, his capital may appear as follows:

Jonathan Jones, Capital	$7,000

For commercial purposes it is desirable to consider the proprietorship of an enterprise as a distinct entity and to prepare financial records accordingly. However, there is no legally approved line of demarcation between the assets used in the enterprise and other assets of the proprietor, nor between the liabilities of this activity and other of the proprietor's liabilities. Attention is called to this fact in Chapter I. It must be kept in mind both by the person preparing a balance-sheet for such an enterprise and also by the reader of the balance-sheet.

Partnership

16-10. In a partnership each partner having any legal claim to any of the partnership assets must be represented on the financial records by a capital account. The account with each partner performs essentially the same function as does the capital account of the sole proprietor. It is credited with the net book value of all assets contributed by the partner, with his proportion of the profits and with any other claims. It is debited with the amounts of his withdrawals and with his share of the losses. Each partner's capital account at any time, after proper adjustment, displays the net amount of the assets to which he is entitled. The total of the partners' capital accounts equals the book value of the assets in excess of the liabilities of the business.

In the balance-sheet of a partnership the total proprietorship may be displayed as one item called "capital"; or each partner's capital account may appear; or the total capital account may be analyzed so as to display the elements which are desirable.

This may be illustrated by the following three statements of the capital of a partnership:

First

Partnership Capital			$100,000

Second

Partnership Capital:			
Balance, Jan. 1, 1921		$85,000	
Net Profits for year 1921	$32,000		
Withdrawn by Partners	17,000		
Added to Capital		15,000	$100,000

Third

Partnership Capital:		
A. B. Carter	$40,000	
D. E. Frank	35,000	
G. H. Irwin	25,000	$100,000

Corporations

16-11. The proprietorship of a corporation may be expressed in a single account if the capital-stock certificates representing the proprietorship do not indicate a par value. If the capital-stock certificates are stated in terms of par value a separate account for each class of capital stock must appear on the balance-sheet. The excess of proprietorship over par value of outstanding capital stock is "surplus." On the other hand, if the par value of the capital stock outstanding is in excess of the proprietorship or accounting capital the excess is expressed on the accounting records by a debit account called "deficit."

Even in case of no-par capital stock proprietorship may be expressed in two items on the balance-sheet. One account "capital stock" may show the net value of the assets contributed to the organization in return for the issuance of capital stock. Any excess over this amount may be stated as surplus.

Surplus also may be subdivided into many groups depending upon origin of the surplus or upon the intentions of the corporation with regard to its disposition.

The various classes of capital stock are explained in Chapter XVII. Subdivisions of surplus are discussed in Chapter XVIII.

CHAPTER XVII

Capital Stock

17-1. In Chapter XVI it was said that the financial statement of a partnership might display a capital account for each partner or owner. In the balance-sheets of corporations one account only appears for each class of capital stock outstanding. Individual ownership is not given expression in such balance-sheets. If the capital stock is issued with par value, the amount in the balance-sheet will be expressed in terms of par value, regardless of whether or not the amount is equal to the value paid to the corporation for such stock. If the stock is issued without par value the amount to be expressed in the balance-sheet is discussed later in this chapter under the head "no-par stock."

Book Value of Shares

17-2. When the accounting capital of a corporation is divided into several accounts they are frequently represented upon the balance-sheet by indented amounts, and the total is brought into the last column. A name may be applied to this total to indicate that it expresses the complete amount of the accounting capital of the corporation. The idea may be carried further and the net worth of a share of outstanding capital stock may be expressed parenthetically, usually as "book value per share." If there is only one class of capital stock outstanding this method may be employed with accuracy. If there is more than one class of capital stock outstanding the rights of each class must be carefully determined. Any rights of preferred stockholders to dividends that have not been voted must be recognized. If the balance-sheet contains paid-in surplus the rights of the respective stockholders in such paid-in surplus must be observed.

Capital Stock as Protection to Creditors

17-3. If the assets of a partnership prove insufficient to meet the legal claims, creditors by proper legal process may obtain liens upon any other assets of the individual partners even though such assets have never been part of the partnership fund. Since assets

withdrawn by partners from the partnership fund may still be available as protection to creditors, there are few legal restrictions upon the amount which partners may withdraw.

In a corporation the liability of stockholders is limited to their original investment, except as in the case of bank stock when a double liability attaches. Evidently, therefore, there must be some legal limits to the withdrawal of corporate assets by stockholders. In the case of stock with par value fully paid stockholders may not withdraw assets from a corporation if such withdrawal reduces the net proprietorship below the amount of the par value of capital stock issued and outstanding. The amount of the capital stock is the fund invested in the corporation not only for purposes of operation but also for the protection of creditors.

Assets may be lost as the result of business operations without any compulsion upon stockholders to restore the amount lost, except in the case of assessable stock or stock with double liability; but there may be no legal distribution of dividends to stockholders except from current earnings or from surplus. In other words, assets represented by capital stock may not be distributed to stockholders except at time of liquidation or of authorized reduction of capital stock. There is an exception to this rule in the case of corporations organized under the mining laws of a few states, which permit corporations to distribute dividends from the capital sum instead of limiting them to distributions of profits or of surplus. Such distribution may never be legally made if the rights of creditors are jeopardized thereby.

In the case of no-par stock the amount that may not be legally withdrawn by stockholders is measured by the nominal value per share fixed by the statute of the state under whose laws the corporation is organized.

Par Value

17-4. In the simplest form of corporate organization the amount of capital needed is expressed in some round amount, such as $5,000, $100,000, $1,000,000, etc. The charter granted by the state expresses the capital authorization. The capital is divided into a fixed number of units known as shares, identical as to value, rights and privileges.

The amount of the authorized capital divided by the number of shares indicates the authorized or par value of one share. This may

be any number of dollars unless the state granting the charter limits the amount of par value. The most common par values assigned to stocks are $100, $10 or $1 each. A corporation beginning with an authorized capital stock of $100,000 might decide to divide this into one thousand shares of $100 par value each or ten thousand shares of $10 par value each, or some other par value might be selected. Par value once fixed and approved by the state can not be changed except by legal process and an amendment of the corporate charter.

17-5. There was a time when par value expressed the actual amount of assets contributed by stockholders. If stockholders of the corporation above mentioned contributed exactly $100,000 in cash or other assets and certificates for capital stock to this amount were issued to them, the accounting capital of the corporation at that moment would be the same as the capital stock. If the corporation made no losses and if all profits were distributed as earned, the par value of all outstanding certificates would continue to express the worth of the proprietorship. Such a condition, however, is hypothetical and seldom exists. The par value of the capital stock is fixed. The accounting capital increases or decreases with the fluctuations of business. Accounts other than "capital stock" must be provided to express the difference. If the par value of capital stock is in excess of the accounting capital the difference with a few exceptions is expressed by an account called "deficit." If the accounting capital is in excess of the par value of capital stock the excess is expressed by "surplus."

17-6. It is not necessary to set up an account in the financial records to indicate the amount of capital authorized. As subscriptions for stock are received, financial accounts must be set up and properly named. For instance, "subscriptions to capital stock" may be debited and "capital stock subscribed" may be credited. As capital stock is issued "capital stock subscribed" should be debited and "capital stock issued" should be credited. All the accounts referring to capital stock with par value are expressed in terms of par value. They are discussed in their appropriate chapters of this book. If all the stock is paid for and issued, the amount of assets received should equal theoretically the amount of the capital-stock account. Formal documents called "certificates of capital stock" are issued to each stockholder indicating the number of shares for which he has paid.

If all corporation accounts were so simple the par value in stock certificates would have a real meaning; but unfortunately it is seldom that such a condition exists. Among the things which complicate procedure are : (1) issuing stock before it is fully paid; (2) issuing stock at a premium or at a discount; (3) giving stock as a bonus; (4) dividing capital stock into classes differing from each other as to rights and privileges; (5) issuing stock with no par value; and (6) accumulating undistributed surplus or deficit.

Assessable Stock

17-7. Under the corporation law of some states capital stock may be issued to subscribers who have not paid in full, provided the payments made equal or exceed a certain percentage of the par value of each share. Such stock is subject to further assessments up to the amount remaining unpaid. The stock certificates issued should indicate the amount that has been paid so as to serve notice to any possible purchasers of such stock that they may be liable for additional assessments upon it.

Capital stock of some corporations, such as those issued under the banking laws of the various states, may be subject to assessments in addition to the par value expressed in the certificate. If necessary for the protection of creditors, holders of stock subject to double liability — even though their stock is fully paid at par value — may be called upon for further amounts up to but not exceeding the par value of the stock.

It was originally intended that the par value expressed in a certificate should be the amount paid in to the corporation as the basis for issuance of its stock.

In either case noted above the par value in the certificate does not equal the value of the assets contributed. Stock is not always paid for in cash. Most states allow capital stock to be issued for property of any kind and for services. The value fixed upon such property or services for capital-stock purposes may differ greatly from actual cash value.

In most states which forbid the original issuance of capital stock at a discount the spirit of the statute may readily be evaded. For instance, capital stock may be issued for property which the directors have appraised at an amount in excess of its true value. After receipt of this stock the holders may donate a portion of it to the corporation. Such donated stock, having been originally issued

for what was alleged to be a value equal to its par, may now be sold at whatever value is obtainable without violating the law forbidding the original issuance of capital stock at a discount.

Premium or Discount on Stock

17-8. Stock may be issued at a premium and in many states may be issued at a discount. If assets received for capital stock have a true value in excess of the par value of stock issued that excess must appear in the records as "premium on capital stock." It is of the nature of contributed capital or paid-in surplus. It must not be confused with earned surplus. It is not an earning of the corporation. It is an amount invested by the stockholder but not represented in the par value of the capital stock which he received. If the amount of assets contributed is less in value than the par of the stock issued for them, the difference must appear as "discount on capital stock." This is not a deficit and must not be confused with losses from operations. It merely represents the amount by which capital contributed fails to equal par value of stock issued. It is sometimes treated as organization expense or used to offset any "premium on capital stock."

Bonus Stock

17-9. Corporations, if allowed to do so by their charter and by the laws of the state in which they are organized, occasionally issue capital stock as a bonus. The bonus may consist of common stock given with subscriptions to preferred stock, or common stock may be given as a bonus with the sale of bonds. Such stock does not constitute a separate class upon the balance-sheet. It does not differ in any way from other shares of the class to which it belongs. Evidently its par value may have little relation to the value of the services which were the reason for its issuance.

Classes of Capital Stock

17-10. If a corporation has only one class of capital stock, it is known as "common stock." The rights, privileges and values represented by the stock are held by the stockholders in common.

Corporations frequently find it desirable to issue two or more classes of capital stock. Such a division is of no effect unless one or more classes are given preferences or privileges. In that case they are called "preferred stocks."

Capital Stock — Common

17-11. Common capital stock is the controlling stock of a corporation. It includes all capital stock except such as has been granted special privileges. It is known as common stock because it indicates that the net assets are represented in common by these shares, and that each share ranks with any other share as to value, authority and earning power.

Common stock may be with par value or with no par value. In the case of par-value common stock, the account on the balance-sheet indicates the number of shares outstanding, multiplied by the par value of each share. If the values received by the organization for this stock were greater or less than the par value, the premium or discount would be applied to a different account and would not affect the capital-stock account. In the case of no-par stock, the account on the balance-sheet may indicate either the value paid for the stock issued or the net proprietorship represented by it. The number of shares must be indicated in such a balance-sheet, because the number of dollars in the account would not enable the observer to determine how many shares had been issued.

Capital Stock — Preferred

17-12. The preference accorded to preferred stock may lie in the distribution of profits or in the distribution of assets at time of liquidation or in both. There is no uniformity of practice with regard to the preferences. The preferred stock of one corporation may have little in common with the preferred stock of another corporation. Preferences must be designated specifically in each case. They are usually expressed in the body of the stock certificate itself and also in the certificate of incorporation of the company. In a few instances they appear only in the by-laws. Prospective owners of any preferred-stock issue should ascertain definitely the particular preferences attaching to the stock.

Preference in the distribution of profits means that in each year dividends of a certain amount must be voted to preferred stockholders before any dividends may be voted to common stockholders. This amount is usually a percentage of the par value of the preferred stock. It may be a certain number of dollars per share. In the case of preferred stock without par value the dividend must be determined by the latter method. Preference in the

distribution of assets at time of liquidation means that after liabilities of the corporation have been fully liquidated, the remaining assets must be applied to redemption of preferred stock at par or at other agreed amount. Not until this has been done may the remaining assets be distributed to holders of common stock.

17-13. Preferred stock is a cross between common stock and a bond. It is neither the one nor the other but partakes somewhat of the attributes of each. It is often issued by corporations in the attempt to provide securities which will be attractive to investors and yet will not commit the corporation to obligations which circumstances may not allow it to fulfill. Such stock must therefore be relieved of some of the risk of proprietorship and be given some of the advantages of creditorship.

Control is a natural right of proprietors. As each share of capital represents proprietorship it carries with it the right to control — that is, the right to vote — in corporation matters unless this right is specifically taken from it. Voting rights naturally attach to all proprietors. If the number of shares of preferred stock exceed the number of shares of common stock the voting control will pass out of the hands of the common stockholders. To avoid this, preferred stocks are often issued without voting powers. Or they may be issued with the provision that no voting powers shall attach to the preferred shares unless the corporation fails to pay dividends upon them for a stipulated number of periods.

The element of risk to investors is greater in preferred stock than in true liabilities but not so great as in common stock. If preferred stock is given priority in disposition of assets it will rank next after liabilities and no payment may be made in liquidation of common stock until after preferred stockholders have been fully reimbursed. If the preferred stock has been given priority as to dividends no dividends can be paid upon common stock in any year until after the full dividend requirements of the preferred stock have been met. The income risk therefore is greater than in the case of bonds but not so great as in the case of common stock.

17-14. Some preferred stocks contain provisions whereby the common stockholders, so far as they are able, guarantee dividends. This means that if there have not been sufficient profits to pay cumulative dividends upon preferred stocks at time of corporate dissolution such unpaid dividends may be withheld from the prin-

cipal sum otherwise applicable to the common stock. To illustrate this let us make the following assumptions. A corporation is being dissolved. All liabilities are paid and provision has been made for costs of dissolution. Capital stock outstanding consists of preferred, $100,000 and common, $100,000. Assets to be divided amount to $190,000. Two cumulative dividends of 6% each remain unpaid. If the common stockholders have guaranteed these dividends, $112,000 must be distributed to the holders of preferred stock and the remaining $78,000 will be distributed to the common stockholders. Very few issues are so guaranteed. Without a guaranty clause, preferred stockholders if given priority as to assets would receive $100,000 and common stockholders $90,000. If the preferred stock was preferred only as to division of profits, both common and preferred would share alike in the asset distribution and each shareholder would receive 95 cents for every dollar of par value.

Occasionally the element of fixed maturity is involved, as some preferred-stock issues contain provisions for redemption by the corporation either at a fixed date or upon call. It must be kept in mind, however, that the corporation can not be compelled to meet such obligations if the rights of others would be jeopardized. How far this fixed maturity date creates an absolute obligation upon the corporation is a question that must depend upon the terms of the contract.

Preferred stock may be classed as cumulative and non-cumulative, and as participating and non-participating.

Capital Stock — Preferred Cumulative

17-15. In the case of cumulative preferred stock the claim on profits accumulates year after year. A seven per cent cumulative preferred stock must receive seven per cent dividend in any given year before any dividend is paid to the common stock. If in any year this dividend is not declared, the right accumulates and the amount passes on to the next year so that in the latter year fourteen per cent dividend must be paid to the preferred stockholders before any distribution of profits can be made to the common stockholders.

To illustrate: A corporation has outstanding $100,000 in common stock and $100,000 in 6% cumulative preferred. If these stocks were issued to become effective in 1919 and no dividends

were paid until 1922, the preferred stockholders in that year would have to receive 24%, that is, 6% for each of the years 1919, 1920, 1921 and 1922, before any dividends could be paid on the common stock. If preferred dividends are paid regularly every year, there is of course no accumulation. The cumulative provision is of great importance, however, when circumstances do not permit the continuous payment of dividends.

It must be noted that the preference is only against stockholders of lower rank. It is not a right which places preferred stockholders in the class of creditors. To set up a liability for cumulative dividends that have not been voted is an error. No liability attaches to the corporation because of dividends which have been passed. No liability is created until the board of directors declare the dividend. On a balance-sheet any cumulative dividends in arrears should be shown beneath the capital stock item in parenthesis or by footnote. Otherwise the respective rights of stockholders would not be made clear by the balance-sheet.

Capital Stock — Preferred Non-cumulative

17-16. When preferred stock is not cumulative priority as to dividends in any year expires with the end of that year and does not carry over to the following year. To illustrate: If in 1918 the dividends of a corporation having 7% non-cumulative preferred stock were passed, neither preferred nor common stockholders received any distribution for that year. If in 1919 conditions justified the board of directors in voting dividends, no dividend could be paid on the common stock until 7% had been voted to the preferred stock then outstanding. It would not be necessary to apportion an additional 7% because of the lack of dividend in 1918, as it would be in the case of cumulative stock.

If the common stockholders have the power to do so, and if the preferred stock is non-participating, advantage may be taken of non-cumulative stock by allowing profits to accumulate and by declaring dividends, say, in alternate years. This would give the preferred stockholders only half the amount which they would receive were dividends voted annually, and to which they are apparently entitled.

Capital Stock — Preferred Participating

17-17. Corporations may give to preferred stockholders right to a share in the profits in addition to the fixed rate of dividend. There is little uniformity with regard to the amount of such participation. As an illustration: A stock issue may be preferred as to 7% regular annual dividend with an additional participating feature that in any year, after the common stock has also received a dividend of 7% the preferred stock and the common stock shall thereafter participate in any further dividends, share and share alike. A stock may be preferred as to a set dividend, say, 6%, and after an equivalent dividend to the common stock the preferred may participate further to a limit of, say, 10%, the common stock not being so limited.

Participating preferred stock has the advantage of a regular income somewhat similar to bond interest so long as the profits of the corporation enable such dividends to be paid, and in addition it has a speculative feature, in that increased corporate profit leads to increased dividends to such preferred stockholders. The participating feature may apply either to cumulative or to non-cumulative preferred stock though it is more commonly found with the former.

Capital Stock — Preferred Non-participating

17-18. A preferred stock issue whose dividend rate is definite and limited, no additional participation in profits being allowed, is a "non-participating preferred stock." Most preferred stocks belong in this class. They may be either cumulative or non-cumulative.

Sinking-fund Preferred Stock

17-19. It has been suggested already that certain classes of preferred stock are redeemable by corporations under specific conditions. To provide a fund for this purpose corporations may set aside annually certain amounts usually based upon a pre-determined percentage of profits. Such a fund may be known as a "preferred-stock redemption fund." Ordinarily there is no obligation upon the corporation to set apart such a fund if the interests of other parties will be jeopardized thereby.

No-par Value Stock

17-20. Since the par value of capital stock does not always equal the value of the assets received for it by the corporation, and since

it seldom equals the book value and practically never equals the market value, it is evident that par value is largely a fiction. It is an amount printed on a certificate but it does not indicate actual value. As complications have developed in the business world the par value shown in stock certificates has become more and more meaningless. In recent years this has led in many states to the adoption of laws whereby corporations may issue stock without any par value expressed in the certificates. If a corporation has only one class of stock and there are one thousand shares outstanding, a man owning ten of these shares owns one per cent of the corporation. The money amount written on his certificate may have little relation to the true value of his ownership. Under a no-par stock law there is no par value expressed on his certificate.

There are two common methods for expressing the amount of capital stock without par value. Under the first method the no-par capital stock account is carried at the net proprietorship represented by that stock. The account is credited with the assets originally contributed and with any additions because of net profits and is debited with withdrawals and net losses. It is similar to the capital account of a sole proprietor. Although this method probably reflects the original purpose of laws authorizing no-par stock, it does not give all the information desired for accounting and managerial purposes.

Under the second method the no-par capital stock account is credited with the value of the assets contributed by stockholders. Any increase because of net profits is carried in the surplus account as in the case of stock with par value. The advantage of this method is that it displays through the surplus account the net increase in assets from operations as distinct from assets that have been advanced or contributed.

As an illustration: A corporation may be organized to buy the assets and assume the liabilities of another organization. The assets are recorded on the books at a value of $250,000 and the liabilities assumed total $80,000. If 10,000 shares of no-par stock are issued for these assets the no-par stock account will be credited with $170,000. This is equivalent to $17 a share. Later, if 10,000 additional shares are sold for $25 each, the no-par capital stock account will be increased to $420,000. A balance-sheet displaying this amount would show in parenthesis that 20,000 shares of no-par stock were issued, giving an average value of $21 a share.

This at the moment would be the book value of a share but if no more stock were issued this amount would remain constant, whereas the book value might increase because of accumulated profits. On a balance-sheet the no-par capital stock account and the surplus account would be expressed in an indented column, and the total would be carried to the main column as the book value of the 20,000 shares of no-par stock.

Capital Stock Subscribed but Unissued

17-21. When subscriptions are received for capital stock, asset accounts with the individual subscribers are opened. In a balance-sheet, these amounts would be totaled under a heading "subscribers to capital stock" or some similar title. The offsetting account would be to "capital stock subscribed but unissued." As the capital stock is actually issued, this account would be debited and "capital stock" account would be credited. This account, like all other accounts affecting capital stock of par value, must be carried at the par value, whether it represent the subscription price or not. Any premium or discount must be carried in a different account.

Stock that is neither issued nor subscribed should not be included in this account. In fact such stock has no legitimate place in the balance-sheet. Some firms display the whole amount of the authorized capital stock on the balance-sheet, deducting from it the amount unissued and carrying out the difference as "capital stock issued." It is doubtful if any advantage is gained by such presentation, except in unusual cases. Ordinarily the amount issued and outstanding, together with any amounts subscribed but unissued, is sufficient. The amount authorized may be shown by parenthetical comment.

On the balance-sheet the total of unpaid subscriptions, as shown by the account "subscribers to capital stock" (¶ 6–16), may be deducted from the amount of stock subscribed, so that the difference will represent the payments that have been received on account of subscriptions, as, for instance:

Capital Stock Subscribed but Unissued .	$500,000	
Less: Unpaid Subscriptions	180,000	
Capital Stock paid for but Unissued .		$320,000

CHAPTER XVIII

SURPLUS

18-1. The surplus of a corporation is the amount by which the assets properly valued exceed the sum of the liabilities and the capital stock. It has within itself no characteristics subject to measurement. It can only be determined by measuring all the other elements on the balance-sheet. It is the balancing element. It is the most sensitive item on the corporate balance-sheet. Every fluctuation in the value of assets not equalized by a similar fluctuation in liabilities or capital stock affects the amount of surplus.

A question at once arises whether or not the business world has yet reached a satisfactory method of determining surplus. The very word "surplus" seems to imply an excess of value over the needs of an organization. If that is the proper construction to put upon the term it is evident that its application should be more limited than present practice requires. Few corporations, indeed, could pay out to stockholders the full amounts shown by their surplus accounts without seriously handicapping, if not wrecking, their business operations.

The word "surplus" as at present used is not intended to convey its apparent meaning. It is no more than a measuring account indicating, as defined above, the excess of asset value over the amount advanced by creditors and in addition an amount represented in capital stock which must be maintained for the protection of creditors.

Surplus may be classified according to its source or according to the intentions of the board of directors with regard to its disposition. Under the latter classification would come also those apportionments of surplus which may be required from time to time because of contractual relations of the corporation with bondholders or with other parties. Its presentation on the balance-sheet should preferably be such as to give effect to both the above classifications. It is a part of the proprietorship of the corporation, and, however it be analyzed, the total surplus should appear adjacent to the capital-stock accounts. The sum of the capital stock and the surplus may be shown as the book value of the capital stock or the net worth of the corporation.

Classes of Surplus

18-2. It is evident that the assets measured by the surplus account of a corporation can come from only four sources:

1. From contributions by the proprietorship. These are paid-in surplus.

2. Contributions from parties other than the proprietors in such circumstances that no liability is created nor compensating service or value is rendered. These include subsidies granted to corporations. Items of this kind are infrequent and each one should be given a name indicating definitely its source.

3. Receipts from the sale or conversion of capital assets for an amount in excess of book value. Such amount may be called "capital surplus."

4. Profits or income earned in the operation of the business. This is known as "earned surplus."

A fifth classification as to source is sometimes created by applying the term "surplus" to the credit item resulting from appreciating the book value of certain assets, the ownership of which is retained by the corporation. This may be known as "surplus from appreciation" or "surplus from re-valuation." Perhaps a better title is "reserve for unrealized appreciation."

18-3. In addition to the classifications of surplus indicative of its source, further classifications may be made showing the intentions of the corporation with regard to the disposition of surplus. The term "surplus" theoretically refers to assets which may be distributed to stockholders. In practice, however, as has been indicated, it is seldom that all surplus of a corporation may be distributed without handicapping activities. A portion may be reserved to provide sufficient working capital. A portion may be held back because the assets are needed for enlarging facilities or for meeting emergencies. Surplus for these purposes may be designated by such titles as "reserve for working capital," "reserve for new factory," "reserve for contingencies," etc. Such reserves from available surplus may be created at the discretion of the board of directors.

The corporation may be required by the terms of some contract, such as that with bondholders, to withhold amounts of earned surplus from distribution for the purpose of creating a fund for the retirement of an obligation. Under this head come "reserves for bond sinking fund," "reserves for redemption" and other reserves

of like purpose. Such appropriations of surplus are not optional with the board of directors but are obligatory under contract. When reserves of this character are not made obligatory by contract they may be set up if deemed desirable by the board of directors. Instead of using the term "reserve" as part of the titles of accounts, other expressions such as "surplus appropriated for sinking fund," "surplus reserved for contingencies," etc., may be employed.

PAID-IN SURPLUS

18-4. Paid-in surplus consists of all values contributed to and retained by a corporation as capital in excess of the par value of the capital stock issued and outstanding. It does not include loans made to a corporation by stockholders nor any other values received for which definite liabilities are set up on the books of the corporation.

Paid-in surplus may arise from

1. Original issuance of capital stock at a premium.
2. Re-acquiring capital stock at a discount.
3. Donation of capital stock to the corporation.
4. Donations other than of capital stock made by stockholders.
5. Forfeiture of part payments made on stock subscriptions.

Premium on Capital Stock of Original Issue

18-5. The account "premium on capital stock of original issue" represents the amount paid to the corporation in excess of the par value of stock.

If a portion of the capital stock is sold at a premium and a portion is sold at a discount, the one should be used to offset the other, and the difference should appear as net premium or net discount on stock issued. (See ¶ 13–16.) If the amount paid for capital stock is not in cash the excess of value over par of the stock issued therefor must be unquestionable before a corporation can be justified in creating a paid-in surplus account, such as "premium on capital stock issued." If assets contributed for stock are intangible, it is doubtful if the accountant can ever be justified in allowing a paid-in surplus to be created. When intangible assets have been so recorded on the books that a "paid-in surplus" account results, the accountant in preparing the balance-sheet should reduce the book value of the intangible assets by the amount of the alleged paid-in

surplus or should give some other designation to the credit account. A designation such as "reserve for unrealized appreciation of patents" or some similar title might perhaps be used. It is preferable, however, to eliminate all more or less meaningless amounts from the asset side of the balance-sheet.

Discounts on Capital Stock Re-purchased

18-6. The result of re-acquiring capital stock at a discount is a reduction of the capital stock outstanding without a corresponding reduction of asset value. After such a transaction the corporation has in its possession assets contributed for capital purposes for which there is no capital stock outstanding. Such assets evidently constitute paid-in surplus. To illustrate: Assume that "A" has paid $100 cash for one share of stock in Corporation "X." Later Corporation "X" re-acquires this share of stock for $80 cash. The net result is that Corporation "X" possesses $20 of assets received from a stockholder but not represented by the par value of capital stock outstanding. This $20 appears on the balance-sheet as "discount on capital stock re-purchased" and is paid-in surplus.

Any premium paid in the re-purchase of capital stock constitutes a decrease of surplus and should be so treated in the records.

Stock Donation

18-7. When stockholders give back some of their stock to a corporation, usually for purposes of providing additional working capital, an account called "donated stock" is debited and an account called "stock donation" is credited with the par value of the stock so contributed. The reasons for this are discussed under the heading "donated stock." (See ¶ 17-7.) The purpose of the stock-donation account is to measure the value of the gift received. If donated stock is sold later at a discount the amount of discount should be debited against the stock-donation account, so that when the stock is finally disposed of this account will indicate the value of the net assets received for the stock.

Different methods of finally disposing of this account have been advocated by financial authorities. If capital stock has been issued originally for property whose true value is evidently less than the amount at which it is accepted in payment for par-value stock, any donation of such stock to the corporation would seem to be an admission of over-valuation. Accountants have insisted in these

cases that the corporation should reduce the book value of the property by the amount remaining in the stock-donation account, thus eliminating the latter account from the balance-sheet.

This plan, however, is subject to criticism. For instance, the lower the true value of the property concerned, the greater will be the discount to be allowed on any sale of donated stock. This will result in greatly lowering the balance of the stock-donation account and the value of the property will be written down by only a small amount. On the other hand, if donated stock could be sold at very slight discount, it would be evidence that the basic property really possessed great value — yet the less the discount by which the stock-donation account is reduced the greater will be the balance on that account, which will be used by this method to write down the value of the property.

To illustrate: A corporation is formed to acquire certain properties and issues therefor common stock to the amount of $1,000,000. Later, in order to provide working capital, the stockholders donate to the corporation one half of the stock received. The effect of these transactions upon the balance-sheet would be

Assets		*Capital*	
Properties.	$1,000,000	Capital Stock .	$1,000,000
Donated Stock . . .	500,000	Stock Donation . .	500,000

Assume that this donated stock ultimately nets only forty cents to the dollar, producing $200,000 of assets. The discount, amounting to $300,000, will be charged against the stock-donation account, reducing it to $200,000. If this be used to write down the cost of properties, the resulting balance-sheet will show assets of $1,000,000, consisting of cash $200,000 and properties $800,000.

On the other hand, assume the properties to have such an appeal to the investing public that the donated stock nets $450,000. The discount will reduce the stock-donation account to $450,000 and if this be written against the value of the property the resulting balance-sheet will show assets of $1,000,000, consisting of cash $450,000 and properties $550,000 — yet it is quite evident that in the latter case the properties are really worth more than in the former. The method is, therefore, illogical.

However, if this method is not employed — in other words, if the assets for which the original stock was issued are considered to be worth the amount assigned to them by the board of directors in

the original issue — the amount of the stock-donation account becomes paid-in surplus representing the value of assets of the business resulting indirectly from stockholders' contributions in excess of the amount of outstanding capital stock. If the latter method be applied in the illustration just given it will affect the balance-sheet as follows:

Assets		*Capital*	
Cash	$ 450,000	Capital Stock . .	$1,000,000
Property	1,000,000	Paid-in Surplus . .	450,000

No-par Stock Donation

18-8. If the stock donated to the corporation is of no par value some accountants hold that no financial entry need be made on the books. The only effect of such contribution is to reduce the number of shares of no-par stock outstanding. The number of shares is indicated on the balance-sheet by indention or parenthesis. The total value is not changed by such donation.

If it is desired to set up a value for donated stock of no par value the problem arises as to determination of the value. Either of the following values may be used:

(*a*) The value per share at which the stock was credited when it was issued.

(*b*) The average value per share of all no-par stock outstanding at the date of the donation, found by dividing the amount representing this stock on the balance-sheet by the number of shares issued and outstanding prior to the donation.

It is possible that the two methods will produce the same result, but when they result differently, judgment should be used to select that which will be the more just to all concerned and will clearly portray the true condition.

Donated stock of par value is seldom resold at a premium; but it is entirely possible that no-par stock donated may be sold for an amount in excess of the figure at which the donation is recorded in the books. If the disposal of donated stock results in such an excess, it will be credited, of course, to the stock-donation account and increase that account on the balance-sheet.

Surplus from Donations

18-9. Stockholders may contribute to a corporation assets other than capital stock or may cancel true liabilities of the corporation to

them. The effect of either action is to create paid-in surplus. This is seldom done, however, unless there is urgent need, such as the overcoming of a deficit, and in that case the surplus would be credited to the appropriate account.

Surplus Arising from Forfeited Payments on Capital Stock

18-10. If subscribers to capital stock fail to complete payments according to their contracts the payments which have been made may be forfeited to the corporation. Instead of declaring all such payments forfeited the corporation may issue capital stock for the amount of payments made. Ordinarily this is optional with the board of directors unless the contract with subscribers contains a provision relative to the matter.

Any amounts forfeited should be transferred to an account "surplus from forfeited payments on capital stock." This forms a part of paid-in surplus.

Capital Surplus

18-11. There is no definition of capital surplus generally accepted. Different accountants use it to express quite different things. It is desirable, however, that surplus arising from the sale of capital assets should have a special designation, and it seems logical that the term "capital surplus" should be used for the purpose.

Some accountants apply the term to the amount created by appreciation of capital assets. It is doubtful if such appreciation is surplus at all and the use of the term in this way is apt to lead to confusion. More conservative accountants prefer the designation "reserve for unrealized appreciation" for such an account, if it is brought into the records at all.

It is difficult to separate accurately surplus arising from the sale of capital assets and surplus arising from earnings. If an asset sells for more than its book value the excess may be called "capital surplus." However, the excess may be due to the fact that the organization has written off too much depreciation in past years. Depreciation may have reduced net profit and consequently have reduced earned surplus to an unwarranted extent. Conversion of the asset by sale restores to surplus the amount improperly charged to expense in other years. Part or all of this amount in such circumstances is an adjustment of earned surplus. It is evidently impos-

sible in such a case to determine to what extent the surplus arising from the sale of the asset should be called capital surplus. It is ordinarily sufficient to consider the whole amount as of this classification, without attempting to analyze it further.

It is difficult also in analysis of surplus at a specified date, if both earned surplus and capital surplus are involved, to determine to what extent either of these has been reduced in the past because of dividends. Presumably dividends to stockholders may be declared not only out of earned surplus but also out of certain other kinds of surplus. Unless past dividend payments have been ear-marked or one arbitrarily assumes that they have been paid out of earned surplus, great difficulty will be encountered in attempting to analyze the surplus remaining on hand at any date.

Capital Surplus (Municipal Balance-sheets)

18-12. In municipal accounting, it is sometimes desirable to present a balance-sheet consisting on the one hand of capital assets only and on the other hand of long-time liabilities and reserves applying against capital assets. Any excess of assets in such a statement is frequently called "capital surplus." This may not be the best possible term, but it has been difficult to find a better that is not too long and complicated. The objections to use of the term are that this excess is not, strictly speaking, a surplus and that the term has a different usage in the commercial world. Strictly speaking, this account in municipal balance-sheets should be entitled "excess of capital assets over long-time liabilities which are applicable against such assets." (See current surplus ¶ 18–22.)

Earned Surplus

18-13. The total amount of surplus representing values earned by and still in the possession of an organization may be known as "earned surplus." The amount may appear as one item on the balance-sheet or it may be divided more or less arbitrarily. Usually the division is into two items known as "available surplus" and "appropriated surplus," which are discussed later.

All earned surplus is presumably available for dividends unless appropriated for some specific purpose. Appropriations of surplus may be divided into two groups: those obligatory on the organization and those optional with the board of directors.

Various surplus reserves, such as "reserve for sinking fund,"

"reserve for betterments," etc., come under appropriated surplus. The common classifications of surplus appearing in balance-sheets are discussed in this chapter and in Chapter XIX.

18-14. True determination of net earnings is one of the most difficult and complicated questions in accountancy. After gross earnings have been properly computed they must be reduced by all costs or expenses applicable to the period in which they were produced before the amount of net earnings can be determined. Among costs or expenses must be included not only those involving payments or obligations to parties other than the organization itself, but also that portion of the reduction in value of the organization's assets which may properly be applied to the period concerned. In other words, out of a particular dollar of gross earnings a certain amount must be paid to others for services rendered and a further amount must be considered as a return to the organization for money already expended for such things as equipments, materials or other assets which have decreased in value because of the creation of the gross income or because of the passing of the time during which the gross income was earned.

The problems involved in the determination of the portion of gross income which must be considered as a return to the organization for other values lost, include the various elements discussed in Chapter V, such as depreciation, depletion, etc. With regard to the basis of computation there is much conflict of opinion in the business world. Some able authorities hold that there should be held back from gross income periodic amounts based upon the estimated cost of replacement of the assets used instead of a depreciation based upon actual cost. Their contention demands consideration of the fundamental question: What constitutes surplus? If the word surplus is construed to mean the accumulated assets which may be distributed to stockholders without handicapping the business and without the necessity of calling for increased contributions, it is evident that present accounting practice is unsatisfactory. So long as replacement cost for service assets is greater than original cost, it must be evident that, if all profits above a return of original costs are distributed, an organization will be unable to replace its service assets without additional financing.

To illustrate this point briefly: An organization has a factory which cost $100,000, and during the years of its usefulness the company has been depreciating it according to the accepted principles

of business practice. It has withheld for depreciation a total of $100,000 less the estimated salvage value of the property. Profits above this may have been added to surplus or distributed to stockholders. When the time comes to replace the factory the organization may find that it requires $200,000 to build and equip a factory of the same efficiency as the old. Therefore, $100,000 additional must be taken out of surplus. The question is whether or not this additional $100,000 should have been provided by heavier charges to depreciation during the years of use of the old factory. In other words, should depreciation be based upon cost price or upon the estimated value of replacement? There are many advocates of the latter. Their arguments seem convincing if one carries the question no further.

18-15. It must be kept in mind, however, that the balance-sheet — in its present use, at least — must be an exposition of present conditions based upon past transactions. Whenever a balance-sheet begins to assume prophetic powers it ceases to perform efficiently the primary functions for which it is intended. These functions are of such importance to the business world that they must not be disregarded for the sake of adding an additional function of doubtful value.

Assume that the organization in the above illustration withheld $200,000 as a reserve for depreciation of its factory. To accomplish this, profits year by year must be charged with twice the amount of cost applicable to these several years. At the expiration of the period during which the depreciation reserve has been accumulated the directors may decide not to rebuild the factory. They will then have reserved not only the original $100,000 which was put into the factory but also another $100,000. Presumably both these amounts will be available for distribution to stockholders at that date. This will be exceedingly unjust to those who have held stock during the years preceding this particular year. There will have been withheld from the book value of their stock year by year an amount which is not a cost, nor a replacement of any cost, nor an amount that has to be paid to anyone save to the stockholders when it is declared available — a violation of justice as well as of good accounting.

During the use of property, who can tell what it will cost to replace it? Carrying this idea further, why not increase the rate of depreciation on the cost of a leasehold on the theory that it will

cost a greater amount to renew it at its expiration? Why not charge any other service as expense at an amount greater than cost, on the theory that it will require a greater amount to purchase an equivalent service for a future period? Labor is constantly increasing in cost. Why not withhold from the profit of one year a labor-expense item based on the estimated higher cost of equivalent service in future years? Perhaps these questions are absurd; but any one of them is as logical when applied to one cost of service as to another. An expense must be based on what it has cost or does cost, not upon what a similar service may cost in future years. A machine used from 1910 to 1920 must be depreciated according to its cost to the organization during those years, not upon what it will cost the organization in 1920 to acquire a machine for the following ten years. That will be a consideration for the period of its use.

18-16. It must be kept in mind that in accountancy, as in any other profession, science or service, there may be many practices which on casual observation seem faulty, but if the observation be carried further they may be found correct. Students and practitioners of accountancy should not be too ready to adopt proposed changes in methods. Such changes often lead to absurdity. This must not be construed to mean that present principles are the final word in accountancy. They are not. Thought and experience will constantly devise improved methods; but this does not justify the acceptance of proposed changes until they have been demonstrated to be an aid and not a hindrance in the development of scientific business record. Any plan which suggests departure from the well established principle that cost of capital assets is a prepaid expense over the period of use must be regarded with caution. Otherwise the balance-sheet will fail to do the things for which it is intended, things which are essential to the business world. There is a limit to what can be done with one financial statement. Perhaps a new statement, supplementary to the balance-sheet, and depicting values according to efficiency rather than cost, may appear in the commercial field. If so, deep study and the results of practical experience will be needed for its development. The balance-sheet can not perform its present and this additional function.

18-17. Available Surplus on a balance-sheet represents the total surplus of a corporation which may be distributed as dividends. It includes all earned surplus not specifically appropriated for other

purposes. It may include paid-in surplus, as in most states that also may be distributed to stockholders by action of the board of directors, provided no contractual agreement with any class of stockholders is violated thereby.

18-18. Appropriated Surplus may be used in the balance-sheet to indicate the amounts of surplus that have been set aside for specific purposes. It is generally classified to indicate the respective amounts so appropriated. Whether or not this account has a vital meaning depends upon the method of appropriation. For instance, portions of surplus appropriated as a reserve for sinking fund may have been set aside as the result of a contract with bondholders so stated that failure to comply with its provisions would bring penalties upon the corporation or its stockholders. On the other hand, a board of directors may, without any such compulsory contract, appropriate certain sums from surplus, such as for "reserve for betterments," "reserve for contingencies," etc., thus rendering them not available for dividend purposes. Such impounding is often more apparent than real. Usually the board of directors by vote may reverse its previous action unless other persons are directly involved. That a board of directors has set aside a certain amount as a reserve for improvements is not of itself a guarantee that this reserve will be continued, for at a later date the board by vote may turn this reserve back into the general surplus again. This point is frequently overlooked in consideration of balance-sheets.

The total of appropriated surplus may appear on the balance-sheet as one amount or in various subdivisions indicating specifically each purpose for which appropriation has been made. These appropriations are for the purpose of liquidating liabilities or for acquiring assets in addition to those displayed upon the balance-sheet. Among the appropriations may be "surplus appropriated for sinking fund," "surplus appropriated for additional equipment," "surplus appropriated for redemption fund," etc. Accounts representing these amounts are frequently designated as reserves. Because of this they are discussed in detail under their respective headings in Chapter XIX. Reserves that are set aside to cover shrinkage in the value of assets already owned do not come into this category. Reserve for depreciation, as an illustration, is not a surplus reserve. It represents amounts withheld from gross profits before net income or surplus is determined. Therefore it must not appear in this group on the balance-sheet.

Surplus Appropriated for Replacement of Assets

18-19. In paragraph 18–14 there is discussion of the possibility that the replacement value of service assets will be greater than cost. It is often desirable to retain in an organization assets sufficient to make such replacement. The inconsistency of treating such replacement value as the basis for depreciation expense has been mentioned. No amount in excess of the actual outlay for the service involved can be treated as cost or expense. An additional amount, however, may be appropriated from surplus. Such appropriation is still a part of the book value of the stock; it is merely withheld from dividends so that the assets may be retained in the corporation. It must be noted that there is a sharp difference between withholding an amount from distribution and treating an amount as expense. Failure to recognize this distinction has led many commentators into error.

18-20. Undivided Profits may be the name upon the balance-sheet for all the earned surplus not appropriated; or the term may be used for only an arbitrary portion of such surplus. Some corporations bring all their earnings into an account called "undivided profits" and from this at times set aside specific amounts in another account called "surplus." As there is no generally accepted line of demarcation, students of balance-sheets in which this distinction is made can only guess at the intentions of the corporation, unless they have specific information. As a rule it is the intention to convey the idea that the amounts described as "surplus" are to be held in the organization for development or other purposes and are not to be distributed as dividends. It is a distinction without much value, because of lack of uniformity in practice. Some corporations use the term "undivided profits" in their annual balance-sheets to indicate that portion of the net earnings of the preceding period which has not been appropriated and transfer the undivided profit of other periods to the surplus account.

Surplus from Revaluation
Reserve for Unrealized Appreciation

18-21. The credit entry resulting from an addition to asset book value because of estimated appreciation has been handled in many different ways. Some business men have treated it as a profit. That is manifestly incorrect. Some have added it to surplus and on the strength of it have paid dividends to stockholders. That is

contrary not only to accounting principles but also to sound judgment and business policy.

Others have treated the item as a reserve account. Evidently it can be no more than that. It represents an estimated increase in value which has not yet been realized. When it is realized it will be surplus. Until that time it must be held back from true surplus — in other words, "reserved." The term "reserve," therefore, is correctly applied to the account. Reserve for unrealized appreciation may be defined as an amount held back or reserved from surplus because of estimated appreciation which may be realized in the future. (See ¶ 18–25.)

Current Surplus (on Municipal Balance-sheets)

18-22. In municipal accounting, it is frequently worth while to prepare a balance-sheet consisting, on the one hand, of current assets, and, on the other hand, of current liabilities and reserves of a current nature. Any excess of assets in such a balance-sheet frequently is represented by an account on the liability side called "current surplus."

It differs from surplus in the ordinary commercial use of the term, in that it is in reality nothing more than the excess of current assets over the need for them. It is somewhat akin, therefore, to the commercial element called "working capital." (See ¶ 18–12, 23–4.)

Revenue Surplus

18-23. In municipal balance-sheets, the term "revenue surplus" is sometimes used to indicate the excess of assets available for current needs, such as available cash, current collectible tax levies and unused supply inventories, over the obligations of a current nature applicable against such assets. The revenue-surplus account in such a case indicates that apparently there is an amount of revenue available greater than is required by current needs.

Consolidated Surplus

18-24. The term "consolidated surplus" appears in consolidated balance-sheets. It represents the amount of surplus of the parent or holding corporation as revealed by consolidating the accounts of the subsidiaries. It is discussed at length under the heading "consolidated balance-sheets." (See Chapter XXI.)

Realized Appreciation

18-25. Under the heading "appreciation of developed properties" the setting up of a credit account called "surplus from appreciation" or "reserve for unrealized appreciation" was discussed. As the appreciated property is converted into income through production and sale any portion of that income which represents appreciation may be transferred by journal entry from the "surplus from appreciation" or "reserve from unrealized appreciation" and credited to an account called "realized appreciation." This account represents true surplus and is available for the purposes for which other earned and unappropriated surplus is available. When appreciation is the result of exploration or development, as in case of mineral land, oil and gas wells, this method is followed.

Items must not be credited to realized-appreciation account unless they represent realization, that is, an actual conversion of appreciation into other assets. If oil properties are developed and a proper calculation of the value of the discovered oil leads to appreciation in book value of the property above cost, any production or sale of oil results in a depletion of the permanent asset. The sale price of the oil should cover:

1. Any expenses applicable to the period of sale.
2. A return of part of the original investment.
3. A realization of the appreciated value.
4. Current profit.

The third item represents the amount which should be transferred from "reserve for unrealized appreciation" to "realized appreciation." The latter represents true assets and is a surplus item. In other words, by this method the profit on oil produced is divided into two parts. A portion is considered as current profit and a portion as realization of asset value existing when the property was acquired but only brought to light by the discovery and development.

DEFICIT

18-26. Any amount by which the assets of an organization fall short of the total of liabilities and capital is known as a "deficit." It is the opposite of surplus, and is usually caused by operating losses. One of its distinctive characteristics is that it comes into existence only after the formation of an organization. Organizations are not supposed to begin business with a deficit, but it is

quite possible for them to begin with a surplus, such as a paid-in surplus. To illustrate: If a corporation issued $100,000 of stock for $120,000 cash, there would be a paid-in surplus of $20,000. But if it issued $100,000 of stock for $90,000 in cash, the difference would not be called a "deficit." Instead there would be created a debit account, known as "discount on capital stock." (See ¶ 13–16.) If a corporation issued $100,000 worth of stock for $100,000 in cash or other assets, and as a result of a period of operation the net assets shrank to $90,000, there would be a deficit.

As a deficit indicates a shrinkage in proprietorship, it properly belongs in the balance-sheet to the proprietary group of accounts. For instance:

Capital Stock Issued	$100,000	
Less: Deficit	10,000	
Net Proprietorship		$90,000

Until recent years deficits sometimes appeared among the assets on balance-sheets, not because a deficit was an asset, but apparently because it was an account with a debit balance. If this practice is followed the deficit should be shown distinct from the assets. Since it possesses none of the attributes of an asset but instead is a shrinkage that has taken place in the assets, it should be definitely separated from them. It may be shown on the asset side as follows:

ASSETS	
Cash	$ 5,000
Merchandise	35,000
Equipment	50,000
Total Assets	$90,000
Deficit	10,000
	$100,000

But even this is subject to criticism. It is much better to show a deficit as a deduction in the proprietorship group.

CHAPTER XIX

Reserves

19-1. "Reserve" is a term applied to many classifications differing greatly from each other. One might go so far as to say that there is no one characteristic common to all accounts to which the term reserve is at times applied, except that they all have credit balances. On a balance-sheet one occasionally finds all the various reserves grouped together without regard to their significance. Such a thing, however, is a relic of the days before accurate classification and arrangement became a part of accountancy.

A study of the various accounts found in American balance-sheets bearing as part of their titles the word "reserve" shows that they may be divided into four groups. Three of these are well defined. The fourth involves difficulties in classification. There are three major divisions of accounts in balance-sheets, namely: assets, liabilities and capital. To each of these reserves may apply. We have therefore:

1. Reserves applying to assets.
2. Reserves that are true liabilities.
3. Reserves that are part of the accounting capital and are appropriations of surplus.

A fourth group includes reserves which are of a deferred application. Their ultimate character depends upon the result of future operation. They may result in obligations of liability or in profit or they may be a combination of these two.

The most common reserve accounts are discussed under four groups. It is often difficult to determine in which class a reserve belongs. As an aid to determination one should give consideration to what the result would be in case of solvent dissolution of the corporation. In such a dissolution, assuming that the estimates represented by reserves have been correct in all cases, it can be readily determined whether a reserve represents a decrease in the realization value of an asset, an amount that must be paid to creditors or an amount belonging to the proprietors.

Reserves Applying to Assets

19-2. The word "reserve" indicates something that is held back. Asset reserves are amounts held back from credit to specific asset accounts. In case of certain decreases of assets, especially those which are of a cumulative nature and are estimated as to amount, it is customary to set up an account designated as a reserve for the purpose of recording such credits instead of combining them with the asset account itself. Such reserve accounts are in reality divisions of the asset accounts to which they apply. Therefore, it is desirable that such reserves be subtracted from the asset accounts in balance-sheets and the net amounts, known as the book value of the asset, be carried into the cumulative columns.

As an illustration, machinery in use is subject to continuous reduction in value. This is expressed by periodical credit entries. If the credit entries were made in the asset account relating to the machinery, the balance in that account would be reduced and would at any time show the estimated book value of the machinery. However, there are reasons why it is desirable that the cost price of the machinery, as well as the book value, should be apparent at all times. Consequently, the account for machinery is divided and two accounts are used. One of these accounts displays the cost of the machinery. It is debited with the cost of any machinery acquired and credited with the cost of machinery withdrawn from use. The other account is used to record the credits reflecting the estimated decrease in value due to depreciation. This credit account is called "reserve for depreciation," meaning that it summarizes the depreciation credits and reserves or holds them back from entry in the asset accounts to which they apply.

It will be noted that all reserve accounts applying to assets represent an estimated amount of decrease in value due to some operating element. They are, therefore, built up as offsets to debits against nominal accounts, that is, against accounts which reduce income in the various accounting periods. Reserves applying to assets may be divided into two classes: first, those which reflect a decrease in value known to be real, although the amount is estimated rather than actual; second, those which make provision for a decrease in value which is probable but not certain.

Reserves for such decreases in the value of assets as are discussed in Chapter V come under the first class. These reserves

apply to capital assets. The most common are "reserve for depreciation," "reserve for amortization" and "reserve for depletion." They cover decreases in value, reasonably certain to have occurred, the amount of which is not determinable until a future date. These reserves, therefore, represent the best estimate that the organization can make as to the amounts of decreases. These decreases in value are known to exist when the reserve is created. Such decreases in value as are discussed in Chapter V under the heads "obsolescence," "accident," etc., also may be offset by reserves; but, in such cases the reserves are usually known as "reserves for contingencies" or by some similar title and they do not come within the present class. They do not represent a loss known to be actual, but rather one which may take place in the future. Reserves of this type are "surplus reserves" representing an appropriation of proprietorship. They are discussed later in this chapter.

In the second class come reserves representing decreases in the value of accounts resulting from income operations which are contingent and may not become real losses at all. "Reserve for loss on receivables" belongs under this head. This loss may not take place, although experience may show that it is sufficiently probable to justify anticipation by means of a reserve.

Reserve for Depreciation

19-3. A reserve for depreciation should reflect the accumulated total of amounts which have been charged as expense of operation measuring the service cost of an asset. On the balance-sheet reserve for depreciation should be subtracted from the asset account. The difference brought into the final asset column is the value remaining to be charged to future operating periods, plus the value which, it is expected, will be recoverable after the period of service. In case an asset is taken out of service and its cost is removed from the asset account, the reserve for depreciation must be debited with the amount that has been reserved on account of such asset. The balance on this account should represent the amount of depreciation of assets still owned and in use.

Reserve for Amortization of Capital Assets

19-4. Because of unusual conditions it is sometimes necessary to write down the book value of assets more rapidly than ordinary physical depreciation would justify. Such a decrease of book value is usually represented by a reserve for amortization. (See discus-

sion, ¶ 5-16.) The reserve represents the amount by which it is considered that capital assets have decreased in value beyond the amounts covered by depreciation or depletion.

The term "amortization" applies to the writing down of any amount, and it is possible to have amortization reserves which do not apply to capital assets. Their purpose should always be clearly indicated.

Reserve for Depletion

19-5. The distinction between depletion and depreciation is discussed in Chapter V. The amount of depletion of any wasting asset which has been charged to operating cost is accumulated in the credit account "reserve for depletion."

Reserve for Loss on Receivables

19-6. It is possible that accounts receivable and notes receivable within a certain period may be collected in full, so that there will be no loss because of bad debts. On the other hand, collection experience may show the probability that some of the accounts will prove uncollectible in whole or in part; the reserve for bad debts is an estimate of the probable amount of such loss. Like reserves for depreciation, these reserves are an offset to charges against operating income.

To illustrate: If a certain organization finds that it has been able to collect, on the average, 99% of all accounts resulting from sales, and if in the year 1920 its net sales amount to $100,000, it is justified at the close of that year in making an entry debiting an expense account and crediting "reserve for accounts receivable," $1,000. This is based on the idea that the year 1920, which is credited with the profit on the $100,000 sales, should also bear the loss of $1,000 which is expected to occur in turning these accounts into cash, instead of allowing the loss to be borne by the year 1921, which does the collecting but receives no credit for the profit on the $100,000. Or it may be considered that while the various charges to customers amount to $100,000 and must be so recorded, the real credit to income should only be $99,000 based upon past experience in collection.

Charging to 1920 the estimated loss on collection of the accounts incurred during that year and crediting $1,000 to the reserve for accounts receivable allows the balance of that account appearing

in the balance-sheet as at December 31, 1920, to be carried at a conservative figure. The book value which appears thereon is the amount which it is expected will be realized in cash. If in 1921 the actual collection of accounts should prove the estimate to have been correct, the bad accounts would be charged against the reserve, thus reducing it during the year to zero. If, however, some of the accounts believed to be good were not collected in that year, they would still remain upon the books and form a part of the accounts receivable at December 31, 1921. The amount of reserve applying to them would also form a part of the reserve carried over at that date, to which would be added any additional reserve set aside for loss in the collection on account of sales of 1921.

If the loss in collection of $100,000 should be less than $1,000, the excess of the reserve over the amount of actual loss would be properly transferable to the profit account. It is usually adjusted to current operations and no attempt is made to carry it back to the year of its origin. This is true also of adjustments to the reserve for depreciation or to any other reserves.

Reserve for Inter-company Inventory Profit

19-7. An account known as "reserve for inter-company inventory profit" occasionally appears upon consolidated balance-sheets. It represents the amount of inter-company profit which, it is estimated, is in the inventory at the date of the statement. On a consolidated balance-sheet the total of the inventories of the various companies concerned may be indented. From this amount the reserve may be deducted, and the net total will be the value of inventories for consolidated purposes. The reason for this is discussed under the head "consolidated balance-sheets." (See Chapter XXI.) If one corporation includes in its inventory items, which have been transferred from another affiliated company, at a price above cost the effect, so far as a consolidated balance-sheet is concerned, is that of having transferred merchandise at an enhanced price from one department to another of the same company. The advance in price is of course an unrealized item and must be eliminated both from the asset and from surplus. This is accomplished by means of the reserve for inter-company inventory profit. Care must be taken, however, that no inventory profit shall be eliminated except that which applies to the consolidated surplus. In other words, any portion of surplus, accumulated from inter-com-

pany transfers of merchandise, which belongs to stockholders outside the consolidation must not be eliminated from the inventory value. Otherwise an organization would be penalized for transferring merchandise from one department to another. This of course would be contrary to good business and to good accounting.

It is worthy of notice that this reserve does not appear upon the books of the parent or of any subsidiary corporation. It is an item appearing only on the consolidated balance-sheet. It automatically reduces consolidated surplus by the amount of the reserve.

Reserves that are Liabilities

19-8. There are times when liabilities must be recorded on the books before the exact amount is determinable. Such estimated amounts when set up on the books are frequently designated as reserves. It must be noted that reserves which relate to liabilities already recorded on the balance-sheet are not true liabilities and should not be listed among them. They are discussed under "proprietorship reserves." As an illustration, a reserve for bond sinking fund is a surplus reserve. The obligation which it is presumed to protect is itself recorded among the liabilities. To record such a reserve among the liabilities would be a duplication. The amount that must be paid to creditors is shown by the bond account. After such payment has been made the amount of the sinking-fund reserve becomes free and available surplus. The purpose for which it was appropriated has been fulfilled.

Liability reserves may be exemplified by "reserve for taxes," "reserve for restoration of leased property" and "reserve for maintenance of real estate sold."

Reserve for Taxes

19-9. Taxes are liabilities from the time of their incurrence until they are paid. An estimated amount may be brought into the records before the exact amount is known. Such an amount may be called "estimated tax payable" or "reserve for taxes."

To illustrate: In preparing the balance-sheet of a corporation as at December 31, 1921, the amount of income and excess-profits tax applicable to the taxable year then closed might not be absolutely determinable, but an estimated amount might be set up under the designation "reserve for income and excess-profits tax." This is a true liability in character, although estimated as to amount, and

should appear on the balance-sheet among the current liabilities. To carry this account in the proprietorship group so that it enters into the book value of proprietorship is an error, as it does not represent an amount to which the proprietors have title at that date nor one that will be payable to them. Instead, it is a definite obligation to make payment to the government and is a liability ranking even higher as to priority of claim than the other liabilities upon the balance-sheet.

Reserve for Restoration of Leased Property

19-10. Organizations sometimes desire to make extensive changes in the condition of leased property to serve their own purposes during the period of the lease. These alterations, however, may render the property less valuable for other later tenants, and the owner of the property may require the lessee at the expiration of his lease to restore the property to its original condition. Under such contracts the lessee should carry on the books a reserve of an amount sufficient to make restoration at the expiration of the lease.

Reserve for Maintenance of Real Estate Sold

19-11. Real estate is sometimes improved and sold with a guaranty of future maintenance. From the amount of the sale, after deducting the cost of developed land sold, a further deduction must be made to provide for future maintenance. A cemetery developed by a private corporation which guarantees with the sale of each lot that certain conditions will be maintained either in perpetuity or for a specified number of years, is a typical case. If the contract is for perpetual maintenance the sum withheld for this purpose must be such that the income from it will be sufficient to provide the maintenance required by the contract. On the other hand, if the contract of maintenance is for a limited number of years, the amount withheld must be such that the income, together with the amortization of the principal sum, will be sufficient for the maintenance required by contract. Under this plan at the end of the specified number of years the maintenance cost will have absorbed the principal sum as well as all the income thereon.

Deferred Liabilities

19-12. On the balance-sheet prescribed by the Interstate Commerce Commission the account "deferred liabilities" represents the

liability of a company for the amount of assets which it controls for the administration of employees, pension, savings, relief hospitals and other association funds.

Insurance-reserve Account (on Balance-sheets of Life-insurance Companies)

19-13. The "insurance reserve" account used by life-insurance companies differs from any other account known to business. It is difficult to describe briefly its full meaning. It is said to be the account recording the net assets which a life-insurance company must have at a certain date in order to be solvent. It is the amount of assets above other liabilities which an insurance company must have so that if every holder of a policy on a given date continues to pay his premiums as they fall due, and if the assets earn the net amount of interest which has been used as the basis of the calculations of the actuary, and if all holders of policies die in the exact ratios set forth in the mortality tables used in the calculations, the organization will have exactly enough assets to meet each policy as it matures.

There is not space enough in this book to devote to a full discussion of how these amounts are determined. These are matters of actuarial science. In the balance-sheets of life-insurance companies, assets are valued according to the same principles that apply in other organizations. The amount of the "insurance reserve" is calculated by an actuary and is set up as one item on the liability side of the balance-sheet, but distinct from the other liabilities. The amount by which the total assets exceed the sum of this reserve and the other liabilities is the real proprietorship of the insurance company. If this is greater than the capital stock, the excess is true surplus. In other words, the assets of the insurance company, properly valued, are offset by four items: (1) the insurance reserve, (2) other liabilities, (3) capital stock, and (4) surplus. All these items except insurance reserve are determined according to ordinary accounting methods.

Proprietorship Reserves

19-14. In a corporation, the accumulated amount of profits and of other increases of proprietorship constitutes surplus under the control of the board of directors and is presumed to be looked upon with yearning eyes by the stockholders, for out of it dividends may be declared.

It is nearly always desirable that portions of surplus be withheld from dividends and be utilized for increasing effectiveness of the organization, for building up new service assets, for safeguarding the payment of fixed liabilities and for various other purposes which may from time to time arise. In order that these purposes may be accomplished, the board of directors will authorize setting aside certain amounts of surplus for specific purposes, usually indicating by the designation the purposes which such reserves are to serve, for example "reserve for new factory," "reserve for sinking fund" and "reserve for contingencies."

These surplus reserves or proprietorship reserves are usually for the purpose of acquiring additional assets or to provide for liquidation of liabilities. They may be for other purposes, such as a reserve for dividends, which is no more than setting aside in expectation of formal declaration of a dividend a certain amount which will later be transferred from the proprietorship group to the liability group. Until the formal declaration is made, however, the amount should be retained in the surplus group. In the balance-sheet, proprietorship reserves should appear under the proprietorship heading and adjacent to other surplus classifications.

There is one type of reserve, "reserve for unrealized appreciation of assets" which has been discussed under the subject "appreciation." (¶ 18–21.) This reserve account is no more than an entry to offset the amount by which assets have been written up as a result of appraisal above their cost price. It is not of the character of the other surplus reserves, yet in balance-sheets it may be included in the proprietorship groups, provided it be not merged with any other account or accounts so as to lose its identity. This is discussed also under the heading "surplus." (See ¶ 18–2.)

Reserve for Undeclared Dividend

19-15. As has been said, organizations sometimes set aside out of surplus amounts to care for future declarations of dividends, especially those on preferred stock. Amounts so set aside may appear under the heading "reserve for undeclared dividend." They still form a part of surplus and should appear with the proprietary group in the balance-sheet, as setting aside these amounts does not give them the characteristics of liabilities. A definite liability, however, is created when a dividend is legally declared by the board of directors. The result of such action should be expressed by a div-

idend-payable account which is a true liability. (See ¶ 14–16.) Setting aside a reserve of this kind does no more than indicate a withholding from surplus of an amount to care for dividends if and when they may be declared.

19-16. Reserve for Debt Redemption is similar to the reserve for sinking fund (see ¶ 19–17) and is commonly used as an offset to a redemption fund on the asset side of the balance-sheet. This reserve usually represents surplus profits set aside periodically and accumulated for redeeming some specified obligation or series of obligations. The methods of building up this reserve are similar to those discussed under the head "sinking fund."

19-17. Reserve for Bond Sinking Fund represents the amount of surplus appropriated because of contractual agreement whereby during the life of bonds there must be set aside out of profits and withheld from dividends amounts sufficient together with the earnings thereon to equal the face of the obligation at its maturity. (See discussion under Sinking Fund, ¶ 8–18.) Amounts set aside in this reserve constitute true surplus and after the maturity and liquidation of the bond issue they may be transferred to the open surplus account.

19-18. Reserve for Betterments or Improvements may appear under more specific headings, such as "reserve for new factory" or any other title indicating the purpose. These reserves are portions of surplus reserved from dividends to permit an accumulation of assets from the profits of the corporation which will enable it to acquire the desired betterment or improvement without creating a liability or calling for additional contributions of capital. They represent attempts to improve the facilities of the corporation by withholding profits from the stockholders instead of borrowing from creditors. Such reserves are portions of surplus and after they have fulfilled their function the amounts remaining in them may be transferred to the open surplus account.

19-19. Reserve for Contingencies is a term which may be applied to amounts of earnings withheld from dividends for the purpose of meeting any "contingencies" which may arise. Sometimes these contingencies are definitely in mind when the reserve is made. At other times the board of directors merely creates a reserve in order to be prepared for anything that may unexpectedly arise and will require the expenditure of funds. Such a reserve generally indicates foresight and conservatism on the part of the management, but,

like any other surplus created only because of the action of the board of directors, it may be eliminated and transferred to surplus by later action of the board.

Reserve for Insurance

19-20. Instead of obtaining maximum insurance protection through insurance companies, some organizations prefer to carry a portion or all of the risk themselves. This is based on the assumption that the amounts they would have to pay as premium for full protection would probably be greater than the loss against which protection is secured. The usual method of handling such accounts is to credit a reserve account periodically with the amount of premium which could be charged by insurance companies for the protection which is self-carried. Any losses which the company may have to bear will be charged against this reserve.

There is some question in the minds of accountants as to the proper treatment of such a reserve. As before noted (see ¶ 19–1), reserves are classified in four groups. The first group includes those which relate to reduction of asset value. Evidently this reserve does not come in such a class. No asset is reduced in value because the organization is carrying its own insurance. Another group of reserves applies to estimated liabilities. This reserve does not apply to any indebtedness to anyone. The third group includes reserves which are no more than appropriations of surplus, and it seems that it is here that this reserve should be placed. It is a form of "reserve for contingencies" but is specific as to the contingency. If operating accounts are charged with the amount of the estimated premiums, an element of expense will be introduced which will not be real, except as it may be justified by actual losses charged against the account. If these charges enter into the cost of goods manufactured, there is danger that inventory will be increased by an amount represented on the other side of the balance-sheet by an addition to the surplus reserve. Such a result would be in violation of accounting principles in that it would be including on the one hand as a cost an item which at the same time appears on the other side as a profit.

Reserves of a Deferred Application

19-21. Reserves of deferred application include those accounts on the books representing asset values received which do not be-

come a part of the proprietorship or of earnings until certain obligations are fulfilled. They are in the nature of liabilities, with the difference that they are payable in service rather than in money. This service may be accomplished simply with the passing of time. Interest that has been received in advance is not really income until the passing of the time for which the interest payment is made. Amounts received before they have been earned should be credited to an account such as "interest prepaid," "income received but unearned" or "reserve for unearned interest."

These accounts often appear on the balance-sheet in the proprietorship group. This, however, results in anticipation of profit, which is incorrect. Sometimes they are displayed in the liability group. This also is incorrect, as they do not constitute an obligation to turn over values to parties other than the proprietors.

No sharp line of distinction can be drawn around this group. To a certain extent every reserve belongs to it, in the sense that a reserve is usually an estimate. Any excess of estimate over the need for which the reserve is created becomes an addition to surplus. However, in most cases no recognition can be given of this possible error until it has become absolute.

As to presentation upon the balance-sheet, each reserve account must be carefully studied to determine its predominating character and must be grouped accordingly. If necessary a special classification, other than liability and capital, may be made on the balance-sheet to care for reserves which can not be properly classified under either of these groups.

Deferred Credits

19-22. The term "deferred credits" is occasionally found in balance-sheets, but, if used at all, it should be accompanied by more definite description. Most amounts coming under this heading are such as ultimately will be converted into a liability or into a surplus item. Some organizations classify under this heading all items of income received in advance of the period to which they properly belong. As accounting periods pass, the organization transfers the proper amounts from deferred-credit accounts to income accounts. It seems to be the tendency of accountants to group these items under specific reserve accounts indicating their nature with such definiteness that their relation to the financial condition of the organization may be readily seen. Here would appear such items as prepayments for service to be rendered, premiums on securities

issued, discounts on securities purchased, etc. The word "reserve" may or may not form part of the name of these accounts.

Prepaid Rentals

19-23. When the lessor of a building receives rentals in advance, the amount received may be credited to prepaid-rentals account. As the periods of service pass, the amounts applicable thereto are transferred from this account to income. This account may also be called "reserve for prepaid rentals" or "reserve for unearned rentals."

Reserve for Prepaid Leasehold

19-24. When the lessor of a property receives in advance an amount which is not applicable to the rental for the current period but is an amount covering the entire period of the lease, it should not be credited to profit in the year in which it is received but rather it should be credited to "reserve for prepaid leasehold" or some similar account. This amount would be apportioned over the life of the lease and the periodic amounts transferred from it would be credited to the income accounts of the respective years. (See Chapter IX.)

To illustrate: If "X" leases a piece of property to "Y" for a period of 20 years and receives in advance a payment of $100,000 for the leasehold, this amount should be set up as described, and should be transferred to income during the twenty years. By the straight-line method, this would result in annually debiting this account with $5,000 and crediting the same amount to income. Other methods would change the amounts of periodic transfer, but whatever the amount it would be treated as the $5,000 above is treated. The reserve for prepaid leasehold is a deferred profit and the true accrued profit is periodically transferred from it to the gain accounts.

In the above illustration, if "Y" agrees to pay a certain amount as annual rental in addition to the prepayment of $100,000, the real periodic income to "X" is the amount of the annual payment plus that part of the $100,000 which belongs to each period.

Unearned Advertising

19-25. Organizations receiving an income from advertising may credit the amounts received in advance to "unearned advertising" account, transferring from it periodically the amounts applicable to each period.

To illustrate: A magazine receives a sum in prepayment for advertisements to appear in ten issues. The amount will be credited to "unearned advertising." As each number of the magazine in which the advertisement appears is issued, the proper amount is transferred from this account to an income account. The account is used not only by publishing houses, but by billboard companies and various other kinds of advertising agencies which receive prepayment for service to be rendered over a period of time.

Unearned Subscriptions

19-26. Magazines, which receive revenues from subscriptions paid in advance and prepare monthly profit-and-loss statements, should not credit the subscriptions to income when received, but should credit them to "unearned subscriptions" or some similar account, transferring amounts from this account to income only as they are earned.

Unearned Interest

19-27. When interest is collected in advance or is included in the face of a note receivable, the amount of interest should be set up in an "unearned interest" account to be transferred to income as the interest is actually earned. This is especially true in the case of long-time notes receivable when the amount of interest included is considerable and covers a number of accounting periods.

Reserve for Prepaid Orders

19-28. Organizations, such as mail-order houses, which receive orders for goods accompanied by prepayment, should credit the cash as received to an account with the heading "reserve for prepaid orders" or one of similar meaning. As shipments are made, debits should be passed to this account and corresponding credits to sales income.

Advances Received for Contract Work

19-29. An amount received for contract work in advance of performance of the service may be set up as a liability, as it represents money which would have to be refunded if the organization failed to complete the service for which the payment was made. It should not be considered as income until the service has been rendered. If the contract provides that payments shall be received periodically

during the progress of the work and shall not be refunded, the account may appear as a deduction from cost of contracts in progress on the asset side of the balance-sheet instead of appearing as a liability.

Unamortized Discounts on Securities Purchased

19-30. When securities are purchased they may be carried at purchase price, the difference between that price and their redeemable value being amortized during the intervening periods, as explained in ¶ 8–6. Or the asset account representing the securities may be set up at par value, the discount or premium being recorded in a specific account. (See ¶ 8–7, 13–11.) If the purchase price is less than maturity value of the securities the difference may be carried in an account "unamortized discount on securities purchased." This amount represents a profit between the time of purchase and the realization. It is therefore transferred to income proportionately during the periods intervening. The method is described in ¶ 8–7, 8–8.

Premium on Bonds Issued

19-31. The amount received for a bond issue in excess of its face value should not be treated as an immediate profit by the issuing corporation but should be set up in a credit account to be apportioned to profit during the life of the bond issue. The portion not transferred to profit remains in the balance-sheet as a reserve. If the bonds contain a clause whereby they may be redeemed at a premium, only so much of the premium received from their sale as is in excess of the premium that may have to be paid for their redemption should be amortized.

19-32. Unadjusted Credits is the title of an account appearing on the balance-sheet prescribed by the Interstate Commerce Commission. It is somewhat miscellaneous as it embraces such items as accrued taxes, operating insurance and casualty reserves and accrued depreciation, which represents the estimated decrease in value of assets and should appear as a deduction therefrom. It is not a classification which meets the present-day demands of accountancy and it should not be used by organizations other than those under direction of the Interstate Commerce Commission.

CHAPTER XX

Comparative Balance-sheets

20-1. Nearly all impressions with regard to facts are relative. Very few are absolute. We judge an amount to be large or small by comparison with other amounts either actual or in mind. We think of profits as large or small always in relation to some other amount. We reach our conclusions, therefore, largely by comparison. We compare the profits of an organization for one period with profits of similar periods of the same organization or with profits of other organizations for the same or another period or with some fixed amount which has been set in advance as a standard — and according to this comparison we consider the profits large or small. Similarly, the condition of an organization at any time is understood best when compared with the condition of the same business at a previous date or with other pertinent facts.

The comparative balance-sheet is intended to give additional assistance in appraising the financial standing of an organization at a given date. It displays the various classifications so that the amounts in each classification at two basic dates may be readily compared. Increases and decreases in each classification are usually shown in order to aid the comparison. The comparative balance-sheet showing conditions at the beginning and at the end of a period may also display the disposition of profits or of other increment during the period — which is often most desirable information.

Arrangement

20-2. The common form of arrangement provides four columns for figures. In the first column are the amounts representing conditions at the more recent date. In the second column are the amounts showing conditions at the earlier date. In the third and fourth columns the increases or decreases, respectively, are shown. The last two columns may sometimes be merged in one by the use of two colors for the figures, such as black for increases and red for decreases.

Assets, liabilities and capital may be arranged in schedule form, the liability and capital items being listed below the asset items; or they may be arranged in the so-called balanced form in which the liabilities and capital are arranged to the right in opposition to the assets. As the latter form necessitates an unusual width of paper in order to provide two columns for names of accounts and eight columns for figures, it is not so popular for comparative use as the schedule or running form. The main advantages of the balanced form for the ordinary balance-sheet are partly lost in so complicated a thing as a comparative balance-sheet.

If separate columns are used for increases and decreases, each will have its totals for assets, for liabilities and for capital items. As a result, the most essential fact, that is, the net increase or decrease, is not clearly displayed. The facts, however, may be shown quite satisfactorily in a summary following the comparative balance-sheet. The summary will reduce to a few terms the essential facts as to increase or decrease. It will be a valuable aid to the layman, as without it he may fail to see that on the liability and capital side of the balance-sheet some increases are favorable and others are unfavorable. For instance, both a decrease of liability and an increase of assets are favorable. Either may be represented by an increase in a capital classification.

The net increase of capital shown by a comparative balance-sheet, plus any withdrawals of profit, such as dividends, and minus any contributions of capital, such as from stock sales, will be the profit for the period between the dates of the balance-sheets.

In the case of organizations having imperfect records or no records at all of the transactions of a period, it may be impossible to prepare a profit-and-loss statement for the period. In such a case, the net profit or loss for the period may be determined if it is possible to ascertain (*a*) the increase or decrease of capital or net worth from a date at the beginning to a date at the end of the period and (*b*) the contributions and withdrawals of capital during the period. This may determine the amount of the net profit, but it is not to be considered a statement of income and expense for the period. It does not analyze the net profit nor show how it was obtained. Instead it shows only the amount by recording its disposition — that is to say, by showing how much of it is represented by increased assets, decreased liabilities or by any combination of these factors.

Condensed Balance-sheet

20-3. When it is desirable to present a balance-sheet on which only the essential features appear, the accounts may be so condensed that only a few headings will be necessary on each side of the balance-sheet. The exact form will vary of course with the nature of the accounts and with the kind of organization.

The following is an illustrative form:

The X Manufacturing Company, Inc.
Condensed Balance-sheet
as at December 31, 1921

ASSETS	
Current Assets	$0,000
Capital Assets	0,000
Investments	0,000
Goodwill	0,000
Total	$0,000

LIABILITIES	
Current Liabilities	$0,000
Capital Liabilities	0,000
Capital Stock	0,000
Surplus	0,000
Total	$0,000

20-4. Balance-sheets of single organizations and consolidated balance-sheets may be expressed in comparative form. The comparative balance-sheet is often expressed in condensed terms and made supplementary to the complete single balance-sheet. It is seldom desirable to include in the comparative form as many details as are usually required in the single balance-sheet.

Any balance-sheet may be prepared in condensed form. There is the condensed comparative balance-sheet and the condensed consolidated balance-sheet. If the classifications, however, are too much condensed the balance-sheet will not impart intelligible information in regard to the condition of the company. The usefulness of condensed balance-sheets is limited.

CHAPTER XXI

Consolidated Balance-sheets

21-1. If two or more corporations are controlled by the same interests to such an extent that they are really operated by the same group of people, it is desirable to show the exact financial standing of the combination as a whole in addition to that of each unit. While it is true that each affiliated corporation is a distinct entity so far as its legal existence is concerned, yet from the commercial point of view, they appear to be merely organized departments of one company. This resemblance is especially noticeable in case of corporations which, in order to facilitate their various activities, incorporate each essential operating department as a distinct legal unit. This may lead to more effective organization, both for operation and for financial purposes, but the fact remains that all these several corporations together form one entity so far as the commercial world is concerned.

The reason, then, for consolidating financial statements of related companies is based upon the necessity of obtaining condensed information for business use without regard to the various legal entities thus combined. The government, for purposes of taxation, has recognized that more equitable results can be obtained by consolidating the incomes of those organizations which are essentially one, than could be obtained by treating the legal entities as separate taxable units.

21-2. Consolidation for balance-sheet purposes consists of adding together the amounts of similar classifications in all the controlled companies. The cash of the consolidation is the total of the cash items of all the companies involved. The amount to be shown under each classification in the consolidated balance-sheet is the total of the amounts shown under the same classification in all the balance-sheets. However, in this process certain eliminations may be required. These concern inter-company transactions. The chief adjustments to which consideration must be given in the preparation of consolidated balance-sheets are:

Elimination of inter-company indebtedness
Elimination of inter-company ownership
Elimination of inter-company profit in inventory
Adjustments for inter-company items in transit.

INTER-COMPANY INDEBTEDNESS

21-3. In consolidating the balance-sheets of corporations, it must be kept in mind that each organization is treated as though it were only a department of the greater whole. Indebtedness of one such corporation to another becomes merely an indebtedness of one department to another and so has no place in the consolidated balance-sheet. In other words, if the debt were paid, the consolidation would be neither richer nor poorer, nor would it owe more or less than if the debt remained. Evidently such inter-company indebtedness must be eliminated from both the asset and the liability sides in the consolidated balance-sheet.

Receivables of any organization must indicate legal claims which it has upon parties outside itself and, similarly, payables represent the legal claims of outside parties upon the company whose financial condition is displayed.

Corporation "A" may owe corporation "B" $10,000 on open account or note payable or mortgage or any other form of liability. So far as Corporation "A" is concerned, this may be a legitimate liability, and so should be shown in its balance-sheet. So far as Corporation "B" is concerned, this may be a legitimate asset and so appear in its balance-sheet. However, if the proprietorships of Corporation "A" and of Corporation "B" be so centered that they form one control, and a consolidated balance-sheet is prepared by adding the assets of "A" to the assets of "B" and likewise adding their liabilities and proprietorships it is evident that the $10,000 does not affect the combination so created. The larger unit of "A" and "B" combined has no claim upon any outside party nor any indebtedness to any outside party because of this $10,000. It is evidently neither a receivable nor a payable of the consolidation and so must be eliminated.

This argument applies to bonds as well as to other forms of indebtedness. However, in the case of bonds it is desirable to show in an indented column the total of bonds issued and to show as a deduction those which have been re-acquired and are held in the treasury. In a consolidation, all bonds of one unit owned by

another unit of the consolidation are treated as treasury bonds and are deducted from the total of bonds issued in order to show the net amount outstanding and payable to outsiders.

Inter-company Ownership

21-4. Since it is the purpose of proprietorship accounts to reveal the amounts of the assets belonging to persons other than creditors, it is evident that inter-company-owned stock must be eliminated in consolidation. That is, any stock of one of the consolidated units belonging to another of the units must be eliminated both as an investment and as a capital item.

If corporation "A" owns stock in Corporation "B," it would appear on the former's books as an investment, that is, as a sum invested in another enterprise, and on the books of the latter as a part of the proprietorship outstanding. In a consolidation of the accounts of "A" and "B" both these items would disappear, for the actual assets represented by the stock would be substituted for the investment. Only that portion of "B's" stock would remain outstanding on the consolidated balance-sheet which was owned outside the consolidation.

This elimination sometimes involves complications, as the net assets substituted for the proprietorship may have a value greater or less than the investment as it appears on the books of the owning company. This difference must be adjusted and in the adjustment two difficult factors may enter. One is surplus, the other, goodwill.

Illustration: Assume that Corporation "A" owns all the capital stock of Corporation "B" and carries it on its books at the purchase price, say, $140,000. Assume that on December 31, 1921, the balance-sheet of Corporation "B" shows assets, $175,000, liabilities, $25,000, capital stock, $100,000, surplus, $50,000. In the consolidation, there must be added to "A's" assets the $175,000 assets of Corporation "B" and to "A's" liabilities the $25,000 of "B's" liabilities. The effect is a net worth increase of $150,000, but there must be deducted from "A's" assets the investment of $140,000 for which these amounts are substituted. As a result, there is a net increase of proprietorship of $10,000 over that shown on "A's" balance-sheet. Since "A's" outstanding stock remains the same, this procedure apparently adds $10,000 to the surplus of "A" in order to obtain the real surplus of the consolidation.

21-5. A further complication which may enter into the question depends upon the net value of the assets at the time when "A" paid $140,000 for them. Assume there had been no dividends in the interim, but that Corporation "B" during that time had earned, say, $45,000. If the surplus is only increased $10,000 because of the consolidation, what became of the other $35,000 of profits? One might say that Corporation "A" paid too much for the stock, as it paid more than the book value, and that the $35,000 went to make up that deficiency. However, it is contrary to the fundamental principles of investment that a deficit should be created by a purchase. Stating the same principle positively rather than negatively, all assets acquired are theoretically worth their purchase price at the instant of acquisition, even though they may at once begin to depreciate. Therefore, at the time Corporation "A" bought the stock of Corporation "B," it acquired assets theoretically worth the purchase price of $140,000. If the net assets at that time were only $105,000, evidently "A" must have purchased an element of goodwill for $35,000. Had a consolidated balance-sheet been prepared immediately after the purchase of the stock, it would have been necessary to list, among the assets, goodwill at a value of $35,000 to prevent shrinkage of the surplus of Corporation "A" because of the purchase of "B's" stock.

Under the subject of goodwill it is explained that it is not necessary ordinarily to write down goodwill that has been duly purchased, unless the goodwill has definitely disappeared. If this theory be applied here, the goodwill item of $35,000 which appears on the consolidated balance-sheet at the time of the purchase of "B's" stock may rightfully appear also on the consolidated balance-sheet at December 31, 1921. If the matter is so treated the consolidation adds $45,000 instead of $10,000 to the surplus of "A," which is evidently as it should be, as according to the illustration, Corporation "B" had made a profit of $45,000 since its stock was purchased by "A" and no dividends had been paid.

The rule may be stated as follows: any amount paid by one unit of a consolidation for the stock of another unit of the consolidation above the book value at the date of purchase may be set up on the consolidated balance-sheet as goodwill. Conversely, if the book value of any stock of a unit be greater at the date of purchase than the purchase price paid for it by another unit of the consolidation, the excess may be used to reduce the consolidated goodwill in case

there is such an element upon the balance-sheet of amount sufficient to permit such treatment. Of course, this principle must not be used so as to create an element of goodwill with a credit balance because such an element would no longer be goodwill but would probably be surplus. It would be similar to the credit balance on the goodwill account of any organization which had sold its goodwill for more than book value.

To illustrate: If the stock of Corporation "Y" has a book value of $100,000 and this is purchased by Corporation "X" for $90,000, it is evident that the substitution of "Y's" assets for "X's" investment would result in increasing the surplus of "X" by $10,000.

After the assets of a consolidation have been properly determined and recorded and the liabilities to parties outside the consolidation (aside from liabilities of a proprietary character) have been determined and recorded, the difference apparently would be consolidated capital. Here a problem arises which does not appear in the capital account of single corporations. The capital stock of the parent or controlling corporation which is owned outside the consolidation is of true proprietary character and may be shown like the capital stock of any single corporation. The problem arises when a portion of the capital stock of some subsidiary is held outside the consolidation. Such capital stock indicates an ownership which applies only to certain of the assets of the consolidation and has no rights whatsoever with regard to the other assets. It represents a part proprietary control over assets which have now been merged in the larger unit, the major control of which is represented by the outstanding stock of the parent or controlling corporation. Such outstanding stock of subsidiaries should be so displayed on the balance-sheet as to indicate the exact status of the item. An illustration of the treatment of such capital stock may be found in the balance-sheet of the Putter Engine Works, Inc., at the end of this volume.

Inter-company Profits

21-6. Trading operations involving profit frequently occur between two or more subsidiaries of a consolidation. At the time of a consolidated balance-sheet any inventory resulting from such trading may contain an element of profit. Since a consolidated balance-sheet attempts to present the financial position of the larger unit of which the individual companies are only a part, it

is necessary that the inventory be carried into the balance-sheet at a figure not exceeding cost. To give effect to this principle, all inter-company profit in the inventory must be eliminated if it affects the consolidated surplus.

To illustrate: Corporation "X" owns the entire stock of Corporation "Y." The latter sells to the former merchandise at an advance of 25% over cost. Each dollar of such inventory in Corporation "X's" balance-sheet represents a cost to Corporation "Y" of only eighty cents. Corporation "Y" however, is no more than a department of Corporation "X," since the latter owns its entire capital stock. Therefore, each dollar of such inventory on Corporation "X's" books has really cost the consolidation only eighty cents and must be carried at that amount in the consolidated balance-sheet. To carry it at one dollar would show an asset at an amount in excess of its cost and would also show an inflation in surplus of twenty cents for each dollar of the inventory. This inflation would not represent profit, but only a transfer between departments. Profits are not made so easily as that.

Again, if the price at which Corporation "Y" transferred merchandise to Corporation "X" could be used as the basis of valuation for balance-sheet purposes, the latter corporation could make its inventory any amount that it chose, with a corresponding effect upon surplus. If the buyer and the seller are one, evidently the price of transfer becomes fictitious and independent of any real value.

If the subsidiary corporation is only partly owned by the consolidation, another element enters. To the outside stockholders of a corporation having no holdings in the parent company, inter-company sales should have the same effect as sales to other organizations. To such stockholders of a subsidiary corporation, sales made outside that corporation may be considered valid. Profits resulting from such sales properly belong to the stockholders. The amount of surplus to which stockholders outside the consolidation are entitled should not be affected because the sales were made to an affiiliated company.

To illustrate: If, in the example given above, Corporation "X" owned only 75% of the stock of Corporation "Y," the former would be entitled to only 75% of the latter's surplus. The consolidated surplus, then, would be affected by only 75% of the profit resulting from the sales of merchandise by Corporation "Y"

to Corporation "X" and therefore only that part should be eliminated. For each dollar of inventory on Corporation "X's" books so acquired, a surplus of twenty cents has been created for Corporation "Y." Corporation "X" is entitled to 75% (that is, to fifteen cents) of this surplus. This, not being true profit to the consolidation, should be eliminated. And fifteen cents on each dollar of inventory should also be eliminated. This removes the inflation from the consolidated surplus and brings the inventory to cost. That the latter is true may be determined as follows: each dollar of such inventory billed to Corporation "X" represents to Corporation "Y" a cost of eighty cents. In addition, five cents properly belongs to the outside stockholders of "Y," making a total cost of eighty-five cents.

The rule with regard to inter-company profits may be stated as follows: in consolidating the accounts of two or more affiliated companies, profits in inventory resulting from inter-company transactions should be eliminated to the extent of the inter-company ownership of the corporation whose surplus is affected by such profits. The treatment which is described above is correct but frequently in practice inter-company profits are overlooked if they are small in amount.

Transit Items in Consolidated Accounts

21-7. Organizations whose accounts are consolidated may have dealings with each other so that transit items may exist at the date of consolidation. For instance, in consolidating the accounts of Corporations "X," "Y" and "Z" it may be that Corporation "Y" has shipped merchandise to Corporation "X" which has not been received by Corporation "X" at the date of the balance-sheet. Since the balance-sheets used in the consolidation were prepared after the deduction of this merchandise from the inventory of "Y" and before its addition to the inventory of "X" it is evident that there is merchandise belonging to the consolidation in excess of the sum of the inventory items appearing on the individual balance-sheets. This should be corrected in the consolidation by adding this amount to the inventory of "X" and deducting a similar amount from the accounts receivable of "Y." The addition to the inventory of "X" should take place before the calculation eliminating the profit in the inventory.

Similarly, Corporation "X" may have sent a cheque to Cor-

poration "Z" prior to the date of the balance-sheet which had not been received by the latter company at that date. Evidently this amount of cash in addition to the sum of the cash items appearing on the individual balance-sheets belongs to the consolidation. It should, therefore, be added to cash in the consolidation adjustments. If this cash was in payment of an indebtedness of "X" to "Z," such as a promissory note, the item would appear in the notes receivable on Corporation "Z's" balance-sheet. As this could not represent any receivable due to the consolidation a deduction of this amount should be made from the total of the notes receivable by the consolidation. Similar treatment would be required if the cash was to pay some item other than a note.

Other problems and complications may arise when the accounts of two or more corporations are consolidated, but usually the solution of the difficulty becomes apparent if it is remembered that the consolidated statements treat as one unit the whole affiliation and that the various individual entities so consolidated are practically no more than departments of the combination.

CHAPTER XXII

Certification of Balance-sheet

22-1. Balance-sheets prepared by accountants in public practice frequently bear certificates signed by the accountants. The form of certificate varies with the custom of the accountant signing it. Whatever the wording, the substance of it should be to the effect that in the opinion of the accountant the balance-sheet expresses the true financial condition of the organization at the date designated. While it is true that some things in a balance-sheet are statements of fact, there are nearly always other things which are questions of opinion rather than of fact. This is responsible for qualification in the wording of the certificate. The certificate is a signed statement in which the accountant briefly expresses his belief in the truthfulness of the balance-sheet.

Sometimes the accountant does not fully verify all the items in the balance-sheet, and he must qualify his certificate accordingly. Any item of vital importance in the balance-sheet, which, for any reason, has not been investigated to the satisfaction of the accountant must be mentioned in a qualifying phrase or statement. Inventories and accounts receivable are typical items of this kind.

It is a quite general practice for the accountant to accept the inventory of a client so far as count and classification are concerned — that is, the accountant does not re-count the inventories nor verify completely the classification. It is often impracticable for him to attempt to do so as his verification is usually at a different date and the proper classification of inventory items frequently involves a technical knowledge which is not within the realm of the accountant. These points are considered in the discussion of inventories. (See Chapter VII.) The accountant generally obtains a certificate in regard to the inventory signed by officers of the organization and, in addition, makes such tests as seem advisable.

An organization may decide not to incur the expense of having the accountant make a complete verification of its accounts receivable. This applies particularly to organizations in which these accounts are voluminous and complete verification of them would

be unduly expensive. The accountant in such cases verifies all the other items in the balance-sheet, makes such tests of accounts receivable as seem proper and then qualifies his certificate by indicating the scope of his verification. This is only permissible when the investigation of the accountant convinces him of the reasonableness of the amount reported to him after he has tested the details as far as he considers necessary. If his test discloses discrepancies, a more thorough investigation must be made and if any evidence of fraud or intentional misstatement is found the accountant must not sign even a qualified certificate until he has made a complete verification and is satisfied of the accuracy of every amount and classification.

22-2. Qualifications or limitations with regard to a balance-sheet may be made in one of three ways:

(a) If few in number the qualifications may be embodied in the certificate itself.

(b) If the qualifications may be briefly expressed some accountants prefer to state them in parentheses immediately following the particular classifications to which they apply in the body of the balance-sheet.

(c) If longer explanation is necessary to express the exact facts a report containing all such comments should accompany the balance-sheet.

As it is the purpose of a balance-sheet to give as clear an understanding as possible of the financial condition of an organization, it is often necessary to do more than merely to state a specific amount in an account. Explanatory comments may be necessary. Consequently it is desirable that the balance-sheet be accompanied by a report wherein the significance of special features in the balance-sheet may be clearly set forth.

In the case of (b) or (c) above, a certificate must be so worded as to refer definitely to qualifications. For instance, if the method used is one referred to under (b), the certificate may read:

> "On the above basis WE CERTIFY this balance-sheet to set forth correctly the financial position of the Blank Manufacturing Company as at June 30, 1923.
>
> (Signed) PERIOD & COMMA,
> *"Certified Public Accountants."*

If the method described under (c) is followed the certificate may read:

"WE CERTIFY that subject to the comments in our attached report the above balance-sheet, in our opinion, is a true and correct presentation of the financial position of the Zero Trading Corporation as at March 31, 1923.

(Signed) DASH & DASH,
"Certified Public Accountants."

22-3. There are technical accounts in the balance-sheets of some organizations, the determination of which is not the work of the accountant. For instance, "discovery value" of oil or mineral companies is the result of an engineering calculation. The so-called "reserve" of life insurance companies is the result of actuarial calculation. In balance-sheets of such companies, the accountant will secure certificates from trustworthy engineers or actuaries relative to the technical accounts involved and will accept such certificates at their face values.

Occasionally one sees a certificate which contains no more than an assertion that the statement to which it is attached is "in accordance with the books." Except in rare cases such a certificate is of no value. The chief purpose of a balance-sheet is to indicate the financial facts concerning an organization, whether such facts are or are not recorded in the books. There may be a wide difference between amounts recorded in books and values actually existent. The investigation of the accountant therefore must go back of the books and must disclose with regard to assets their existence and proper ownership and with regard to liabilities must ascertain whether or not all obligations of the organization are included in the balance-sheet so far as they can be determined not only from the records but from all other supplementary evidence properly obtainable by the accountant in the course of his investigation. The figures "in the books" may be no more than a compilation by some enterprising bookkeeper who has been sitting up nights and recording non-existent assets and fictitious reductions of real liabilities.

22-4. Accountants are occasionally asked to certify a balance-sheet giving expression to a condition of affairs which will exist after proposed financing shall have taken place. As an illustration:

A corporation may decide to issue $1,000,000 additional preferred stock and may make a contract whereby a financial syndicate agrees to underwrite the issue at, say, 97. This means that the syndicate will undertake to sell the preferred stock so that the corporation will receive 97 cents net for each dollar of par value of the new preferred stock issued. To facilitate the sale the syndicate may desire to publish a balance-sheet of the corporation showing what will be the condition of affairs after issuance of the new stock. The accountant preparing such a balance-sheet will show additional amounts of preferred stock, $1,000,000; cash, $970,000; and re-organization expense, $30,000. The headings of such a balance-sheet must be so worded that readers of it will understand that it represents, not an actual condition of the corporation, but the condition of the corporation as it would be, assuming the sale and issuance of the preferred stock to have been consummated. The certificate attached to such a balance-sheet must be so clearly worded that no possibility of misunderstanding may exist.

Many conservative accountants look with disfavor upon those balance-sheets, even though they may at times consent to prepare them in order to meet what seem to be the requirements of the security-selling world. The danger lies in the possibility that such statements may be misinterpreted. Too many people are inclined to look merely at the name of the accounting firm at the foot of a balance-sheet and, if the firm is of good standing, to assume that everything in the balance-sheet represents a condition at the date given. They often fail to give any consideration to a qualified heading or a qualifying clause in the certificate.

22-5. The certificate of an accountant does not constitute a guaranty by him. The accountant presumably exercises his best judgment after thorough investigation of all available evidence as to values or obligations displayed in the balance-sheet. If the statement later proves to be in error the reputation of the accountant may be injured, especially if the errors are vital. But ordinarily he is not liable for any shortages which his audit may have failed to disclose. Legal action may be brought against the accountant for failure to do what by right of his profession he is supposed to do, and in certain circumstances punitive damages may be assessed against him, but it has been held by the American courts that the accountant is not an insurer and, therefore, if he has ex-

ercised reasonable care he can not be held liable for replacement of shortages which his investigation failed to reveal.

22-6. The value of a certificate upon a balance-sheet lies in the fact that the accountant signing it is a disinterested party, that presumably he has the requisite training, ability and judgment to make such an investigation in regard to all items in the balance-sheet as will disclose the truths as nearly as may be, and that conditions are honestly recorded. The values of many balance-sheet items are questions of expert opinion, and it is evident that the importance and worth of a balance-sheet, as a whole, must depend largely upon the skill and judgment of the accountant who has prepared it. In a large and complicated organization matters involving questions of opinion are so numerous that it is doubtful if any two of ten able accountants, working independently, would agree in regard to all of them. A careful study of various accounts discussed in this book will verify the correctness of this statement.

22-7. The certificate of the accountant instead of appearing on the face of the balance-sheet may be attached to or form part of a more or less comprehensive report accompanying the balance-sheet. Illustrations of various types of certificates are shown on the balance-sheets at the end of this book.

CHAPTER XXIII

The Balance-sheet for Credit Purposes

23-1. When credit is granted, the chief concern of the creditor is the voluntary and prompt payment by the debtor, first, of the principal sum advanced and, second, of whatever additional amount may accrue to the creditor as interest or gain.

The principal sum may be due at the end of thirty, sixty or ninety days, or it may not fall due for one or more years. Interest or income may be due when the principal sum is to be repaid or, in the case of loans covering several years, it may fall due annually or at stipulated dates during every year. The ability and the willingness of the debtor to make payments when they are due are matters of great importance to the creditor. Justifiable confidence as to these two essentials can be established by a credit-man only after exhaustive study of the character, past performances and financial condition of the debtor.

The balance-sheet of the debtor not only displays his financial position at the date indicated but offers to the credit-man much additional information of vital interest to him if it is properly prepared and properly interpreted. This necessitates a common understanding between the one preparing the balance-sheet and the credit-man who reads it as to what is meant by each classification and as to the method of measuring or valuing it. One purpose of this book is to aid in such mutual understanding. In a general way a balance-sheet indicates the policy of the management, the values under its control and the manner in which these values have been invested. More specifically it may display the organization's ability to pay its present indebtedness and, if supported by a proper analysis, it aids in forecasting the organization's probable future abilities in this respect. As to the debtor's moral character and his willingness to repay his debts the balance-sheet offers little information, except as his willingness may be affected by financial conditions. In other words, repayment of his debts will depend upon his character, his available cash at the due date, and the ability of his organization to continue to earn income.

23-2. Long-time loans include those made for one year or more. They are usually represented by formal documents as explained in Chapter XV. The grantor of long-time credit is chiefly interested in two things: first, the certainty of repayment of the principal sum at its maturity; second, the certainty of regular payment of interest at interest dates. He is not so concerned with current assets and liabilities of the borrower as with fixed or permanent assets, long-time liabilities and the character and amounts of the various capital stock issues. His investigations are facilitated by balance-sheets prepared according to the "capital" arrangement described in ¶ 1–13. The condition of a borrowing organization as revealed by these more permanent or continuing balance-sheet factors must be such as to offer proper security for the principal sum advanced and to justify confidence that a condition may be maintained which will allow prompt payment of maturing interest.

23-3. Short-time credits include not only interest-bearing loans, such as those made by banks, but also advances of property or service wherein the gain representing interest or profit is contained in the amount named as principal sum. Grantors of short-time credits are not greatly interested in the probable conditions of the far-distant future. Current assets and liabilities are of more concern to them. Balance-sheets prepared for the purpose of obtaining short-time loans usually follow the "current" arrangement (see ¶ 1–13), so that the elements constituting working capital may be emphasized.

23-4. Working capital has been defined as the excess of current assets over current liabilities. (See ¶ 2–16.) Both amount and character of the working capital of an organization are essential elements in determining its credit. The balance-sheet should be so arranged that the amount of working capital can be readily ascertained. This is accomplished generally by displaying the total of current assets and the total of current liabilities opposite each other. The classifications making up these two groups, with the supplementary analyses accompanying the balance-sheet, should be such that the true character of the working capital and its availability for operation and for debt liquidation may be correctly determined.

Some accountants arrange current assets first, followed by current liabilities, the total of which is subtracted from the total of

current assets. The difference is the amount of working capital. To this amount the remaining assets are added and from the total the remaining liabilities are deducted which produces a figure representing the net proprietorship. This arrangement is of doubtful merit, as the slight advantage of displaying the working capital in one sum is more than offset by the confusion likely to arise in the mind of one who studies such a balance-sheet. The total of all assets and the total of all liabilities are not shown by such an arrangement, yet these two items are of great importance.

It is sometimes said that the current assets of an organization should not be less than a certain number of times the current liabilities if the organization is to be considered as a good credit risk. The fallacy in such a statement lies in its failure to recognize the varying needs for working capital by organizations of different types. One organization may need a large working capital, while in another the amount might be small or it might disappear completely without affecting the company's solvency. The amount of working capital necessary for efficient operation depends upon the average amount of cash disbursements during the conversion into cash of items purchased. The determination of whether an organization has sufficient working capital or not involves a knowledge of, first, the average amount of cash requirements every month or other selected period; second, the average number of such months or other periods required for conversion of current assets into cash. As a rule the time between the incurring of obligations and the cash realization divides into two periods: first, for converting the commodity or service into a receivable; second, for converting the receivable into cash. Organizations which collect cash in advance of rendering service shorten the period of conversion and therefore require little working capital.

As illustration: A publishing house requires a large amount of working capital, as usually the cost of producing an edition must be incurred before sales can be made. If the work published is sold on the monthly-payment plan a further period of time elapses before a sufficient part of the proceeds of each sale is converted into cash to cover selling cost, production cost and overhead costs. Monthly cash receipts bear a low ratio to total current assets. If these receipts are sufficient to cover cash requirements, evidently the total of current assets must be several times the liabilities.

Railroads on the other hand receive cash in advance of service rendered for a sufficiently large proportion of their operations to reduce their working-capital requirements to a small amount. Between these two extremes lie many gradations of need for working capital.

23-5. The working capital of an organization should be of such amount and character that the portion converted into cash by periodic operations is always sufficient to meet the cash demands as they develop. If the average time from acquisition of materials or services to the date when these materials or services are converted into cash is, say, four months, the amount of working capital should be approximately four times the average monthly demand for cash. Any amount less than that would handicap operations to some extent. On the other hand, if an organization receives cash for its service in advance of the date when settlement must be made for the cost of such service, very little working capital is necessary.

A careful study of the elements of working capital is essential to the intelligent granting of credit. The creditor must determine, as far as possible, not so much the debtor's condition at the moment as what his condition will be at the date of the maturity of the obligations. Will the debtor have cash at that date to liquidate the debt without jeopardizing his business? The balance-sheet alone can not supply sufficient information to justify any conclusion as to future condition. Some knowledge of probable changes in the financial condition of the debtor during that future period of time must be obtained. Past performances aid in estimating prospects. The changes in which the creditor is most interested are:

1. Cash realization during a given period
2. Cash requirements during the period for current expenses
3. Cash requirements during the period for debts other than those of the interested creditor
4. Cash requirements during the period for items other than expenses and liquidation of present debts, such as for drawings or dividends to the proprietors and for necessary expansion of facilities.

23-6. A balance-sheet properly prepared shows the items which may be converted into cash by operations and the current debts which must be liquidated. For credit purposes a balance-sheet should be accompanied by analyses showing:

(a) Cash realization each month for several past months, or for several subsequent months of the preceding year
(b) Accounts receivable classified as to age
(c) Notes receivable classified as to maturity dates and present status
(d) Accounts payable according to maturity dates
(e) Notes payable according to maturity dates
(f) Any other known factors affecting the cash available during the ensuing period
(g) Relation of inventory to turn-over, analyzed if feasible
(h) Any factors indicating future increase or decrease of sales, such as a schedule of advance orders, etc.
(i) All insurance carried.

With such supplementary information the balance-sheet becomes a potent factor in the determination of credit risks provided the balance-sheet and the analyses are properly prepared by capable accountants, influenced neither by too much pessimism nor by too much optimism as to the prospects of the particular business.

It is a poor business man indeed who is not optimistic about his own business. Recognition of this characteristic influences prospective creditors when considering a balance-sheet prepared by the owner or manager of a business. Even though the borrower may have been quite conservative in his presentation of facts, the creditor generally applies the principles of adjustment which experience has taught him are needed as a margin of safety. This has led to the increased demand for balance-sheets prepared by disinterested persons skilled in ascertaining financial conditions and in expressing such conditions in statements.

In the granting of credit the financial progress of the debtor is of moment. If an organization is not making profit its resources will be constantly reduced by its own operations and, if it is not a corporation, by the withdrawals of proprietors. Statements of profit and loss for past periods with any known facts which will affect profit and loss for future periods are important aids to the credit-man.

The creditor is concerned not only with the amount of past profit of the debtor but also with its disposition. A comparative balance-sheet properly summarized will show to what extent profits of the past have been taken out of the business and to what extent profits left in the business are invested in assets which will aid in the pro-

duction of more profit or of more available cash during future periods. After all, the credit-man's query in regard to a prospective debtor is a simple one: Will he and can he pay what he owes when it is due? Willingness of a debtor to make payment is of little avail if he lack the financial ability. The honest debtor feels sure that he will be able to repay the loan when due. A creditor before granting the loan should use independent judgment as to whether or not the debtor's confidence is justified by his financial condition and prospects.

Every bad loan injures not only the lender but injures every other business man. Any factor that will assist in preventing uncollectible advances and will also aid in granting credits where financial progress will result, is of value to the whole business world and to the whole human race which must depend upon the business world for the things which satisfy wants and desires. As progress is made toward accuracy in measuring and classifying the financial factors of business, so will progress be made in building up sound credits.

CHAPTER XXIV

Treatment of Cash Discounts

24-1. The present method of handling cash discounts has been subject to so much criticism that it seems desirable to devote a chapter to its discussion. Under the present system purchase discount is treated as though it were a profit, and sales discount is treated as a loss. If a man buys merchandise invoiced at $1,000, subject to 2% discount for cash, he debits his merchandise account with $1,000 and credits accounts payable $1,000. If he pays the amount promptly, taking the discount, he debits accounts payable $1,000, credits cash $980 and credits discount $20.

It is evidently illogical to consider that by paying out $980 one acquires merchandise worth $1,000 and makes a profit of $20. It is a fundamental principle of accountancy that a true profit can be made only by the transfer of property or service from seller to buyer for a consideration in excess of the cost to the seller. In other words, there can be no profit in the making of a purchase, though an advantageous purchase may aid in the later production of profit from the use or conversion of the thing purchased.

The cost of the merchandise in the foregoing illustration is evidently $980. That is the total amount expended by the purchaser to obtain right and title to the merchandise. The condition that because of delay a greater amount must be paid does not add to the value of the merchandise. If the date of acquiring possession of the merchandise was close to the date of payment of the $980, evidently the time element did not enter into the price determination. If the purchaser did not take advantage of the discount but delayed payment, the cost of the merchandise was still $980. The $20 was an additional amount imposed as penalty because of delay in payment.

24-2. Another problem arising from our present method of handling cash discount is the treatment of open accounts in the balance-sheet. Some accountants insist that from the total of accounts receivable should be deducted, not only a reserve for possible loss in collection because of bad accounts, but a further amount

representing cash discounts which may be taken by debtors when settling their accounts. Against this argument it is urged that any such amount deducted can be only an estimate as there is no account in the records to show the amount which debtors have the right to deduct when effecting settlements. It is argued further that if possible discounts should be deducted from accounts receivable they should also be deducted from accounts payable. If debtors pay with sufficient promptness to take advantage of the discount and thereby reduce the amount of cash which the organization receives from accounts receivable, this early receipt of cash will enable the organization to take advantage of discounts on its purchases, thereby reducing the amount which it must pay in settlement of its accounts payable.

Despite all of these objections the business world is so familiar with the present method that it is reluctant to make a radical change. However, accountants have attempted to devise better methods, some of which are described below.

24-3. Transactions involving cash discounts may be divided into two broad groups:

First: Transactions in which the maturity date of the invoice corresponds approximately with the date of receipt of the merchandise by the purchaser. If cash discounts are allowed, they apply to the period *preceding* the receipt of the merchandise.

Second: Transactions in which the maturity of the invoice is later than the date of receipt of the merchandise by the purchaser, but the final date for allowing cash discounts corresponds approximately with the date of receipt of the merchandise. Cash discounts apply to the period *following* delivery of the merchandise.

In the first classification the purchaser who takes advantage of the discount lends money to the seller of the merchandise and this loan with interest is paid by the merchandise itself. In the second class, the seller advances values in the form of merchandise to the purchaser. If the latter fails to take advantage of the discount — that is, if he delays payments for the full length of time indicated by the terms of sale — the amount which he pays returns to the seller the value advanced, plus interest thereon during the period.

24-4. There are two principles which govern both classes of transactions: (1) the cost value of merchandise is the amount of money required to pay for it at the date of its receipt; (2) cash

discount, so called, is in reality interest for the use of values plus a fee covering the additional risk of carrying an open account. With these two principles in mind the correct way of recording transactions becomes evident.

First Class of Transactions

In the days of slow transportation the seller, needing money, frequently offered discounts to induce cash payment 30 or 60 days before the purchaser received the merchandise. The purchaser might have recorded the transactions as follows:

Account with Seller	$1,000	
To Cash		$980
Purchase Discount		20

When the merchandise was received the entry would have been:

Merchandise Purchased	$1,000	
To Account with Seller		$1,000

By the above entry the merchandise is recorded at $1,000, which is its real cost; as the seller has received cash, $980 and the use of cash for a period for which $20 is accepted as the proper amount for interest and risk. To the purchaser the $20 is a true earning, representing interest on an investment between the time of its making and the time of its return.

Since the days when this method originated great changes have taken place in the commercial world. Most commercial transactions in America today belong to the second group. No change, however, has been made in recording cash discounts, even though the actual transaction is entirely different.

Second Class of Transactions

24-5. Many mercantile transactions today involve settlement 50 or 60 days after receipt of the merchandise by the purchaser, with an allowance of, say, 2% for immediate payment. Under such terms it is evident that the discounted price is the true price of the merchandise at the date of its acquisition. It is the amount stipulated as its value if payment is made when the merchandise is received. The terms are equivalent to granting to the purchaser the loan of the merchandise value for a period of time, the amount due at maturity being the cost value of the merchandise plus an amount for interest and risk.

In the first class described above it was the seller of the merchandise who borrowed the money and paid the interest. In the second class it is the purchaser who borrows the value and must pay the interest. Despite this difference the practice of recording the interest or cash discount has been the same in both cases. It is still treated as a profit by the purchaser, when as a matter of fact taking a cash discount is no more than a refusal to borrow money. In other words, when the merchandise is received the buyer pays its value and does not take advantage of the opportunity offered him to borrow that value for 50 or 60 days and to pay interest on it to the extent of what is called the cash discount.

If the date of receiving the merchandise is near the date of discount allowance, the treatment on the books may be as follows:

Assume merchandise billed at $1,000 received in 1922, subject to a discount of 2% for prompt cash payment. On the books of the purchaser the following journal entries should be made:

Merchandise Purchases	$980	
Allowable Purchase Discounts, 1922	20	
To Accounts Payable		$1,000

If the purchaser pays promptly and takes advantage of the discount the effects on the accounts would be:

Accounts Payable	$1,000	
To Cash		$980
Allowable Purchase Discounts, 1922 . .		20

As a result of these transactions the account with the creditor and the account with allowable purchase discounts are offset and the net effect is a credit to cash of $980 and a debit to merchandise purchases of the same amount. These are actual results.

If the purchaser does not pay with sufficient promptness to obtain advantage of the discount and therefore sends a cheque for the face amount of the invoice the effect is as follows:

Accounts Payable	$1,000	
To Cash		$1,000

This offsets the account with the creditor but leaves a debit balance of $20 in the account "allowable purchase discounts 1922." This is a nominal account. Any balance remaining at December 31, 1922, is treated as an expense item, like interest paid during the period. It represents a penalty for the use of $980 which belonged to the creditor as soon as the goods had been delivered to the purchaser.

24-6. On the books of the seller of the merchandise the above sale would be recorded as follows:

Accounts Receivable	$1,000	
To Merchandise Sales		$980
Allowable Sales Discounts, 1922		20

If cheque was received promptly for payment of the account, less discount, the effeet would be:

Cash	$980	
Allowable Sales Discounts, 1922	20	
To Accounts Receivable		$1,000

This balances the charge to the customer and the allowable discount item, leaving as net effect a debit to cash of $980 and a credit to sales of $980, which is the true result of the transaction.

If payment was delayed beyond the discount date and cheque for full amount of invoice was received, the effect upon the seller's books would be:

Cash	$1,000	
To Accounts Receivable		$1,000

This balances the account with the customer but leaves a credit of $20 in the "allowable sales discount 1922" account. On December 31, 1922, this account, being nominal, is carried to the profit-and-loss account in the closing entries as a gain, like interest received on loans.

By this method the selling price or purchase price of merchandise is recorded at the net figure without regard to what may or may not result from delay in making payment for it. The allowable cash discount account appears as a profit or loss item. Any balance remaining in it at the end of the year is transferred to profit-and-loss as a gain on the part of the seller and as an expense on the part of the purchaser, as if the payment had been made promptly and had then been re-borrowed for that period of time on the interest terms arranged.

24-7. Allowable cash discount items, advantage of which may be taken in any one year must be separated from those which may be taken in a later year. In other words, at December 31, 1922, allowable cash discounts, advantage of which may be taken in 1923, must not be closed to profit-and-loss. The amounts so transferred to profit-and-loss at the close of a year represent forfeited privileges on the part of the debtors.

As an illustration: Suppose the above sale was made and recorded on the books both of the purchaser and of the seller late in December, 1922. If the last date for taking advantage of the discount falls in 1923, the account representing such allowable cash discounts should be so dated. This amount would not enter into the profit-and-loss figures for 1922 of either the seller or the purchaser. If payment was made so as to take advantage of the allowable cash discount this account would be eliminated. If advantage of the discount was not taken this item would remain open as a nominal account of 1923, representing interest for money retained by the purchaser during 1923 after the date when a right to it was acquired by the seller.

24-8. At the date of balance-sheet preparation it is necessary to segregate the items of allowable cash discount which have been forfeited from those of which advantage may yet be taken. If this is not done the balance-sheet will be incorrect. On the books of the seller, allowable sales discounts which have been set up but can no longer be taken by debtors may be treated as gain accounts. They represent income earned because of the delay in receiving payment from debtors. They should be carried to the profit-and-loss account like interest earned.

Items representing discount advantage of which may yet be taken by debtors must not be so treated. They constitute a real element and on the balance-sheet should be deducted from the amount of the accounts receivable. The net figure resulting from such a deduction shows the value of the accounts receivable at the date of the balance-sheet. If all debtors pay promptly, taking advantage of their discount, the amount collected from accounts receivable will exactly equal the amount shown in the balance-sheet. On the other hand, if the debtors do not take advantage of such privileges and later pay the full amount of the invoices, the excess receipts will be represented on the books of the seller by the open account "allowable sales discount" which will be treated as an earning in the period following the balance-sheet. It will be noted that this method exactly records the facts of the transactions.

Illustrations: Assume the accounts under discussion on the books of a selling corporation show, December 31, 1922, the following amounts: Accounts Receivable $100,000; Allowable Sales Discounts, 1922, $2,500; Allowable Sales Discounts, 1923, $1,500.

The $2,500 is income and should be closed to the profit-and-loss account for 1922. The $1,500 represents the amount by which accounts receivable may be decreased because of prompt payment. On the balance-sheet it would appear as follows:

Accounts Receivable	$100,000	
Less: Allowable Cash Discounts	1,500	$98,500

The $98,500 represents the amount which would be received by the selling organization if all trade debtors remitted on the date of the balance-sheet. Assume that these debtors do not remit but all delay payment beyond dates when cash discounts may be taken. The total amount remitted will be $100,000. This will offset the accounts receivable. The $1,500 remaining as a credit balance on the "allowable sales discount 1923" account shows an excess of cash received during 1923 above the amount required to settle the same accounts at December 31, 1922. The $1,500, therefore, is true income for 1923.

24-9. Assume a purchasing organization whose accounts December 31, 1922, show accounts payable $200,000; Allowable Purchase Discounts, 1922, $5,000; Allowable Purchase Discounts, 1923, $3,000. The $5,000 represents an expense because of delay in making payment for merchandise purchased. Because of such delay the amounts finally paid for such merchandise during the year total $5,000 in excess of the amount which would have been required had payment in all cases been made at approximately the time when the merchandise was received. It is interest for the use of money during the period of delay.

Deducting $3,000 from the accounts payable gives the true amount due to trade creditors at December 31, 1922. Payment of $197,000 on that date would settle in full the claims of trade creditors. This true condition may be displayed as follows:

Accounts Payable	$200,000	
Less: Allowable Purchase Discounts . . .	3,000	$197,000

If the purchasing organization does not make payment promptly any purchase discount lost because of the delay will be an expense of 1923. That year would receive the benefit of the longer use of the money because of such delay.

24-10. Accountants may say that it is not conservative to reduce the amount of accounts payable because of discounts, advantage of which may or may not be taken. It must be kept in mind, however, that in the above illustration the exact amount due to the creditors at the date of the balance-sheet was $197,000. If a greater amount is required later to settle any claims it will be due to retention by the purchasing organization of moneys due to the creditors December 31, 1922. Such additional amounts will, therefore, be akin to interest accruing during 1923 for the use of such sums. If the purchasing corporation had on its balance-sheet of December 31, 1922, notes payable amounting to, say, $50,000 no accountant would insist that an additional amount should be shown because of interest which would accrue in 1923 before the actual payment of those notes.

24-11. In these illustrations all transactions have been indicated by journal entries. It may be unnecessary to point out that facts with regard to discounts may be obtained in all cases by means of columnarized purchase records, sales records and cash records. From these, periodical summaries are posted to general-ledger accounts.

This method of handling cash discounts is not faultless. It is presented here because there seems to be definite need for more logical treatment of cash discounts than has been adopted generally by the business world in the past. This method overcomes the majority of the objections to the method in present use and has much to recommend it where the volume of business is sufficient to justify a change in the handling of the accounts.

CHAPTER XXV

The Statement of Affairs

25-1. Valuation and display in a balance-sheet are founded on the idea of a continuing organization. The assets represent items which presumably will be converted into cash during the process of operation and other items which will be converted into service in subsequent periods.

There are times however when the affairs of a concern must be presented in a different way. For instance, a business may face dissolution. This most frequently occurs when the company is insolvent, that is, unable to meet its liabilities when they are due. Creditors may have the right of forcing the suspension of operations and attaching the assets for repayment of their claims. In such circumstances the whole viewpoint of valuation changes. Instead of considering assets in relation to service to be rendered to the organization in continuing its operations, they now become assets to be converted into cash to pay creditors. Evidently the amount which they will bring for this purpose becomes the determining factor of their value. A piece of machinery which cost $1,000 and therefore for balance-sheet purposes represents prepayment for $1,000 worth of service, is worth for the liquidating of debts only so much as can be obtained for it on sale. If it chances to be a piece of machinery for which no purchaser can be found who will pay more than, say, $100 for it, under this new condition it has a value of $100. In other words, assets which for balance-sheet purposes have been valued on the basis of the service which they will render to the organization must now be valued at what they will bring under the governing conditions. A statement which summarizes all the assets of the organization valued on this new basis is known, not as a balance-sheet, but as a "Statement of Affairs."

25-2. The change affects to a certain extent the liabilities also. In the balance-sheet liabilities are usually grouped according to the date of their maturity. In the statement of affairs they are grouped according to the priority of the claims they represent.

These priorities are based upon the federal bankruptcy act. The claims are usually grouped under at least three headings: first, claims given priority by the law, such as debts due to the United States Government, to various other governmental subdivisions and certain specific wages; second, claims given priority by contract (these include claims for which specific assets have been pledged, such as mortgages secured by real estate, notes secured by certain assets, etc.); third, other claims of creditors.

Since it is desirable that the statement of affairs should "tie up" with the balance-sheet, the following money columns ordinarily are used: on the liability side columns for "book-value" and "expected to rank" and on the asset side columns for "book-value," "estimated shrinkage" and "estimated realization." The amounts in the book-value columns agree with the figures in a balance-sheet of the organization as at the same date. The second liability column, ordinarily headed "expected to rank," tabulates in the order of their rank or priority the claims that must be met from the general fund. The third asset column, usually headed "estimated realization," accumulates the amounts that it is estimated will be available for meeting the claims shown by the last column on the liability side. Any difference between book-value and the appraised amount of realization is recorded in the column headed "estimated shrinkage."

25-3. A statement of affairs is a comparatively simple statement to prepare and to understand, if its purpose be kept in mind. This purpose is so to offset assets specifically pledged and liabilities specifically secured as to obtain (a) the excess of realizable value of assets over specific pledges and (b) the amount of unsecured claims to the payment of which this asset excess must be applied. The first item should be shown by the last asset column; the second item should be shown by the last liability column.

To carry this principle into effect each secured claim and the corresponding asset must be deducted one from the other. If the estimated realization value of the pledged asset be greater than the claim the subtraction should be made on the asset side so that the excess of asset value may be carried into the last money column on that side ("estimated realization"), as this excess adds to the fund available for payment of the unsecured claims. If the estimated realizable value of the asset be less than the amount of the claim for which it is pledged, the subtraction should be made

upon the liability side, so that the excess of claim over asset value may be carried into the last column upon that side ("expected to rank"), as this amount takes its place with other unsecured claims.

25-4. Assume real estate with a book-value of $50,000 mortgaged for $25,000 and appraised to realize $40,000. On the asset side the real estate will be listed with the $50,000 brought into the book-value column, $10,000 appearing in the "estimated shrinkage" column. The mortgage which appears in the book-value column on the liability side will not be extended on that side. Instead the words "deducted contra" will be used to indicate that this mortgage is deducted upon the opposite (the asset) side of the statement. The amount of the mortgage will appear on the asset side as a deduction from the value of the real estate, the subtraction being made in an indented column and the difference, $15,000, is carried into the last column. This indicates that the asset "real estate" will realize enough to care for the mortgage which it specifically secures and provide $15,000 for the general fund, available for liquidating the claims of unsecured creditors.

As a further illustration: Assume an asset such as machinery with an estimated realization less than the claim which it is pledged to secure. The estimated realizability of the machinery would not be carried into the last column on the asset side. Instead the words "deducted contra" would be used to indicate that the subtraction is made on the liability side of the statement. On the latter side the amount of the debt appears in the book-value column. In an indented column the amount estimated to be realized on the machinery is subtracted from the amount of the claim and the difference or excess of claim over realizable value is carried into the last column on the liability side.

25-5. Claims secured by statute, including all those that go under subdivision 1 of Schedule A, of the federal bankruptcy act, should not be carried into the second column on the liability side but should be brought over to the asset side and deducted from the total of the last column, as these claims must be given preference over all others. In case the amount of these claims secured by statute be greater than the total of the excess asset value as shown by the column "estimated realization" they will evidently constitute a claim against some of the pledged assets. In this case the claims supposed to be secured by these assets would suffer to the

extent of this invasion of their protection, and the unsecured claims would receive no payment whatever.

As an illustration: Assume the final column on the asset side shows $100,000 total. Assume that there are debts to the United States Government amounting to $3,000 and wages entitled to priority amounting to $2,000. These two items will be deducted on the asset side from the $100,000. The difference, $95,000, represents the amount estimated to be available for the liquidation of the claims appearing in the final column on the liability side. The difference between these two amounts is the deficiency which must be prorated over such claims.

25-6. The application of these principles is illustrated at the end of this book by a statement of affairs.

It must be remembered that whereas a balance-sheet is prepared from the financial records a statement of affairs is prepared from the balance-sheet plus an appraisal as to the estimated realizability of the asset values. It is not a positive statement of a condition, present or past, but is more in the nature of an estimate of a future result. It is prepared usually to aid in determining the policy of the creditors and is not made the basis of journal entries or adjustments on the books of the company concerned.

25-7. A business facing bankruptcy may prepare such a statement and creditors may learn from it what amount they can hope to obtain by taking full advantage of their legal rights and pressing their claims against the company. If it shows the probability of great loss to them they may decide that it would be wiser not to force the company to adopt extreme measures but instead to devise means whereby the company can continue to operate, probably under the direction of someone satisfactory to the creditors. This may result in a better realization of serviceable assets and so enable the business ultimately to liquidate its liabilities with less loss to the creditors. Frequently such coöperation between proprietors and creditors has solved financial difficulties and ultimately turned a business back to the control of proprietors so that the only loss to creditors was through delay in receiving payment on their claims and the loss to the proprietors was reduced to a minimum.

The statement of affairs does not rank as a major accounting statement, but rather as a secondary statement to aid in determining proper policy with regard to an organization which is threat-

ened with insolvency. A statement of affairs may be prepared for a corporation which is contemplating suspension of its regular operations and realization of assets for reasons other than insolvency, though its use in such cases is rare.

25-8. A statement of affairs is usually accompanied by a supplementary statement known as a "deficiency account." The purpose of this account is to analyze the deficiency appearing as the last item on the statement of affairs. It consists, on the one hand, of any loss from operations which the organization may have suffered as shown by the balance-sheet, plus the estimated shrinkage in assets as shown by the column so headed on the statement of affairs, plus any additional losses or liabilities not shown upon the balance-sheet but applicable to the present condition; and, on the other hand, it displays the proprietorship or other contributions to the organization, plus the balancing item called "deficiency." The two sides of the account are thus brought to equality.

In this discussion it is assumed that there is a deficiency, as a statement of affairs usually reveals such a condition. It is entirely possible, however, for such a statement to reveal a condition in which there is no deficiency. It may be estimated that the assets will realize enough to meet all debts.

Any loss to stockholders or proprietors would not be shown by a statement of affairs as proprietary accounts do not appear.

APPENDIX

COMMENTS ON STATEMENTS IN APPENDIX

The statements which follow are included for the purpose of illustrating typical business organizations and not with the intention of implying that they are models as to form or content. They indicate the use of many of the classifications described in the text, as well as the various arrangements discussed in Chapter I. They represent neither the largest nor the smallest business firms, but rather those with which the accountant comes most frequently in contact.

The balance-sheet of the Score Fabricating Corporation is arranged according to the suggestions made by the Federal Reserve Board in its bulletin of April, 1917. The Statement of Affairs and Deficiency Account of the Hook and Slice Producing Company, Inc., must not be confused with balance-sheets. Rather, they are introduced to illustrate the distinction discussed in Chapter IV and Chapter XXV.

The selection includes some balance-sheets certified by public accountants and others not certified.

Balance-sheet of

ALBERT C. NIBLICK, SOLE TRADER

as at June 30, 1923

ASSETS

Cash on hand and in bank		$ 2,147.51
Accounts Receivable		27,418.00
Accrued Interest		130.82
Notes Receivable		4,400.00
Merchandise		87,128.37
Total Current Assets		$121,224.70
Furniture and Fixtures	$14,093.15	
Less: Reserve	3,916.80	10,176.35
Delivery Equipment	$ 6,852.00	
Less: Reserve	3,319.70	3,532.30
Total Assets		$134,933.35

LIABILITIES

Accounts Payable		$ 28,777.32
Notes Payable		10,350.00
Accrued Expenses		2,182.37
Total Liabilities		$ 41,309.69
Albert C. Niblick, Capital		
Balance, December 31, 1922	$88,450.10	
Profit January 1 to June 30, 1923	11,173.56	
	$99,623.66	
Less: Drawings	6,000.00	
Balance, June 30, 1923		93,623.66
Total Liabilities and Capital		$134,933.35

FAIRWAY TRADING CORPORATION

CONDENSED COMPARATIVE BALANCE-SHEET

as at December 31, 1922 and December 31, 1921

ASSETS

		December 31, 1922	December 31, 1921	Increase	Decrease
Cash		$ 24,488.59	$ 24,886.70		$ 398.11
Advances on Consignors' Accounts		64,615.27	59,301.02	$ 5,314.25	
Accounts Receivable	$207,446.91				
Less: Reserve	10,581.28	196,865.63	168,135.31	28,730.32	
Notes Receivable		35,935.37	27,721.43	8,213.94	
Merchandise on hand		149,271.26	146,086.95	3,184.31	
Merchandise in hands of Consignees		255,004.16	252,213.26	2,790.90	
Total Current Assets		$726,180.28	$678,344.67		
Prepaid Expenses		3,164.21	863.30	2,300.91	
Delivery Equipment	$ 9,463.59				
Less: Depreciation	4,334.10	5,129.49	6,535.60		1,406.11
Store and Office Equipment	$ 45,233.45				
Less: Depreciation	14,921.13	30,312.32	34,998.67		4,686.35
Land and Building		102,750.00	102,750.00		
				$50,534.63	$ 6,490.57
				6,490.57	
Total Assets		$867,536.30	$823,492.24	$44,044.06	

LIABILITIES

Due to Consignors	$156,432.87	$170,670.16		$14,237.29
Other Accounts Payable	166,022.73	141,464.99	$24,557.74	
Accrued Expenses	4,215.16	3,931.77	283.39	
Total Current Liabilities	$326,670.76	$316,066.92		
Mortgage on Land and Buildings		42,500.00		42,500.00
			$24,841.13	$56,737.29
				24,841.13
Total Liabilities	$326,670.76	$358,566.92		$31,896.16

CAPITAL

Preferred Stock Issued and Outstanding	$228,500.00	$173,700.00	$54,800.00
Common Stock Issued and Outstanding	250,000.00	250,000.00	
Paid-in Surplus	25,000.00	25,000.00	
Earned Surplus	37,365.54	16,225.32	21,140.22
Total Capital and Surplus	$540,865.54	$464,925.32	$75,940.22
Total Liabilities, Capital and Surplus	$867,536.30	$823,492.24	

SUMMARY

Net Increase in Assets		$ 44,044.06
Net Decrease in Liabilities		31,896.16
		$ 75,940.22
Net Profit for year	$ 63,299.22	
Less: Dividends Paid	42,159.00	$ 21,140.22
Proceeds from Sale of Preferred Stock		54,800.00
		$ 75,940.22

PUTTER ENGINE WORKS, INC.
AND SUBSIDIARY COMPANIES

CONSOLIDATED BALANCE-SHEET
as at March 31, 1923

ASSETS

FIXED ASSETS:			
Real Estate used for Plant		$ 683,403.00	
Plant and Equipment	$5,023,116.25		
Less: Depreciation	2,123,498.07	2,899,618.18	
Patterns and Drawings (current only)		53,193.27	
Patents, Trademarks and Goodwill		1,000,000.00	$4,636,214.45
BOND SINKING FUND in hands of Trustee:			
Cash		$ 183,128.50	
Securities		989,963.28	
Accrued Interest		26,908.22	1,200,000.00
INVESTMENTS:			
U. S. Treasury Certificates		$ 375,000.00	
U. S. Liberty Bonds		212,750.00	587,750.00
PREPAID EXPENSES:			8,137.93
CURRENT ASSETS:			
Raw Materials and Supplies		$ 718,192.73	
Uncompleted Contracts	$1,032,729.18		
Less: Advances Received	752,830.00	279,899.18	
Accrued Dividends on Mutual Insurance		6,138.21	
Notes Receivable		85,210.00	
Accounts Receivable (less Reserve)		553,920.18	
Accrued Interest Receivable		8,218.76	
Cash		81,273.78	1,732,852.84
			$8,164,955.22

WE CERTIFY that the above consolidated balance-sheet is in accordance with the financial records of the Putter Engine Works, Inc., and subsidiary companies and, subject to the comments in our report dated April 26, 1923, truly presents the financial condition of those companies as at March 31, 1923.

(Signed) ASTERISK & AMPERSAND

Members American Institute of Accountants

LIABILITIES

FIXED LIABILITIES:			
20-year Gold Bonds due 1931		$2,000,000.00	
7% Coupon Gold Notes issued in 1918 (maturing $100,000 per year)	$ 800,000.00		
Less: Notes retired	500,000.00	300,000.00	$2,300,000.00
CURRENT LIABILITIES:			
Advances Received on work not begun		$ 210,530.00	
Notes Payable		48,075.00	
Bills Audited		469,453.13	
Estimated Liability Bills Unaudited		9,480.75	
Accrued Liabilities:			
Liability Insurance	$ 12,034.01		
Interest	70,912.50		
Federal Income Taxes	21,316.08		
Other Taxes	31,885.23		
Payroll	31,318.92	167,466.74	905,005.62
Total Liabilities			$ 3,205,005.62

CAPITAL

CAPITAL STOCK STYMIE ENGINE COMPANY:			
Common—Issued and Outstanding		$1,200,000.00	
Less: Shares owned Inter-company		853,000.00	
		$ 347,000.00	
Proportion of Surplus applying to outside Stockholders		121,316.43	468,316.43
CAPITAL STOCK PUTTER ENGINE WORKS, INC.:			
Preferred—7,500 shares Issued and Outstanding		$ 750,000.00	
Common—12,174 shares Issued and Outstanding (20,000 shares authorized)		1,517,400.00	
		$2,267,400.00	
SURPLUS:			
Appropriated:			
For Sinking Fund Reserve	$1,200,000.00		
For Plant Extensions	550,000.00		
For Contingencies	112,250.00		
	$1,862,250.00		
Unappropriated	361,983.17	2,224,233.17	4,491,633.17
			$ 8,164,955.22

LOST BALL PETROLEUM COMPANY

Balance-Sheet

as at December 31, 1922

ASSETS

Current Assets:			
Cash			$ 170,420.10
Accounts Receivable		$ 380,601.35	
Less: Reserve		8,306.80	372,294.55
Notes Receivable			55,100.00
Trade Acceptances Receivable		$ 210,770.33	
Less: Trade Acceptances Discounted		121,210.05	89,560.28
Accrued Interest on Notes Receivable			1,635.10
Inventories:			
Crude Oil in Storage		$1,317,682.30	
Refined Products		604,721.00	
Chemicals and Supplies		14,205.10	1,936,608.40
Total Current Assets			$ 2,625,618.43
Prepaid Expenses:			
Prepaid Interest		$ 1,713.10	
Unexpired Insurance		201,424.01	
Advance on Drilling Contracts		35,900.00	239,037.11
Investments:			
Nineteenth Hole Pipe Line Co. (921 shares)		$ 92,100.00	
Birdie Distributing Co. (1100 shares)		110,000.00	202,100.00
Capital Assets:			
Refinery Plant (Land, Buildings and Equipment)	$4,717,319.28		
Pipe Lines & Equipment	681,913.73		
Trucks and Automobiles	28,317.42		
Furniture and Fixtures	11,023.08		
	$5,438,573.51		
Less: Reserve for Depreciation	1,728,914.12	$3,709,659.39	
Undeveloped Leases		430,713.00	
Developed Leases	$ 810,305.61		
Appreciation of Developed Leases	4,905,317.81		
	$5,715,623.42		
Less: Reserve for Depletion	1,260,391.02	4,455,232.40	
Equipment on Leases	$ 773,662.44		
Less: Reserve for Depreciation	261,273.93	512,388.51	9,107,993.30
			$12,174,748.84

LIABILITIES AND CAPITAL

Current Liabilities:			
Accounts Payable			$ 272,094.70
Notes Payable			580,428.20
Trade Acceptances Payable			685,480.00
Leasehold Bonuses Payable			48,910.00
Accruals:			
Gross Production Tax Payable		$ 11,091.17	
Royalties Payable		15,318.90	
Wages and Salaries		10,528.30	
Interest		63,187.00	100,125.37
Total Current Liabilities			$ 1,687,038.27
Funded Liabilities:			
Gold Debenture 6% Bonds:			
Authorized and Issued		$ 2,000,000.00	
Less: Bonds Retired		300,000.00	1,700,000.00
Total Liabilities			$ 3,387,038.27
Capital Stock:			
Preferred (15,000 shares)		$1,500,000.00	
Common, no-par value (21,462 shares)		1,373,420.00	2,873,420.00
Surplus:			
At December 31, 1921		1,113,172.60	
Net Profit for 1922	$ 530,168.87		
Realized Appreciation for 1922	290,631.10	820,799.97	1,933,972.57
Surplus from Revaluation			3,980,318.00
			$12,174,748.84

We Certify that in our opinion the above balance-sheet correctly presents the financial condition of the Lost Ball Petroleum Company, as at December 31, 1922.

(Signed) WILLIAM PARENTHESIS & CO.

Certified Public Accountants

SCORE FABRICATING CORPORATION

Balance-Sheet

as at October 31, 1923

ASSETS

Cash:			
On Hand		$ 500.00	
In Bank		13,218.17	$ 13,718.17
Notes and Accounts Receivable:			
Notes of Customers on hand (not past due)		$ 6,400.00	
Notes Receivable discounted		5,150.00	
Accounts with Customers (not past due)		38,372.12	
Notes of Customers (past due) (Cash Value, $3,375.00)		4,575.00	
Accounts with Customers (past due) (Cash Value, $1,290.00)		3,127.43	
		$57,624.55	
Less: Provision for bad debts	$ 3,037.43		
Provision for discounts, freights and allowances	1,481.22	4,518.65	53,105.90
Inventories:			
Raw Materials on hand		$ 31,280.73	
Goods in process		41,290.19	
Uncompleted Contracts	$62,318.19		
Less Payments received thereon	30,420.00	31,898.19	
Finished goods on hand		53,773.16	158,242.27
Total Quick Assets			$225,066.34
Securities:			
Stocks and Bonds (at not to exceed market price)		$ 22,415.00	
Notes of officers and employees		1,000.00	
Accounts due from officers and employees		2,162.00	25,577.00
Total Current Assets			$250,643.34
Fixed Assets:			
Land used for plant		$ 17,500.00	
Buildings used for plant		58,218.50	
Machinery		81,718.73	
Tools and plant equipment		44,219.62	
Patterns and drawings		9,712.25	
Office furniture and fixtures		13,127.66	
		$224,496.76	
Less: Reserve for depreciation		50,382.98	
Total Fixed Assets			$174,113.78
Prepaid Expenses:			
Interest, Insurance, Taxes, etc.			3,725.16
			$428,482.28

LIABILITIES

Bills, Notes and Accounts Payable:			
Unsecured Bills and Notes:			
Acceptances made for materials purchased		$ 18,370.15	
Notes given for materials purchased		1,828.00	
Notes given to banks for money borrowed		7,210.00	
Notes given for purchase of Fixed Assets		5,715.50	$33,123.65
Unsecured Accounts:			
Accounts Payable for purchases (not due)		$ 83,710.99	
Accounts Payable for purchases (past due)		9,222.37	
Accounts Payable to Officers or Employees		650.00	93,583.36
Secured Liabilities:			
Notes Receivable discounted (contra)		$ 5,150.00	
Obligations secured by collateral		15,250.00	20,400.00
Accrued Interest, Taxes and Wages			6,773.74
Total Current Liabilities			$153,880.75
Fixed Liabilities:			
Mortgage on Plant due January 1, 1926		$ 30,000.00	
Chattel Mortgage on Machinery		28,500.00	58,500.00
Total Liabilities			$212,380.75
Net Worth:			
Preferred Stock, Issued	$100,000.00		
Less: Reacquired	7,500.00	$ 92,500.00	
Common Stock, Issued		125,000.00	
Surplus		38,601.53	
		$256,101.53	
Less: Book Value of Goodwill		40,000.00	216,101.53
			$428,482.28

BRASSIE-SPOON RESTAURANTS COMPANY

Statement of Assets and Liabilities

As at June 30, 1921

ASSETS

Current Assets:			
Cash:			
Main Office	$ 8,515.17		
Imprest Funds	12,500.00	$ 21,015.17	
Accounts Receivable		1,715.35	
Claim for Fire Loss		9,462.12	
Inventories:			
Provision Supplies	$ 2,130.53		
Provision and Other Stores	31,134.14		
Beverages	1,250.81		
Cigars and Cigarettes	3,212.20		
Reserve Stores: Linen, China, Glassware, Silverware, etc.	39,820.84	77,548.52	$109,741.16
Prepaid Current Expenses:			
Insurance		$ 6,414.19	
Rent		8,638.00	15,052.19
Restaurant and Kitchen Equipment:		$ 97,666.37	
Less: Depreciation		28,102.14	69,564.23
Alterations and Decorations of Leased Premises		$ 81,317.05	
Less: Amortization		24,912.31	56,404.74
Leaseholds, Prepaid		$121,350.00	
Less: Amortization		34,515.00	86,835.00
Building		$ 53,128.00	
Less: Depreciation		3,781.90	49,346.10
Goodwill			45,000.00
			$431,943.42

LIABILITIES

Current Liabilities:			
Vouchers Payable		$ 30,612.50	
Notes Payable to Banks		37,500.00	
Reserve for Taxes		2,138.00	$ 70,250.50
Long-time Liabilities:			
Notes Payable (payable $12,000 per year)		$ 30,000.00	
Mortgage Payable (due 1925)		35,000.00	65,000.00
Reserve for Restoration of Leased Properties			3,075.00
			$138,325.50

PROPRIETORSHIP

Benjamin Brassie, Capital Account:			
Balance, January 1, 1921	$183,385.30		
Share of Six-months' Profit	18,109.50		
	$201,494.80		
Less: Amounts Withdrawn	3,600.00		
Balance, June 30, 1921		$197,894.80	
Samuel Spoon, Capital Account:			
Balance, January 1, 1921	$92,783.52		
Share of Six-months' Profit	12,073.00		
	$104,856.52		
Less: Amounts Withdrawn	9,133.40		
Balance, June 30, 1921		95,723.12	
			293,617.92
			$431,943.42

DRIVER STEEL WORKS, INC., AND SUBSIDIARY COMPANIES

Consolidated Balance-sheet
as at June 30, 1923

ASSETS

Current Assets:		
Cash in Banks and on Hand		$ 1,916,435.10
U. S. Government Securities (par value $110,000.00)		109,000.00
Notes Receivable		261,500.00
Accounts Receivable	$ 2,064,370.00	
Less: Reserves	173,106.00	1,891,264.00
Accrued Interest Receivable		11,480.00
Total Cash and Receivables		$ 4,189,679.10
Inventories (at the lower of cost or market)		
Finished Products	$ 1,810,420.71	
Partly Finished Products	3,213,270.03	
Raw Materials and Supplies	4,149,910.17	9,173,600.91
Total Current Assets		$13,363,280.01
Prepaid Expenses:		
Interest, Insurance and Taxes		93,170.00
Investments:		
Stocks and Bonds of other Corporations (at cost)		206,385.00
Bond Sinking Fund:		
Cash and Securities in hands of Trustee		4,500,000.00
Property:		
Real Estate, Plant, Equipment and Intangibles	$63,920,280.17	
Less: Reserves for Depreciation and Amortization	17,322,260.54	46,598,019.63
Mining Properties	$10,871,300.00	
Less: Reserves for Depreciation	2,904,106.12	7,967,193.88
		$72,728,048.52

We Certify that subject to the comments in our attached report the above consolidated balance-sheet is, in our opinion, a correct presentation of the financial condition of the Driver Steel Works, Inc., and subsidiary companies, as at June 30, 1923.

(Signed) COLON, SEMI-COLON & QUOTE
Certified Public Accountants

LIABILITIES

Current Liabilities:		
Notes Payable		$ 950,600.00
Accounts Payable		830,217.14
Accrued Taxes		402,513.19
Accrued Expenses other than Taxes		104,112.04
Dividend on Preferred Stock, Payable July 1, 1923		385,700.00
Dividend on Common Stock, Payable August 1, 1923		375,000.00
Total Current Liabilities		$ 3,048,142.37
Fixed Liabilities:		
First Mortgage 5% Bonds Maturing in 1933		10,000,000.00
Bonds of Subsidiary		
Midiron Foundry Company 5% First Mortgage Bonds (Being retired at $200,000.00 per year)		1,000,000.00
Total Liabilities		$14,048,142.37

CAPITAL

Capital Stock:		
Preferred 7%, Issued 120,000 shares	$12,000,000.00	
Less: In Treasury, 9,800 shares	980,000.00	
Outstanding, 110,200 shares	$11,020,000.00	
Common, Issued and Outstanding 300,000 shares	30,000,000.00	41,020,000.00
Surplus:		
Appropriated:		
For Bond Sinking Fund	$ 4,500,000.00	
For Insurance and Contingencies	600,000.00	
	$ 5,100,000.00	
Unappropriated	12,559,906.15	17,659,906.15
		$72,728,048.52

EAGLE TRUST COMPANY

Condensed Statement of Resources and Liabilities

as at October 31, 1923

RESOURCES

Specie		$ 392,118.70
Other Currency authorized by the laws of the United States		7,218,493.00
Deposits with other Banks and Trust Companies		19,111,480.00
Exchanges for Clearing House		9,821,318.82
Accrued Interest and Accounts Receivable		1,003,720.19
Loans and Discounts:		
Secured by Real Estate Collateral	$ 1,877,317.00	
Secured by other Collateral	47,651,288.27	
Notes secured by Collateral	12,113,361.91	61,641,967.18
Securities Owned:		
U. S. Government Securities	$31,982,725.00	
State and Municipal Bonds	6,723,816.54	
Other Bonds	9,113,442.07	
Bonds and Mortgages on Real Estate	567,000.00	
Stock of Federal Reserve Bank	1,200,000.00	49,586,983.61
Bank Premises		3,186,552.12
Furniture and Fixtures		1.00
Customers' Liability on Acceptances:		
Outstanding (see contra)	$ 4,583,280.44	
Less: Anticipated payments	100,000.00	4,483,280.44
		$156,445,915.06

LIABILITIES

Deposits subject to Cheque		$89,133,720.80
Demand Certificates of Deposit		238,217.23
Certified and other Cheques Outstanding		5,231,205.51
Time Deposits and Certificates		9,993,870.00
Deposits by other Banks and Trust Companies		17,316,425.18
Acceptances Outstanding:		
For account of Customers (see contra)	$ 4,583,280.44	
Other	425,713.32	5,008,993.76
Accrued Interest Payable		206,720.38
Reserve for Taxes		701,337.23
Unearned Interest		232,069.16
Capital	$10,000,000.00	
Surplus	10,000,000.00	
Undivided Profits	8,383,355.81	28,383,355.81
		$156,445,915.06

Statement of Affairs
HOOK AND SLICE PRODUCING COMPANY, INC.
as at September 30, 1923

LIABILITIES

		Book Value	Expected to Rank
Unsecured Claims:			
Trade Accounts Payable (per books)		$118,372.80	$118,372.80
Notes Payable (other than those listed below)		65,350.00	65,350.00
Accrued Interest on Unsecured Notes (not entered on books)			2,016.50
Accrued Payroll (other than that given priority below)		2,435.00	2,435.00
Other Liabilities (not entered on books)			4,327.19
Claims Secured by Specific Liens:			
Notes Payable secured by Lien on Machinery and Equipment	$53,800.00	53,800.00	(b)
Accrued Interest on above Notes (not entered on books)	2,421.00		
	$56,221.00		
Less: Realizable Value of Security	27,500.00(a)		28,721.00
Mortgage on Real Estate	$30,000.00	30,000.00	
Accrued Interest on Mortgage (not entered on books)	900.00		(b)
Deducted Contra	$30,900.00		
Claims Given Priority by Statute:			
Taxes (Deducted Contra)		3,163.73	(c)
Accrued Payroll (Deducted Contra)		5,270.50	(d)
Total Liabilities as per Books		$278,392.03	
Total of Unsecured Claims			$221,222.49

ASSETS

		Book Value	Estimated Shrinkage	Expected to Realize
Cash		$ 2,371.50		$ 2,371.50
Accounts Receivable	$90,372.30			
Less: Reserve for Loss	1,428.60	88,943.70	18,750.88	70,192.82
Notes Receivable		27,100.00	4,500.00	22,600.00
Inventory: (on books at cost)				
Raw Materials		40,378.30	15,118.30	25,260.00
Work-in-process		39,702.19	31,702.19	8,000.00
Finished Goods		91,800.52	36,720.52	55,080.00
Furniture and Fixtures	$ 5,600.00			
Less: Reserve for Depreciation	1,422.00	4,178.00	2,328.00	1,850.00
Machinery and Equipment	$152,300.00			
Less: Reserve for Depreciation	20,723.50	131,576.50	104,076.50	(a)
(Estimated Value, $27,500.00, Deducted Contra from Notes Payable carrying Lien)				
Buildings	$37,000.00			
Less: Reserve for Depreciation	2,220.00	34,780.00	9,780.00	
Land		20,000.00		
Estimated Cash Value of Land and Buildings	$45,000.00			
Less: Mortgage and Accrued Interest thereon	30,900.00(b)			14,100.00
Total Book Value		$480,830.71		
Total Estimated Shrinkage			$222,976.39	
Total Expected Realization				$199,454.32
Deduct: Claims given Priority by Statute:				
Taxes	$ 3,163.73(c)			
Accrued Payroll	5,270.50(d)			8,434.23
				$191,020.09
Estimated Cost of Realizing Assets and Liquidating Liabilities				25.000.00
Amount estimated to be obtained for paying Unsecured Claims of Creditors				$166,020.09
Deficiency, or amount of estimated loss to be borne by Unsecured Creditors				55,202.40
Total of Unsecured Claims				$221,222.49

HOOK AND SLICE PRODUCING COMPANY, INC.

Deficiency Account

as at September 30, 1923

DEBIT		CREDIT	
Liabilities not entered on Books:		Capital Stock	$200,000.00
Various Accounts Payable	$ 4,327.19	Surplus, as shown on books	2,438.68
Accrued Interest on Unsecured Notes .	2,016.50		
Accrued Interest on Secured Notes . .	2,421.00		
Accrued Interest on Mortgage	900.00		
Estimated Shrinkage of Assets, per Statement of Affairs . .	222,976.39		
Cost of Realization and Liquidation	25,000.00	Deficiency, per Statement of Affairs . .	55,202.40
	$257,641.08		$257,641.08

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