1918

Contingent liabilities

Anonymous

amounts. A credit card took the place of money. Transfers of value were made through a "simple" system of book accounts.

From a central station, music, rendered by the most celebrated artists, was distributed by a telephonic device. One had only to turn on a switch at any hour of the day or night to be thus entertained. Sermons by eminent divines might be heard in the same way.

Domestic servants were unknown. Public laundries, kitchens, and dining places supplied the domestic needs of society. In short the whole country was on a coöperative basis.

The millenium has not yet arrived. The peaceful relations of the great nations of Europe are not "assured by an international council which regulates the mutual intercourse and commerce of the members of the union." The time is not yet when "the value of a man's service to society fixes his rank in it." One is struck forcibly, however, by the fact that the book contains so little which is inconsistent with the progress achieved since it was written. All that it portrays has not come to pass. It contains, no doubt, many promises for the future.

Contingent Liabilities

THE traditional contingent liabilities of the past have been those pertaining to accommodation endorsements and notes receivable discounted.

When Smith wanted to borrow from the bank and the bank wanted an endorser, Smith went to Jones and got him to endorse as a matter of accommodation.

All went well as long as Smith paid when the note fell due. In the meantime there was always the possibility that he might fail to do so. In such event Jones would be called upon to satisfy the bank. The contingent liability would become a real liability.

Business organizations which take notes from customers and discount the notes have, in the same way, a contingent liability until the notes are paid.

The "Liberty Loans" have brought with them possibilities for contingent liabilities. Many public spirited business concerns have subscribed to the loans on behalf of employes. In other words employes have subscribed with the understanding that if for any reason they should be unable to complete the installment payments, the employer would take over the subscription. There is in such cases a contingent liability on the part of the employer which should not be overlooked.

The inauguration in 1914 of the Federal Reserve Bank System brought with it an instrument, common in Europe but little used in this country, namely, the "trade acceptance."

Trade acceptances, ordinarily, do not, in their relation to the financial condition of a company, differ from notes payable. They may not be used for purposes other than agricultural, industrial or commercial. They are drawn by the seller on the purchaser; accepted by the latter when he receives the goods; may be taken by the seller to the bank and discounted or sold. They help to make elastic the credit system in that they may be re-discounted with the Federal Reserve Bank. Their use under ordinary circumstances results in the creation of a real liability on the part of the acceptor.

In certain industries, cotton for instance, trade acceptances are beginning to be used in a somewhat unique way.

The grower, or in many cases his representative, the commission man, puts the cotton in a warehouse. Incidentally it may be said that the Federal Reserve Banks have done much to raise the standard of warehouse conditions and practices. The grower, using the word as a representative term, obtains from the warehouse a warehouse receipt.

The grower next obtains from some mill having a satisfactory financial standing, acceptances dated so as to correspond to the (weekly) consumption needs of the mill and payable at some future time.

The grower now takes the warehouse receipts and acceptances to the bank and gets, in effect, the money for his cotton.

The bank releases the warehouse receipts to the mill as the datings on the acceptances mature.

In the interim between the time of executing the acceptances and the datings thereon there is a contingent liability on the part of the mill. There is of course on the other hand the contingent asset in the form of cotton deposited in the warehouse. The value of the asset depends, however, on the fluctuation of the spot cotton market.

Transactions such as the above frequently are not recorded on the books. They grow out of contracts for future deliveries and the introduction of the trade acceptance into the situation does not alter the situation in any way. The acceptance is merely an instrument in the accomplishment of the contract.

Opinions may differ as to the propriety of setting up the contingent asset and contingent liability. The way one feels in the matter of booking contracts for future execution, or commitments generally, must govern in the present case. The auditor naturally will not criticize the client for having too much information on the books. The auditor should not fail, lest he suffer criticism, to note contingent liabilities such as the above at the foot of the balance sheet.

The use of the trade acceptance is increasing. According to the Federal Reserve Bulletin, May, 1918, "Between November 20, 1917, and March 4 of the present year, acceptance liabilities of the national banks increased from 153.6 to 230.2 millions, or about 50%. * * * Acceptances held by the Federal Reserve Banks * * * show a substantial increase from 209.9 on November 23, 1917, to 317.9 millions on March 8 of the present year."

We should be on the lookout for new uses of trade acceptances. What applies to the cotton industry may apply to other industries. It is incumbent upon the accountant to make inquiry concerning such matters. If he discovers contingent liabilities they should be set forth.

Bonus Computations

WE are able through the courtesy of Mr. L. L. Perrine, Assistant Treasurer of the American International Corporation, to present herewith a formula, or rather a series of same, covering tax situations wherein there are involved normal income, war income, and war excess profits taxes and a bonus based on net income.

The essential portion of Mr. Perrine's letter relating to this matter follows:

> "I am setting forth in this letter formulae for determining the amount of bonus computed on a percentage applied against net income. Without going into more elaborate explanation, I think the following will clearly show the nature of the problem:

Let a = Net income prior to deduction of (1) Bonus; (2) War Excess Profits Taxes; and (3) War Income and Income Taxes.

b = War Excess Profits Taxes, computed as if there were no bonus.

c = War Income and Income Taxes, computed as if there were no bonus.

d = Percentage of net income (after deducting bonus itself and all taxes) which represents bonus.

x = Net income after deducting bonus and all taxes.

If I understand your problem correctly, the first four quantities, a, b, c, and d, are known quantities for each