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Accounting Questions: Qualification of Certificate Regarding Audit of Subsidiaries, Expenses of Retail Coal Dealers, Capitalization of Repair Items

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Accounting Questions

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QUALIFICATION ON CERTIFICATE REGARDING AUDIT OF SUBSIDIARIES

Question: We have been called upon to make an audit of the XYZ company, a joint stock association, which owns practically 100 per cent. of the stock of various subsidiary corporations. The XYZ company is a large operator in a major industry, while the subsidiary corporations operate only in kindred lines.

The ownership of the XYZ company is closely held and the general public is not interested in its welfare. The XYZ company borrows money from banks. Some of the loans are unsecured, but the majority is secured. This money is used to finance the operations of the XYZ company and to make advances to subsidiary corporations. The XYZ company carries the investments in subsidiary corporations at the lower of cost or book values of the respective companies, and these items are to be treated in this manner on the balance-sheet.

We are requested to prepare a certified balance-sheet of the XYZ company without examination of the books and accounts of the subsidiary corporations and give an unqualified certificate as to the financial position of the XYZ company. Detail statements of the various subsidiary corporations are available to us in the office of the XYZ company, all of which have been prepared by XYZ internal audit department. The XYZ company has a well developed system of accounting and reports. We are accorded the privilege of sending out from the office of the XYZ company any verification letters we may deem necessary regarding the accounts of subsidiary corporations. The subsidiaries are widely scattered and the XYZ company does not consider it necessary to incur the expense of auditing the subsidiaries.

Please advise whether it would be necessary to qualify our certificate as to the audit of subsidiaries or, providing we could obtain satisfactory information from the office of XYZ company, if an unqualified certificate would be in order.

Answer No. 1: The question does not give any indication of the relative size of the investments in and advances to subsidiary companies in comparison with the total assets of the parent company.

If the investments in and advances to subsidiary companies represent an important part of the total assets of the holding company, we do not think that in ordinary circumstances an accountant would be warranted in signing any certificate on the accounts of the holding company unless he had made examinations of the accounts of the subsidiaries either at the date of the balance-sheet or at some relatively recent date. We can not, of course, give a definite opinion as to the extent of the examinations. Broadly speaking, however, we should consider that the examinations to be made of the accounts of subsidiary companies should be as extensive as would be made if the same accounts were found in branches of the parent company not separately incorporated.

On the other hand, if in the accounts of the holding company these assets in subsidiary companies represent a relatively small part of the total assets, we believe that a certificate could be given, but only with a definite qualification. Such a qualification should state that no examinations had been made of the subsidiary companies and that the accounts of those companies had been accepted on the basis of statements prepared by the company's internal auditors and that they represented only approximately a given percentage of the total assets.

Answer No. 2: We are of the opinion that the accountant should state clearly in his report, with reference to the investments of XYZ company in subsidiaries, that he has not examined the books of account and supporting data of such subsidiaries and the extent of the information regarding the affairs of the subsidiaries furnished him by the management of XYZ company. Finally, his opinion should be qualified in respect to such comments. We assume that the accountant would qualify his report further if the statements of the subsidiaries examined by him disclosed any condition affecting the value of investments in subsidiaries as shown in the balance-sheet of XYZ company.

Answer No. 3: It seems to us, irrespective of the information available in the office of the holding company regarding the status of the various subsidiaries, and having in mind the correspondence between the special committee on coöperation with the stock exchanges, of the American Institute, and the committee on stock list of the New York stock exchange, in which a uniform certificate was decided upon and this particular point was stressed, that it is essential that the certificate to be issued by the independent auditor of this company should be qualified by stating that the subsidiary companies' investments and advances are included at cost or book value and that no audit of these accounts had been made by independent auditors. Without this qualification it would naturally be assumed by anybody receiving the statement of the parent company, with the auditors' certificate, that the auditors had satisfied themselves as to the values assigned to these various investments and advances to subsidiaries.

EXPENSES OF RETAIL COAL DEALERS

Question: Will you please obtain, if possible, the generally accepted basis used in allocating the following expenses (of retail coal dealers handling both coal and coke) to coal and coke sales:

1. Yard expense
2. Selling expenses
3. Administration and general expenses

Answer No. 1: It has not been my practice definitely to allocate these expenses on the books of account or in my report. I usually show them as deductions from the gross margin of profit realized from the sale of both commodities. As a matter of information, however, usually I calculate these expenses on a tonnage basis and, in my opinion, if it is desired to allocate them definitely, the tonnage basis is a fair one.

I do not know of any alternative basis that could be fairly used with respect to yard expenses; but selling, administrative and general expenses might be allocated, if desired, on the basis of the respective dollar volume of sales of each commodity to the total sales.

CAPITALIZATION OF REPAIR ITEMS

Question: The client (a manufacturing company) carries machinery and equipment at original costs in excess of $750,000. It has been customary in the past to charge to the repair account items, say, of $50 or under, which are not considered wholly as capital expenditures, with the exception, however, that such items as painting, re-surfacing, etc., are charged to the repair account.

The board of directors of the concern felt that with increasing investment in new machinery, etc., the total amount of depreciation was so steadily increasing as to cause the company considerable concern in the computation of costs of manufacturing of various commodities. In due course, it was suggested that many of the items charged against repairs were in fact wholly or partly of a capital nature; and with this idea in mind it has been the custom for several years to capitalize one-half of its repairs by monthly journal entries. This procedure had the approval of the directors of the company, although the full original charges to repairs had been deducted for income-tax purposes and allowed by the internal-revenue bureau.

We do not know of any case where a similar procedure is practised, and for the preparation of certificates of audit I am writing to ask you if in your opinion this practice is "in accordance with accepted principles of accounting."

Answer No. 1: It seems to me that the whole question turns upon the rates of depreciation which are in use and for what such depreciation is to provide. The practice of charging small items of what would otherwise be capital expenditure, say of $50 or less, to an expense account is not an unusual one in large corporations and can well be defended. It is a practicable and conservative practice.

The deliberate charging of 50 per cent. of the regular repair account to capital expenditure is, however, quite another proposition and can not be defended in any circumstances, unless it is done merely as a measure to equalize charges for repairs from year to year. If this practice were followed there might be equal justification for charging the whole repair account to capital. The justification for such an action could, of course, only be found in establishing such a rate of depreciation as would take care of normal repairs. If the company has used rates of depreciation which will do this there can be no great criticism.

Possibly a better plan, however, would be to charge off all repairs in the year when they are made, with the exception, possibly, of major repairs of material amount—such, for instance, as the reroofing of a whole building or the replacement of a costly fence which in the course of years has become unserviceable. In these circumstances there would be justification for spreading such cost over a limited period of from three to five years. I think this would be a better plan than that apparently followed by your correspondent's client. The case in point could only be considered as "in accordance with accepted principles of accounting" if the rates of depreciation were undoubtedly sufficiently large to carry this added burden.

Answer No. 2: The question here appears to be entirely one of fact. If the items capitalized do not in the opinion of the accountant extend the useful life of the equipment beyond that contemplated by the rates being used for depreciation and obsolescence, such capitalization could not be said to be "in accordance with accepted principles of accounting."

In other words, if the only reason for this procedure is to reduce the apparent expense of doing business so that the apparent costs of manufacturing various commodities will be less, than they would be if properly calculated, the procedure would not appear to be correct.