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Correspondence: Resources and their application; What is Practice?; Coal in Transit

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Correspondence

RESOURCES AND THEIR APPLICATION

Editor, The Journal of Accountancy:

SIR: At the examination of May, 1921, the following problem was submitted to the American Institute candidates:

Prepare a statement of resources and their application for the twelve months ended December 31, 1920, using the following data:

THE HALL MANUFACTURING CO.

BALANCE-SHEETS

Assets

	Dec. 31, 1919	Dec. 31, 1920
Cash	$5,000	$1,800
Accounts receivable	30,000	32,000
Raw material	12,000	14,500
Goods in process	16,000	17,500
Finished goods	21,000	19,000
Land	70,000	100,000
Buildings	115,000	170,000
Machinery	90,000	100,000
Tools	26,000	23,000
Patents	30,000	28,000
Discount on bonds	....	2,000
Investment in stocks	25,000	....
Advances to salesmen	500	1,000
Unexpired insurance	300	250
	$440,800	$509,050

Liabilities

	Dec. 31, 1919	Dec. 31, 1920
Accounts payable	$35,000	$10,000
Notes payable	25,000	5,000
Bank loans	20,000	....
Bonds payable	200,000	300,000
Reserve for depreciation, buildings and machinery	20,000	29,000
Reserve for bad debts	1,200	1,500
Reserve for construction	16,000	20,000
Capital stock	100,000	100,000
Surplus	23,600	43,550
	$440,800	$509,050

Following is an abstract of the surplus account:

	Dec. 31, 1919	Dec. 31, 1920
Balance, January 1, 1920		$23,600
Add net profits for 1920		8,950
" appraisal increase in land		30,000
Total		$62,550
Deduct credit to reserve for construction	$4,000	
Dividends paid December 31, 1920	15,000	19,000
Balance, December, 1920		$43,550

Depreciation was provided during the year as follows:

Credited to reserve for depreciation, buildings and machinery.....	$10,000
Written off from tools..	5,000
Written off from patents..	2,000

During the year machinery which cost $7,000 was sold for $6,000. The loss was absorbed in the reserve for depreciation.

A solution of this problem appears in volume XXXII, pages 66 and 67, of THE JOURNAL OF ACCOUNTANCY.

I know that THE JOURNAL OF ACCOUNTANCY does not claim that the solutions which it publishes are official, but there is no doubt that all the students of accounting who read THE JOURNAL believe that they are. The students enrolled in my correspondence course are asked to solve the problem referred to in the foregoing, and the unanimity with which they copy the solution published by THE JOURNAL is an evidence of their belief in its orthodoxy and official character.

My personal belief is that the solution at issue is not a good one; that it is not true to accounting principles, and that, in order to balance, it violates accounting. It is because I hope to stir the interest of accountants in general, and bring about a salutary discussion of the points at issue, that I ask you to publish this letter in your JOURNAL. I have no desire to advertise myself or my course; I am actuated only by my firm belief in the truth and sacredness of accounting principles.

After having presented a comparative balance-sheet at the beginning and at the end of the calendar year 1920, showing increases and decreases of assets, liabilities, reserves and surplus, the editor of the *Students' Department* offers the following statement:

STATEMENT OF APPLICATION OF FUNDS, YEAR ENDED DEC. 31, 1920

Funds provided:		
By net profits before providing for depreciation and bad debts.........................		$8,950.00
Add depreciation		
Building and machinery.................	$10,000	
Tools................................	5,000	
Patents..............................	2,000	
		17,000.00
Add provision for bad debts.................		300.00
		$26,250.00
By issue of bonds		
Par..................................	$100,000	
Less discount..........................	2,000	
		98,000.00
By sale of investments in stocks..............		25,000.00
By sale of machinery		
Cost.................................	$7,000	
Less loss charged to reserve.............	1,000	
		6,000.00
Total funds provided...............		$155,250.00

which were applied as follows:

To purchase of fixed assets:		
Buildings	$55,000	
Machinery	17,000	
Tools	2,000	
		$74,000.00
To payment of dividends		15,000.00
To increase in working capital and deferred charges (exhibit "C")		66,250.00
		$155,250.00

Exhibit "C", to which the above refers, is made up of the following increases and decreases:

Increase of accounts receivable	$2,000	
" " raw materials	2,500	
" " goods in process	1,500	
		$6,000.00
Decrease " accounts payable	$25,000	
" " notes payable	20,000	
" " bank loans	20,000	
		65,000.00
		$71,000.00
" " cash	$3,200	
" " finished goods	2,000	
		5,200.00
Increase of working capital		$65,800.00

The editor of the *Students' Department* uses the term "funds" but does not say whether these funds are cash or asset funds. His terminology indicates that cash is at issue, since he says that the funds provided were applied to purchase assets and pay dividends; but it also indicates that assets are at issue, since he says that funds were applied to "increase in working capital." I assume, of course, that the editor did not mean to say that cash had been applied to reduce the asset cash, and above all to reduce the asset finished goods.

Passing now to the source of the very funds which were applied, I find that "tools" which must have been consumed by, and charged to, operations, since the decrease suffered by the asset has not been set aside out of profits, have produced $5,000 of cash or asset funds; that the amortization of patent value (which the editor refers to as "depreciation") has been written off the asset, charged to operations as a profit-and-loss charge, but, nevertheless, has produced $2,000 of cash or asset funds. Whether it is cash or asset funds which the editor has in mind makes no difference whatever; in either case, he advances the theory that one of the means of providing funds is to consume assets or to write off intangibles.

The solution of your editor gives the impression that the profits of the year were $26,250 before providing for depreciation and bad debts. That is true only provided the profit-and-loss account reads as follows:

PROFIT-AND-LOSS ACCOUNT

Provisions for reserves:		Operating profits..	$26,250.00
For depreciation of B. & M.	$10,000.00		
" accounts receivable	300.00		
" depreciation of tools	5,000.00		
" " " patents	2,000.00		
	$17,300.00		
Balance transferred to surplus	8,950.00		
	$26,250.00		$26,250.00

But the profit-and-loss account does not read that way, because the writing off of the asset "tools" in the amount of $5,000 is not "depreciation" and, therefore, has not been set aside out of profits. The writing-off of tools is the result of an inventory which, when opposed to the prior inventory and to subsequent purchases, shows that the operations have actually consumed a value of $5,000 which must be considered as cost of goods manufactured, or, at any rate, as a profit-and-loss charge operating against inaccurate operating profits. The same thing is true of patents: in this case, as well as in the case of tools, a reserve was not created; the patents lost a value proportionate to the amortization of their active life, and, therefore, the loss was charged to operating profits which were too high. Thus the profit-and-loss account must read:

PROFIT-AND-LOSS ACCOUNT

Provisions for reserves:		Operating profits..	$19,250.00
For depreciation of B. & M.	$10,000.00		
" accounts receivable	300.00		
	$10,300.00		
Balance transferred to surplus	8,950.00		
	$19,250.00		$19,250.00

In reality, the actual profits of the company are, not $19,250, but $18,250, since the surplus reserved for depreciation of buildings and machinery has suffered a loss of $1,000. This loss the company's accountant did not fail to take into consideration when rendering the income-tax report. This report, when it was rendered in 1920, must have been as follows:

Operating profits............................		$19,250.00
Deduct:		
Loss on machinery sold....................	$1,000.00	
Depreciation of machinery and buildings......	10,000.00	11,000.00
Taxable income.......................		$8,250.00

The reserve for bad debts is excluded because, in 1920, it was not an allowed deduction, and, further, because, as there had been no loss of the previous reserve, an increase of that old reserve was purely sentimental and, therefore, useless.

There is not, to my knowledge, a principle of accounting which links the new resources obtained during a period with the cash receipts, and the resources of a prior period, consumed in the present one, with the cash disbursements. It appears to me that your editor's solution is brought to a balance by forcing the funds, i. e., by making them come from sources which are impossible.

Of course, you expect me to submit to your readers what I believe to be the true solution of the problem at issue. Here it is:

STATEMENT OF RESOURCES AND APPLICATIONS

(a) Increase of corporate wealth:		
(1) Through appraisal of land up to the market value thereof at 12/31/20—(Credited to surplus)		$30,000.00
(2) Through acquisition of fixed assets:		
Tools	$2,000.00	
Buildings	55,000.00	
Machinery:		
New machinery acquired $17,000		
Less old machinery sold.. 6,000	11,000.00	68,000.00
(3) Through increase of operating assets:		
Raw materials	$2,500.00	
Goods in process	1,500.00	
Accounts receivable (including advances to salesmen $500.00)	2,500.00	6,500
Total 1, 2 and 3		$104,500.00
(4) Through the retention, as an asset, of the discount lost on bond issue		2,000.00
(5) Through the release of liens encumbering assets:		
Cancellation of bank loans	$20,000.00	
Reduction of acc'ts payable	25,000.00	
" " notes payable	20,000.00	65,000.00
		$171,500.00
(b) Decrease of corporate wealth:		
(1) Through decrease of assets:		
Investment in bonds	$25,000.00	
Finished goods	2,000.00	
Unexpired insurance	50.00	
Cash	3,200.00	
		$30,250.00

(2) Through consumption of assets by operation:		
Tools consumed by process..........		$ 5,000.00
(3) Through amortization of intangible values—patents.....................		2,000.00
(4) Through loss on machinery, resulting from sale........................		1,000.00
(5) Through distribution of surplus earned in past periods......................		15,000.00
Total 1, 2, 3, 4 and 5................		$53,250.00
(6) Through use of credit:		
Increase of liability for corporate bonds through issue thereof.............		100,000.00
Total decrease of corporate wealth		$153,250.00

(c) Net increase of wealth through reinvestment of profits of the calendar year as follows:

(1) Net profits after appropriations, i. e., net profit transferred to surplus.........		$8,950.00
(2) Appropriated out of current earnings:		
For depreciation of buildings & machinery........................	$10,000.00	
For increase of reserve for acc'ts rec....	300.00	
		10,300.00
		$19,250.00
(3) Deduct loss of surplus previously appropriated.		
Loss of reserve for depreciation of machinery and equipment.........		1,000.00
Net profits reinvested, to secure net increase of wealth........		$18,250.00

I beg to point out to your readers that this solution expresses a perfectly well known and eminently sound principle of business philosophy. It says that a concern obtains new wealth by:

(1) increasing its assets,
(2) relieving its assets of the liens which encumber them.

It says, further, that a concern diminishes its wealth by

(1) decreasing its assets,
(2) using its credit,

and it ends by saying that the net increase of wealth obtained in a period results from the net increase of assets, made possible by the reinvestment of profits, as measured by the net increase of surplus.

It is my contention that both the layman and the accountant can understand the statement which I have submitted; whereas neither the accountant nor the layman can understand the statement submitted by the editor of your *Students' Department.*

In support of this contention, permit me to say that, very recently, I had in my office, seeking advice, one of the partners in a firm of accountants. This accountant had been asked by a new client to check up "a statement of resources obtained and applied" produced by his predecessor on the lines of the statement which I have criticized in the foregoing.

The client professed inability to understand the said statement, and the accountant proclaimed loudly that he could not "make head or tail" out of it. He was convinced that a figure had been used to balance the statement, which was merely a "forced figure." My opinion was in every way corroborative of his.

Trusting that you will see your way clear to publish this letter, in the interest of our beloved theory of accounting.

Very truly yours,

PAUL-JOSEPH ESQUERRÉ.

New York, March 26, 1925.

WHAT IS PRACTICE?

Editor, The Journal of Accountancy:

SIR: Your editorial in the March issue of THE JOURNAL was splendid. I am referring to the heading *What is Practice?*

The argument submitted by your correspondent is a selfish one and one that every practising accountant is familiar with. The correspondent overlooks the fact that the whole theory of accountancy legislation is not for the purpose of granting certificates to applicants to satisfy their ego, but the certificates are granted to individuals who comply with the law, as a protection to the public and under the assumption that the individual intends to practise as a public accountant. All of the certificates granted by the respective state boards of accountancy, that I have ever seen, certify that "This certificate is granted to John Doe, entitling him to practise as a certified public accountant."

It is a splendid thing for the profession that the certified accountants have through their good work created a value for the certificate. Having done this, it is only just and right that they should protect themselves by making needful rules and regulations that will prevent selfish individuals, who have not the interest of the profession at heart, from procuring certificates to satisfy their vanity or increase their prestige in private employment.

Yours truly,

JOHN Y. RICHARDSON.

Portland, Oregon, March 12, 1925.

COAL IN TRANSIT

Editor, Journal of Accountancy:

DEAR SIR: I have just been reading an article in the April issue of the JOURNAL written by Mr. McDowell, upon a subject which is of much interest to me, i.e., examination of bituminous coal companies.

While the author has confined the scope of the examination to only one of the many possible purposes for which examinations are conducted, and while he assumes that his readers generally will have a more or less acquired knowledge of the coal business, the article seems to be a rather complete exposition of the high points in this special class of work. However, being myself largely engaged in just this kind of practice, I feel that some notice should be taken of at least one statement or instruction which appears in the article.

The portion I refer to makes mention of the proper method for valuing and accounting for coal in transit. Mr. McDowell's statement that "cars mined but not invoiced should be valued at cost and inventoried in the balance-sheet" is not sufficiently qualified or clear to be readily understood without further explanation.

Possibly the fact has been overlooked that coal shipped upon orders to a sales company, although no invoice has been received, represents actual sales and irrevocable disposition of goods under the usual contract. It would seem more proper to recognize the element of profit, if any, in coal in transit by valuing it at the sales-realization price, inasmuch as the transaction, so far as the coal company is concerned, represents its part of the executory contract and an activity falling within the period under review.

It must be remembered that this situation is one in which the terms of sale have been made a matter of contract, the only contingency being the destination of the coal, and the matter of consigned goods is not at all comparable hereto. It is of course recognized that where coal is consigned to agents, the procedure suggested by Mr. McDowell's article would be proper, but it is the writer's opinion that a careful distinction should be made in this matter, as the item "coal in transit" often represents a large proportion of the coal company's current assets.

Yours very truly,

S. A. Blustein.

Charleston, West Virginia, April 4, 1925.