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Accounting Questions: Accounting Treatment of Mortgage; Reserve for Bad Debts; Apportionment of Store Rentals to Departments; Amortization of Salesmen's Commissions and Organization Expenses

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Accounting Questions

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ACCOUNTING TREATMENT OF MORTGAGE

Question: Company A is deeded a property in consideration of $100, delinquent interest on a first mortgage, and unpaid taxes. A new mortgage and bond is not executed. Company A takes control of the property, pays all back taxes and interest, and raises the question that inasmuch as it has not executed a new bond or mortgage it has no liability but an asset consisting of the money actually expended to the date of acquiring title. Should it be recorded on the balance-sheet as an equity, or should the total costs including the mortgage be recorded among the assets and the mortgage deducted therefrom still showing the equity on the asset side, or should the costs of acquisition appear as an asset and the mortgage appear as a liability? No question is raised about the mortgage appearing as a liability where the company's name is on the bond and the mortgage.

Answer No. 1: It is hardly possible to give a definite answer to the question as stated. If the question means that company A received the entire property which was deeded to it and owed nothing on the mortgage I would then say that the property might be set up at the amount of the money paid. If, however, it was understood that company A assumed or would assume the mortgage I see no reason for treating it differently from any other mortgage.

Although the question is not entirely clear it seems to me that the inquirer wishes to know whether there is some middle ground between being liable on the mortgage and not being liable. So far as I can see, this does not exist. If he is not liable on the mortgage it should not be mentioned and if he is or will be or has agreed to be liable I should say that the liability should be shown in the usual manner as a liability and an asset consisting of the entire cost of the property plus the amount of the mortgage should be carried against it.

The whole question turns on the intention of company A. Does company A intend to assume the mortgage or not? The fact that this intention may not have been fully carried out does not seem to be material.

I do not know whether this somewhat inconclusive statement will do much good but it is, I think, the best answer that can be made to the question as framed.

Answer No. 2: While the purchaser may not have executed a new mortgage and bond, it must be true that the purchaser's equity in the property is subject to the mortgage. Accordingly, it seems to us that the best presentation is the one that sets forth all the facts. The ultimate purchase price will be the amount actually paid plus payment of the existing mortgage. Therefore, we would suggest that the property be set up on the books at such an amount and the mortgage shown among the liabilities.

RESERVE FOR BAD DEBTS

Question: In establishing a reserve for bad debts, where notes are financed without recourse, is it customary to charge the entire amount of the reserve to profit and loss or is part of the reserve sometimes charged to unearned brokerage?

In determining the amount of monthly interest earned, what is the most practical manner to arrive at the amount to transfer from unearned interest to earned interest, without listing each note to ascertain the average number of months covered by the notes outstanding?

Answer: We would suggest that the average outstanding balance of notes for the month be determined, preferably from the daily balances but possibly from weekly balances if there is not much fluctuation. To this average amount should then be applied the rate of interest which the notes carry; where this is uniform no difficulty presents itself, but where the rate varies the average rate can be determined by some convenient method. For instance, it might be advisable to carry a control account for notes on each rate of interest charged and determine the average balance at that rate.

Referring to the first question, we have no experience as to the custom in regard to reserve on bad notes, but it does not seem to us desirable to charge any of it to unearned brokerage; it is only postponing the charge for a short period.

APPORTIONMENT OF STORE RENTALS TO DEPARTMENTS

Question: I am desirous of securing any data that may be available relative to a fair basis for the apportionment of rent to the various departments of a women's ready-to-wear store having departments as follows:

One main department (approximately 60% of sales)
Two fairly large departments
Seven small departments

I am interested in practical plans of apportionment wherein floor area and use of window space on the street floor are given consideration.

Answer: The problem of the apportionment of store rentals to departments consists purely of the determination of the proportion of the total floor space of the store occupied by individual departments and the proportion of the total rent which such space should bear.

As to the determination of the proportion of rent applicable to a given space, it will be realized that not all of the space in a store is equally valuable. The main floor to which customers have ready access is more desirable than the upper floors and should bear a higher rental charge. Not all the upper floors are equally desirable. Accordingly, some of the floor space is worth more than the average rental cost per square foot while some is worth less. There can, however, be no fixed formula for a division of a store rental over its area on a weighted basis, since this would depend upon the location of the individual store, the relative accessibility of the various floors and the requirements of its customers.

It is suggested that the most practical method would be to secure the opinion of a real-estate man, familiar with the property and location, as to the proportion of the total store rent to be assigned to the windows and to the individual floors. From this point the method of determination of graded or weighted rentals per square foot will be obvious after it has been decided whether or not the rental cost of non-productive space is to be absorbed in direct selling department rentals or is to be taken up by service departments and then redistributed in charges to direct selling departments for service rendered.

Similarly, the total rental cost applied to windows may be apportioned among individual windows after giving due weight to their relative size and desirability, such rental costs then to be charged to individual selling departments according to the time during which they have the use of the space.

If there are frequent or seasonal variations in the area occupied by individual departments, it may be necessary to provide the means of accumulating the necessary information on which to base the resulting adjustments of rental charges.

AMORTIZATION OF SALESMEN'S COMMISSIONS AND ORGANIZATION EXPENSES

Question: We are auditing a parent company with six subsidiaries which engage in a small loan business. The companies were organized about three years ago, and obtained their operating capital from the sale of preferred and common stock on which salesmen were paid 20 per cent. of the stock as a commission. The company also incurred rather large organization expenses. We wish to know what would be a reasonable time over which to amortize the salesmen's commissions and organization expenses.

Answer: The most conservative way to handle these transactions is to write them off as soon as they occur. However, it is realized that in many instances this would be unfair to a new concern, and consequently the practice of writing off these items over a period of three to five years has been recognized. In the case mentioned above where the business apparently has been in operation about three years, it seems that these items should be entirely written off by the expiration of the first five years of operations.