Journal of Accountancy

Volume 38 | Issue 4 Article 6

10-1924

Students' Department

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Recommended Citation
Finney, H. A. (1924) "Students' Department," *Journal of Accountancy*: Vol. 38: Iss. 4, Article 6.
Available at: https://egrove.olemiss.edu/jofa/vol38/iss4/6

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Students' Department

EDITED BY H. A. FINNEY

AMERICAN INSTITUTE EXAMINATIONS

[Note.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not lead the reader to assume that they are the official answers of the American Institute of Accountants. They have not been approved by the Institute's board of examiners.]

EXAMINATION IN AUDITING

MAY 15, 1924, 9 A. M. TO 12:30 P. M.

The candidate must answer all of the following questions:

No. 1.

A & B, a firm, ask your advice as to the advantages and disadvantages of incorporating. Their invested capital is $100,000 and their net income (federal income-tax basis) was $30,000. Their business, hardware retailing in a small but growing town, is run by the partners and three employees. What would you tell them?

Answer:

In the abstract, and without particular reference to the case of A and B, the following points may be mentioned in favor of incorporating:

(a) Continuity of life. A partnership may be dissolved by the death, insanity, insolvency or withdrawal of a partner. Thus the continued existence of the partnership is constantly in jeopardy. A corporation can be dissolved only by agreement of the stockholders, expiration of the charter period, forfeiture of the charter by the state or judicial decree.

(b) Legal entity. A partnership has no legal existence apart from the partners who compose it. Hence, a partnership can not sue or be sued by one of the partners, since a person can not be both plaintiff and defendant in the same suit. A partnership is bound by the acts of each partner when acting within the limits of his actual or implied authority, but a corporation can not be bound by the acts of its stockholders individually.

(c) Limited liability. Since a partnership has no legal entity apart from the partners who compose it, all partners are jointly and severally liable for the debts of the partnership. Stockholders, however, have no such unlimited liability. In most states, if the company received par for the stock, all further liability would cease. In some states, there is a further liability not to exceed one hundred per cent of the par value of the stock owned. If stock is purchased from the corporation at a discount, there is a liability for the amount of the discount if the corporation is unable to pay its debts. In practice, the advantage of limited liability is somewhat nullified by the fact that banks often require a corporation's notes to be endorsed by the officers, directors or stockholders.

(d) The stock system. The corporate method of dividing the capital into shares which can be transferred has the advantage of making it possible to obtain capital from a larger number of persons than would be possible under

the partnership form of organization and makes it possible for a stockholder to withdraw from the enterprise by selling his stock.

(e) Management. In a partnership each partner has an equal voice in the management, regardless of capital contributions. This often results in dissension and not infrequently in deadlock. In a corporation the ultimate control rests with the stockholders, who exercise this control at the annual meeting by electing directors. The management is thus placed in the hands of directors, who exercise it through officers elected by them.

On the other hand, the corporate form of organization has its disadvantages, among which may be mentioned the following:

(1) A corporation is subject to the supervision of the state in which it is organized, of other states in which it does business and of the interstate commerce commission, if it does an inter-state business.

(2) A corporation may not engage in any other business than the one which its charter empowers it to conduct.

(3) In some states a corporation may not own its own stock, the stock of other companies or real estate other than its business premises.

(4) A corporation's capital stock may not be increased above, nor reduced below, the amount authorized by its charter without the authorization of the proper state officer.

(5) Corporations must usually obtain a license to do business in a state other than the one in which they are organized. Failure to comply with this requirement may subject them to fines or render them incompetent to bring action in the courts of the state.

(6) All important acts must be authorized by the board of directors and minutes of the directors' and stockholders' meetings must be kept.

(7) Restriction is often placed on the amount of liabilities which may be incurred. Often this amount may not exceed the outstanding capital stock, and directors who are present and who vote for the incurring of excess liabilities become personally liable.

(8) Profits can not be divided in an arbitrary ratio, as may be done in a partnership, but must be divided, if at all, in proportion to stockholdings.

(9) Profits can be distributed only after a formal declaration of dividends by the directors.

(10) The distribution of dividends must not impair the capital.

(11) Minority stockholders may be at the mercy of majority stockholders and without means of protecting their interests.

(12) Frequent and varied reports are required of corporations by the states in which they are incorporated or in which they are doing business.

(13) Organization fees, franchise taxes, stock-transfer taxes and capital-stock taxes often make the total tax burden of a corporation considerably greater than the tax burden of a partnership doing a similar business.

So far as the matter of federal taxes is concerned, it appears that it would be decidedly disadvantageous for A and B to incorporate, although in the absence of information as to the amount of income earned by A and B outside the partnership this can not be definitely known. Assuming, for the sake of illustration, that A and B are both married, that neither has children or other dependents and that the total profits of $30,000 (minus federal taxes) would be

divided by the corporation in the form of dividends, the comparative taxes under the partnership and corporate forms of organization would be:

PARTNERSHIP.

One-half of net income, to each	$15,000
Personal exemption	2,000
Balance	13,000
Amount taxable at 4%	4,000
Amount taxable at 8%	$9,000
Normal tax—4%	$160
Normal tax—8%	720
Surtax	180
Total tax—each partner	$1,060
Multiply by	2
Total tax—both partners	$2,120

CORPORATION.

Corporation tax—12½% of $30,000		$3,750.00
Individual tax:		
Total profits	$30,000	
Less tax	3,750	
Dividends	26,250	
One-half dividends thereof to each	13,125	
Surtax thereon	$113.75	
Multiply by	2	
Total surtax on dividends to A and B		227.50
Total corporation and individual tax		$3,977.50

The foregoing computations have been made on the basis of the law in force at December 31, 1923, as the problem states that the proposed incorporation was in prospect as of December 31st. The total taxes under the corporate form could be somewhat reduced by allowing salaries to the two partners, but not sufficiently reduced to bring the total taxes below those payable under the partnership form of organization.

In addition, the corporation would have a capital-stock tax to pay. Assuming that the capital would be $100,000, as mentioned in the problem, the tax would be $95.

No. 2.

A & B having incorporated on January 1, A dies February 1. His executor thinks he has grounds for believing that A did not receive his full equity in the incorporation of the old firm. B offers to submit all the books and records to you as auditor acting for both parties. State what books and records you would examine and how you would satisfy yourself that A had or had not received full value for his interest in the firm. (Assume that you have not been employed by either party before.)

Answer:

As to the books and records which would be desired, the only possible answer is that you would want them all, whatever they might be. In particular, the articles of partnership should be mentioned, as it would be the auditor's duty to see that the accounts had been kept in such a manner as to give effect to the agreement between the partners.

In the first place, the auditor should see that the assets were fairly valued at the time of the incorporation of the business. Conservative going-concern rules for valuation might have been applied in the valuation of the assets and this might have worked a hardship by transferring to the corporation property at less than its real worth. When a business is incorporated, the transaction may be regarded as a sale of the property by the partnership to the corporation and realizable values may be used instead of going-concern values.

In the second place, the auditor should make a sufficient investigation of the profits of prior years to satisfy himself that they have been correctly computed. This is important for two reasons. First, the credits to the capital accounts would be directly reduced by the amount of any understatement in the profits. Second, the capital accounts would be indirectly reduced if allowances for good-will were based on understated profits.

In the third place, the auditor should see that all charges and credits to the partners' accounts were made in accordance with the partnership agreement; for instance, that profits were divided in the agreed ratio, that drawings were treated as drawings and not as salaries, that salaries were treated as salaries and not as drawings, that interest was not credited on capital or charged on drawings unless there had been an agreement to that effect, and that interest had been allowed on partners' loans.

No. 3.

As the result of the above audit (question 2) you find A was entitled to $2,000 more for his equity, which B settles by transferring additional stock at par for the amount. On April 1 the books of A's executor show the following receipts:

(a) From sale of above-mentioned stock at par..................	$2,000
(b) Rent of property owned by A for the quarter ending February 29	300
(c) Dividend on railroad stock declared the previous December 15, but received February 15................................	300
(d) Six months' interest on a mortgage paid March 31............	600
(e) Refund of excess federal income-tax which A had paid three years previously..	300

and the following disbursements made:

(f) Expenses of A's funeral..................................	500
(g) Rent of A's residence for January, February and March........	300
(h) Household supplies for January............................	100
(i) Cash advanced to A's widow, sole legatee....................	1,000
(j) A's federal income-tax for the previous year and for one month of the current year..	410

Items (a) to (e) are found to be included in the revenue account of the estate, and items (f) to (j) charged to expense. Have you any criticism to offer?

Answer:

(a) The proceeds of the sale of the additional $2,000 of stock at par should not be regarded as income. The additional stock was received as a correction of A's capital in the corporation. It should have been credited by the executor

to the corpus account and shown in the summary statement as an additional asset discovered. Even if the stock had been sold at more than par, there would have been no profit to be shown as income, for the corpus consists of the stock or whatever is realized upon it.

(b) The propriety of the treatment of rent on property owned would depend upon the state in which A lived. Rents do not accrue under the common law. Many states have enacted statutes which provide that rents shall accrue; in fact so many states have passed such statutes that there is a prevalent opinion that rents always accrue, but there are enough states where the contrary rule governs to make it necessary to qualify the answer in this particular. If A lived in a state where rents accrue, two months' rent would be corpus and one month's rent would be income. If A lived in a state where rents do not accrue, the entire amount collected would be income, as it apparently became due and was collected after A's death.

(c) The dividend would be corpus because it was declared prior to A's death.

(d) The interest should be apportioned between corpus and income; the amount accrued at February 1 would be corpus and the remainder would be income.

(e) The refund of excess federal income-tax should be classified as corpus; it was a debt of the government at the date of A's death and constituted an asset at that date. This would be true even though the amount had not been ascertained or the claim acknowledged at that date.

(f) Funeral expenses are a charge against corpus, not income.

(g) See (b). If rents accrue in the state in question, the rent for January would be a charge against corpus and the rent for February and March a charge against income. If rents do not accrue, the date of maturity of the obligation would govern. For instance, if the rents were payable on the first day of each month, in advance, the rents for January and February would be chargeable to corpus, as they were due before A's death.

(h) Household supplies, purchased before A's death, should be deducted from corpus.

(i) The cash advanced to the widow should not be regarded as an expense, although it might be chargeable to income. The point is that it should be regarded as a distribution of the estate and, since the widow is the sole legatee nd entitled to both the principal and the income, the executor could consider he payment either a distribution of income cash or of principal cash.

(j) Federal taxes on income earned by A prior to his death should be classified as charges to corpus. The tax on income earned after death would be chargeable to such income.

No. 4.

A client comes to you for the purpose of being assisted, so far as all accounting matters are concerned, in the consolidation of five manufacturing companies. He informs you that it has been decided that in the first place each concern will send to him a balance-sheet as at the close of its last fiscal year and profit-and-loss accounts for each of the past five years, so that a preliminary statement can be prepared showing the approximate amount of common and preferred stock of the new incorporation that will be turned over to each of the five companies in settlement for its net assets, etc.

The plan outlined for consolidation includes the giving of preferred stock for all tangible assets less liabilities and common stock for the goodwill based upon

past profits. He asks you to prepare for him a letter to be sent to each of these five companies requesting such further information as might not ordinarily appear on a balance-sheet and profit-and-loss account, which it would be necessary to have before you in order to prepare the preliminary figures referred to above. Outline the character of the information which you would include in such a letter.

Answer:

Gentlemen: In order to enable us more equitably to determine tentative figures for the distribution of the preferred and common stock in the proposed consolidation, we request the following additional information:

The estimated appraised value of the physical properties. Presumably your fixed assets are carried on the books at cost less depreciation. It is desired to know approximately the values which could be obtained for such properties in their present state of age and depreciation and in the present market.

The policy which you have followed in regard to the treatment of ordinary and extraordinary repairs. Have these been charged to operations or to the depreciation reserve?

The rates of depreciation used on different classes of property and whether these rates have been applied to cost or to diminishing values.

A classification of the notes and accounts receivable, as to age, with such additional information as you may be able to furnish in regard to probable collectibility. Also the amounts actually charged off for bad debts during the past few years, as distinguished from the amounts credited to the reserve for bad debts.

The method of determining the cost of inventories of goods in process and finished goods.

The amounts paid as executive salaries, showing the title of the officer or other executive and the amount of salary paid.

The amounts of interest payments on long-time and short-time borrowings. Also the approximate borrowings by months.

Any extraordinary or extraneous profits or losses during the past five years, not clearly shown by the profit-and-loss statements as having arisen from sources other than operations.

Present purchase commitments.

Contingent liabilities of all kinds.

Any construction or other contracts.

Requirements as to working capital, sinking fund, etc., connected with bond and preferred-stock issues.

No. 5.

To what extent do you consider it obligatory for an auditor to examine minutes? Illustrate by reference to audits of different classes, such as:

(a) An incorporated company;
(b) A university or hospital partly endowed;
(c) The governing body of a political subdivision, such as a town council or board of freeholders;

giving examples of the character of information which you would expect to find in each.

If in any of these cases you were refused access to the minutes what would be your position?

Answer:

An auditor should always examine the minutes of the concern which he is auditing, and, if he is refused or if he for any other reason fails to obtain access to the minutes, he should make a statement to that effect in his report.

According to Mr. Montgomery, the following points may be involved: "contracts for additions to plant; purchase of other corporations or large interests therein; contracts for future deliveries of goods and materials in unusual quantities; payments of bonuses and special compensation to officers and others out of past profits, actual payment to be made at a future date; settlement of pending litigation and disputes regarding tax and similar obligations, for sums in excess of the liability, if any, carried therefor in the books; possibly of litigation, such as alleged infringement of patents, which might seriously affect the value of assets; contracts or agreements which might tend to increase the assets or reduce the liabilities."

As to universities or hospitals, one of the special points in the audit should be to determine whether or not gifts have been applied in conformity with the expressed wishes of the donors. The minutes should, and usually do, contain copies of resolutions of acceptance and thanks. These would put the auditor on notice as to the gift and would enable him to determine what, if any, specific purpose was named by the donor and also whether the funds had been used accordingly.

In the case of a governing body of a political subdivision, the minutes should be examined to ascertain whether expenditures had been made in accordance with appropriations. As an illustration of the many unusual facts which may be brought to light, it may be mentioned that in one municipality certain local improvements were made which were to be paid for in part by special assessments against property holders and in part by general payments from the town's funds. The minutes disclosed the fact that the expenditures had been authorized, the appropriations made for the amounts to be paid by the town, the authorization made for including the amount in the levy, but the amount was actually never included in the levy. The result was that the town had a considerable accumulation of liability for which it had made no provision.

No. 6.

In auditing the books of a manufacturing concern state fully what steps you would take to satisfy yourself on the subject of the item "wages" in the current profit-and-loss account.

Answer:

Tests should be made in the following manner: Compare a number of weekly payrolls with the record of employees and wages payable at the respective dates. Foot the payrolls. Compare the payroll totals with the amounts recorded. Examine the system of internal check as to the payment of wages and the safeguarding thereof. Compare a few payrolls with the time tickets turned in by the factory employees. Determine whether receipts or cancelled cheques are on file in amounts sufficient to account for certain payrolls.

No. 7.

Mention the chief points to be observed in reporting upon the accounts of a partnership where you are acting on behalf of a retiring partner, when the business is to be continued by the remaining partners.

Answer:

The auditor under such an engagement should remember that there is a distinction between the proper rules for valuation of the assets of a going concern and the rules for valuation of a partnership about to dissolve.

In a going concern, merchandise, for instance, should be valued at cost or market, whichever is lower. This is a conservative rule to avoid the anticipation of profits and in a going concern market values in excess of cost should not be given expression in the accounts. But if a partner is retiring the situation is different. The rising market indicates additional profits to be realized and, since the market increase has taken place prior to the partner's retirement, it is entirely proper that he should share in the benefit. In fact, it would be improper to deprive him of his share of the benefit.

In a going concern, fixed assets are valued at cost less depreciation; replacement values are not given consideration—at least not by credits to the capital accounts. But if a partner is retiring he is selling to the remaining partners his interest in the fixed assets and, if they are worth more than the value at which they are carried on the books, the accounts should be adjusted to bring them to their present realizable value.

In a going concern, conservatism is the acceptable policy and excessive reserves against accounts receivable and other assets and excessive reserves for contingencies may be regarded as a commendable error. But such would not be the case when one of the owners is about to withdraw.

In adjusting the asset accounts to realizable values, the auditor should remember that the undervaluation of some of the assets has affected the profits, while in other cases (such as the adjustment of fixed assets to an appraisal in which increased replacement costs are given effect) the increase in the asset value can not be regarded as a correction of past profits. To the extent that adjustments may be regarded as affecting profits, the auditor should remember that the goodwill to be allowed to his client may also be affected.

In addition to the determination of fair asset values, the auditor should see that the provisions in the articles of partnership have been fulfilled and that his client has received proper credit for investments and profits.

No. 8.

Statement

In the course of your examination of the A-B Company of Duluth, Minnesota, you find that the preferred stock is issued under a covenant that the corporation will at all times maintain net current assets of a value twice the amount of the outstanding preferred stock. The articles of incorporation also prescribe that the term "current assets" means the cash and bank balances, merchandise, current customers' accounts and notes, and the cash surrender value of life insurance, if any.

The final trial balance of the A-B Company at December 31, 1923, submitted for your verification and certificate is as follows:

Account	Dr.	Cr.
Accounts payable		$350,000
Bill payable to banks		1,300,000
Common stock		2,500,000
Cash and bank balances	$525,000	
Cash surrender value of life insurance	150,000	

	Dr.	Cr.
Customers' accounts and notes	$2,150,000	
Deferred charges	110,000	
Merchandise	2,000,000	
Plant and equipment	1,750,000	
Preferred stock		$1,500,000
Stocks and bonds	75,000	
Surplus		1,110,000
	$6,760,000	$6,760,000

In verifying the bank balances you find that two bank accounts, carrying balances to the credit of the corporation of the aggregate sum of $100,000 since August 1, 1923, have suspended payment on all deposit balances at September 1, 1923, and while these banks were open and conducting business on deposits made after September 1, 1923, the $100,000 was not subject to immediate demand and there is no information available as to when these amounts will be released.

In your review and verification of the customers' accounts you find that every required diligence has been exercised prior to the preparation of the statement above to charge to profit and loss all customers' accounts doubtful of realization. Also you discover that in certain territories served by the corporation many banks are closed on account of agricultural and financial conditions and that the retail dealers in these particular territories who are customers of the A-B Company are unable to make settlements according to the firm's usual terms. Your examination of the credit files and correspondence relative thereto convinces you that the debtors have abundant resources, but at the date of the statement above are unable to make remittances, also that requested extensions have been granted them beyond the regular terms of credit. The aggregate of customers' accounts in this condition is $125,000.

Questions

(a) State your understanding of the term "current customers' accounts."
(b) Revise the above final trial balance of the A-B Company at December 31, 1923, so as to give proper expression to financial conditions as expressed above.
(c) How would you report with regard to the preferred stock covenants in the articles of incorporation?

Answer:

(a) Current customers' accounts, strictly defined, are those customers' accounts which are not past due. In some businesses this might mean accounts which have been placed on the books within the last sixty days, while in others it might mean those which have been placed on the books within the past six or nine months. The credit terms are the deciding factor.

The foregoing is, however, a very strict definition which is rarely applied in deciding whether accounts receivable may properly be included in the current asset section of the balance-sheet. A more reasonable definition, in consideration of the latitude usually allowed in practice, would include among customers' current accounts those accounts which arose from merchandise sales, which are not long past due and which there is a probability of collecting in the near future.

The definition of current assets may have some bearing on this question. Current assets have been defined as including cash and other assets which will be converted into cash in the regular order of business. Some might contend

that when a general economic situation exists which makes financially responsible debtors unable to make payments within the usual credit period and necessitates the granting of extensions, the old "regular order of business" has been superseded by a new, temporary, regular order and furthermore that good accounts, which can not be immediately collected, are nevertheless current under the new condition of affairs. While such a theory would probably justify including in the current asset section of the balance-sheet the $125,000 of accounts receivable mentioned in the problem, if there were no special corporate requirements, still it seems doubtful whether it would justify classing these accounts as current in determining whether the preferred-stock requirements have been observed.

(c) Before setting up the revised statement required in (b), it seems advisable to answer the third part of the question. I would not show the corporation as definitely in default on its preferred-stock requirements. I would not include the $125,000 of accounts receivable in the current classification, but I would include the entire amount of bank balances in that classification. This would leave net current assets of an amount more than twice the amount of the preferred stock outstanding. It will be noted that the question uses the words "bank balances" without qualification. Notwithstanding the fact that the $100,000 of cash is not subject to immediate withdrawal, it is nevertheless a bank balance. In the absence of a more explicit statement in regard to the relation of bank balances to current assets, it would seem to be the auditor's duty to make no positive declaration that the company was in default as to the current asset requirements, but to furnish sufficient information to put the preferred stockholders on notice so that they could, if they wished, raise the question of the meaning of bank balances.

A-B Company Balance-sheet

December 31, 1923

Assets

Current assets:		
Cash and bank balances subject to cheque......	$425,000	
Bank balances not subject to cheque...........	100,000	
Cash surrender value of life insurance..........	150,000	
Customers' accounts and notes—current........	2,025,000	
Merchandise..............................	2,000,000	
		$4,700,000
Investments:		
Stocks and bonds..........................	$75,000	
Customers' accounts—not current.............	125,000	
		200,000
Fixed assets:		
Plant and equipment........................		1,750,000
Deferred charges:		
Sundry..................................		110,000
		$6,760,000

Liabilities

Current liabilities:		
Accounts payable..........................		$350,000
Bills payable to banks......................		1,300,000
		1,650,000

Capital:		
Capital stock:		
Preferred	$1,500,000	
Common	2,500,000	
Total	4,000,000	
Surplus	1,100,000	$5,100,000
		$6,750,000

The comments in the report would of course explain the status of the $100,000 bank-balance item and of the $125,000 customers' accounts.

The following question and answer are not part of any examination of the American Institute of Accountants, but they are of general interest.

Problem in Reserves

On January 15, 1908, AB and five others acquired a tract of land containing 500 acres at a cost of $50,000. They incorporated March 1, 1908, as the Valley Realty Company for the purpose of acquiring, subdividing and selling this tract for residential purposes, the company having 5,000 shares of no-par-value capital stock and a declared common capital of $50,000. The land was turned in to the company by AB and his associates for 2,000 shares, the value placed thereon being $120,000. The remaining 3,000 shares were sold for cash in the aggregate amount of $180,000. A landscape architect was engaged and in accordance with his advice sales of lots were not made until March 1, 1918. It was found that errors in early development work had caused the company to borrow $30,000 at 6% on March 1, 1917, the loan secured by mortgage on the entire property. The sales contracts with purchasers of lots provide that the company will maintain the allotment park and driveways in perpetuity. To insure this a fund is to be created for the permanent maintenance and care of the park and driveways, the estimated annual expense of which is $6,000. It is agreed with purchasers of lots that one-third of all cash received from sales shall be invested in bonds to yield 4%, until enough has been so invested to meet the annual expense mentioned. It is further agreed that when all lots are sold the bonds will be turned over to a board of trustees, elected by lot owners, who are to manage the parks and driveways.

You, as an accountant representing the estate of AB, who died March 1, 1924, are requested to audit the company's books, and you find that the tract had been divided into 400 lots of different sizes, but all of the same selling price, and that on February 28, 1924, there were 40 lots unsold. You find that the company has been following the practice of paying 5% commission to its salesmen upon collection in full for sales made; that at January 1, 1924, when there remained 50 lots unsold and in order to hasten the sale thereof, contracts had been entered into for additional improvements to cost $10,000 not yet made at February 28, 1924, these improvements benefiting only the unsold lots. An inspection of the minute-book showed a dividend of $1.00 per share declared February 25, 1924, payable March 15, 1924.

You draw off two trial balances as follows:

	March 1, 1918	Feb. 28, 1924
Debits:		
Cash	$6,000	$102,000
Accounts receivable for sale of lots		100,000
Bonds owned		100,000
Real estate	120,000	120,000
Improvements	160,000	160,000
Improvements replaced	30,000	30,000
General expense	14,000	134,000
Park and driveway maintenance		36,000
Dividends paid		430,000
	$330,000	$1,212,000

Credits:		
Capital	$300,000	$300,000
Sale of lots		900,000
Bond interest earned		12,000
Mortgage	30,000	
	$330,000	$1,212,000

From the foregoing data prepare journal entries, profit-and-loss account for the period and balance-sheet as of February 28, 1924. No provision is to be made for deferred income on uncollected accounts or for federal taxes, it being expected, however, that all other properly deferred and accrued items for which the information is available will be set up.

Answer:

It is assumed that the examiners did not desire entries to record the facts already on the books, but merely those entries which are required to adjust and close the books.

The first step is to include in the real-estate account all expenditures which may properly be regarded as having been made in adding to the value of the property. This of course includes the cost of the improvements. It may also properly include the general expense of $14,000 incurred during the development period, for this expense was incurred for the purpose of making improvements, and it is in reality as much a cost of the improvements as is the amount of $160,000 which has been specifically charged to the improvements account. It also seems permissible to charge the property with the interest paid during the development period. During this period no income was earned, and the same principle which allows the capitalization of interest on bonds during the construction period would seem to justify the capitalization of interest paid during the development period of a company engaged in the subdivision and sale of property. Therefore, in the following journal entry, the charge to property for general expense includes an item of $1,800 which has presumably been charged to the general-expense account during the period from March 1, 1918 to February 28, 1924.

Real estate	$175,800	
Improvements		$160,000
General expense		15,800

To charge the property account with the cost of development, including general expense incurred during the development period, and mortgage interest applicable to that period.

The total cost of the property and the cost of property sold and unsold may be computed as follows:

Real-estate account, per books		$120,000
Add expenditures of development period:		
Improvements	$160,000	
General expense	14,000	
Interest	1,800	175,800
Total cost—400 lots		$295,800
Cost of 360 lots sold (90% of $295,800)		266,220
Inventory of unsold lots at February 28, 1924		$29,580

The next step is to close out the expense and income accounts now on the books.

Profit and loss	$447,420	
Real estate		$266,220
Improvements replaced		27,000
General expense		118,200
Park and driveway maintenance		36,000
To charge profit and loss with the cost of lots sold and with expenses applicable to the operating period.		

It will be noted that only $27,000 of the improvements replaced account was charged off. It did not seem proper to charge the cost of the replaced improvements to the property account and at the same time it seemed hardly equitable to charge the entire expense against the proceeds of ninety per cent of the lots. Therefore ninety per cent of the expense was charged off and the balance was deferred, but not as a part of the inventory. The amount shown in the foregoing entry as general expense is the remainder of the $134,000 shown in the trial balance, after having charged $15,800 to the property.

Sale of lots	$900,000	
Bond interest earned	12,000	
Profit and loss		$912,000
To credit profit and loss with the proceeds of sales and with interest.		

The account with bond interest earned can properly be credited to income as the charge for the cost of perpetual maintenance will be made by a separate entry. The cash collected on bond interest need not be added to the fund, as maintenance expenses during the operating period have been paid out of the general cash.

The entry to be made to record the perpetual maintenance expense requires careful consideration. In the first place, the problem states that sufficient bonds are to be purchased so that the income at 4% will provide an annual amount of $6,000. This will require the purchase of bonds of a par value of $150,000. It is to be assumed that these bonds will be purchased at par. The company has agreed to expend one-third of all cash received for the purchase of such bonds until it shall have purchased bonds of a total par value of $150,000. The company has received $800,000 in cash from the sale of lots, and this amount would have been more than sufficient to provide for the purchase of the total amount of bonds if the company had complied with the terms of the contract. While the company is delinquent in the matter of bond purchases to the extent of $50,000, this fact should be shown in the comments of the report or as a footnote on the balance-sheet; the accountant should not attempt to show this delinquency by setting up a reserve, as any reserve set up should be provided by a charge to profit and loss and this charge should be for the accrued expense, which is considerably more than $50,000, as will be shown directly.

In determining the amount of accrued expense applicable to the period between March 1, 1918 and February 28, 1924, several facts should be taken into consideration. In the first place, the total expense of providing for perpetual maintenance is known to be $150,000. But it must not be assumed that this entire amount of expense has accrued at February 28, 1924, merely because in accordance with the contract all the bonds should have been purchased at that

date. The expense of $150,000 is a selling expense incurred as an inducement to obtain customers. This inducement will no doubt have as much effect in selling the remaining 40 lots as it had in selling the 360 lots already sold. Now it would be manifestly unfair to charge the profits arising from the sale of 360 lots with expenses which are applicable to these lots and also to 40 lots yet to be sold. The correct thing to do is to charge against the profits from the sale of 360 lots the expenses incurred in selling these lots and to charge against the profits arising from the sale of the remaining 40 lots the expenses to be incurred in selling those lots. Since the lots are all to sell at the same price, it has been assumed that they have the same cost and it would appear equitable to assume that the selling expense is incurred in proportionate amounts. Therefore, since 360 of the 400 lots have been sold, a reserve equal to 90% of $150,000 is set up for perpetual maintenance and the remaining 10%, or $15,000, will be set up after the remaining 40 lots have been sold.

Perhaps the question now uppermost in the reader's mind is this: Yes, but the contract says that the company should have $150,000 of bonds on hand in the maintenance fund at this time; therefore the contract requires a reserve of $150,000. The statement of fact in regard to the fund is true, but the conclusion in regard to the reserve is unwarranted. The lot purchasers have a right to insist that the company fulfil its obligation in regard to the purchase of the bonds, but they have no right whatever to dictate in any way as to the amount of the reserve. This is dictated by sound accounting principles. If the company buys the requisite number of bonds it will fulfil its contract even if it sets up no reserve. The reserve is necessary in order to make a correct computation of the profits and is not necessary in order to comply with the terms of the contract. All that is required in regard to the reserve is to determine on what basis and in what amounts the expense of providing for perpetual maintenance is incurred and to set up the reserve by charges to profit and loss accordingly. The method of determining the expense accrual used above seems to be the best one available.

Profit and loss	$135,000	
Reserve for maintenance		$135,000
To set up a reserve to record the expense of providing for perpetual maintenance.		

Attention is next directed to the contract, made on January 1, 1924, providing for additional improvements to cost $10,000. This contract is specifically stated to have been made as an inducement to purchasers at a time when 50 lots remained to be sold and the improvements were to benefit only the lots unsold. The problem is perhaps subject to the interpretation that the improvements would benefit only the 40 lots unsold at February 28, 1924, but this is unlikely. We have, then, an additional expense of $10,000 to be spread over the period during which the last 50 lots are sold. As 10 of the lots were sold between January 1, 1924 and February 28, 1924 and as it is assumed that these lots were sold on the basis of the agreement to make the additional improvements, one-fifth of the expense should be charged against the profits arising from the sale of these 10 lots. Since the improvements have not been made and since neither a cash payment nor a liability has been recorded, a reserve for $2,000 should be set up. It does not appear to be necessary to make any entry for the remainder of the $10,000.

Profit and loss	$2,000	
Reserve for improvements		$2,000
To set up a reserve and record the expense for improvements to be made on lots sold since January 1, 1924.		

The problem states that the company has followed the practice of paying 5% commission to its salesmen upon collection in full for sales made; this presumably means that when the accounts receivable of $100,000 are collected, commissions of $5,000 will be payable. As these commissions were incurred on account of sales already made, the expense thereof should be charged against the profits on such sales.

Profit and loss	$5,000	
Reserve for commissions		$5,000
To record the liability for salesmen's commissions to be paid upon the collection of the accounts receivable now on the books.		

The profit-and-loss account now shows a balance of $322,580, which is transferred to surplus by the following entry:

Profit and loss	$322,580	
Surplus		$322,580
To close the profit-and-loss account.		
Surplus	430,000	
Dividends paid		430,000
To charge surplus with dividends paid.		
Surplus	5,000	
Dividends payable		5,000
To record the declaration, on February 25, 1924, of a dividend of $1 per share on the no-par-value common stock, payable March 15, 1924.		

While it is true that the surplus account will show a debit balance, it nevertheless remains a fact that the directors have declared the dividend, and whether it is illegal or not it is at present a liability of the company.

Profit-and-loss account

For the period from March 1, 1918 to February 28, 1924

Cost of lots sold	$266,220	Sales	$900,000
Improvements replaced	27,000	Bond interest earned	12,000
General expense	118,200		
Park and driveway maintenance	36,000		
Reserve for perpetual maintenance	135,000		
Reserve for improvements	2,000		
Reserve for commissions	5,000		
Net profit—to surplus	322,580		
	$912,000		$912,000

The foregoing is set up in account form rather than in statement form because the problem specifically calls for a profit-and-loss account.

THE VALLEY REALTY COMPANY
Balance-sheet, February 28, 1924

Assets		Liabilities	
Cash	$102,000	Capital stock	$300,000
Accounts receivable	100,000	Reserve for maintenance	135,000
Perpetual maintenance Fund—bonds	100,000	Reserve for improvements	2,000
Real estate	29,580	Reserve for commissions	5,000
Deferred charge—improvements replaced	3,000	Dividends payable	5,000
Deficit	112,420		
	$447,000		$447,000

There remains, the question of the excess amount paid in over the declared value of the common stock without par value. It is believed by some accountants that, when a company declares a stated value as applicable to its no-par-value stock, only this stated value should be credited to the capital stock account and that the excess should be credited to surplus, capital surplus or paid-in surplus. Others hold that the entire amount should be credited to the capital-stock account, as indicative of the amount of capital paid in, and that only profits should be credited to surplus.

This question must be considered with the further question as to whether or not such additional amounts paid in, in excess of the stated value of the common stock, are returnable to the stockholders in the form of dividends. Unfortunately this is a question on which there have, so far as I am informed, been no legal decisions. Until such time as there are decisions covering this point, it seems preferable to credit all amounts received for stock to the capital-stock account. Any other treatment has the effect of arbitrarily assigning a nominal value to the stock, which is contrary to the theory of no-par-value stock. And yet, it must be recognized that there is logical ground for the argument that if a company declares a certain amount as fixed capital, not to be returnable to the stockholders in the form of dividends, the excess of the paid-in capital over this fixed amount is, by inference, returnable to the stockholders.