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Accounting Questions

American Institute of Accountants. Bureau of Information

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Accounting Questions

[The questions and answers which appear in this section of *THE JOURNAL OF ACCOUNTANCY* have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

CLASSIFICATION OF LOSS BY SUBSIDIARY

Question: The question has arisen as to the proper method of classifying loss suffered for the year by a subsidiary.

In your opinion, should this loss represent a surplus charge, or should it represent other income charges on the operating statement of the parent company? The question is a very important one because there are bond holders involved, and if the item should be properly classified as other income charges, they receive no interest. However, if the item is a surplus charge the bond holders are entitled to interest.

For your further information in rendering an opinion on this question, the bond holders have no lien on the assets of the subsidiary.

Answer No. 1: The results of operations of a subsidiary company necessarily affect the amount at which the investment in such subsidiary is carried in the accounts of the parent company. Unless there are certain special circumstances present such as the fact that the investment in the subsidiary is carried at a purely nominal value of, say, \$1.00, we are of the opinion that the losses from operations of a subsidiary should currently be provided for in the income accounts of the parent company.

While it is true that under conditions exactly opposite, profits of a subsidiary, unless distributed formally, might not be available to increase the income of the parent company in an amount sufficient to pay bond interest, in our opinion it would be improper to state the profits of the parent company without making full provision for any shrinkage in the value of the investment in a subsidiary.

Answer No. 2: It is our opinion that in determining the income of the parent company, as distinct from surplus, cognizance should be taken of the subsidiary's operating loss.

We are aware that the position is taken that the parent company, as a separate legal entity, may regard as income only the dividends actually distributed by its subsidiary, the operating losses of which may thus be disregarded. On a

Accounting Questions

strictly technical interpretation such an accounting may have legal sanction although it obscures the actual position and is thus on broader grounds objectionable. It is for the company to decide, under competent advice, whether the legal sanction governs in the particular circumstances.

Again it appears from the question that the interest on the bonds referred to is contingent on the company's income. It is possible therefore that "income" from which the bond interest is payable has already been defined in terms of the issue. We offer this suggestion in case the point has been overlooked.

MINORITY INTERESTS ON CONSOLIDATED BALANCE-SHEET

Question: On July 1, 1935, company A purchased for cash 66⅔% of the common stock of company B for \$500,000.

Company B has \$750,000 common and \$100,000 preferred stock outstanding, the latter to be retired in 1938 at a 10% premium. At the time of purchase of common stock by company A, the books of company B showed surplus reserved for retirement of preferred stock—\$10,000, as well as earned surplus of \$30,000.

The business of the two companies is identical and controlled by the same management. For credit purposes it is desired to submit a consolidated statement.

How should the minority interest be shown on the balance-sheet? Should the \$10,000 reserved for preferred stock retirement be included under the minority interest section?

Answer No. 1: The following is suggested as a statement of the minority interests in the consolidated balance-sheet under the conditions as outlined in the inquiry:

Minority interests:

In preferred stock of subsidiary to be retired in 1938 at a 10% premium:		
Par value	\$100,000	
Reserved for premium on preferred stock	10,000	
		\$110,000
In common stock of subsidiary		250,000
Earned surplus of subsidiary		10,000
		360,000
Total minority interests		\$370,000

It is not intended to indicate by the foregoing specific tabulation that it seems necessary to present the information in exactly the order in which it is shown above nor that the information need necessarily be given in as much detail as is shown in the above tabulation. The same information presented in a more summarized form might be adequate for the purpose.

The question in the letter apparently depends upon the time when the \$10,000 reserved became allocable to the preferred stock. It is understood that it became allocable to the preferred stock at a date prior to that as at which the statement under consideration is to be prepared. The inquiry states:

- (a) That the preferred stock is "to be retired in 1938 at a 10% premium."
This is understood to mean that prior to the date of the statement a

definite commitment was made to retire the stock at a 10% premium and that the date of retirement was fixed in 1938;

- (b) That "the books of company B showed surplus reserved for retirement of preferred stock—\$10,000."

Under the foregoing conditions it seems clear that \$10,000 of the surplus has been definitely appropriated against which the premium on retirement of the preferred stock will be charged. Even though the retirement is not to take place until 1938, two or more years after the date of the statement, it seems clear that at the statement date \$10,000 of the surplus had ceased to be free for payment of dividends and had definitely been allocated for use in preferred stock retirement.

Answer No. 2: In our opinion, the consolidated balance-sheet should reflect the minority interest in the total sum of \$370,000 composed of common stock \$250,000, preferred stock \$100,000, surplus reserved for retirement of preferred stock \$10,000, and proportionate equity in earned surplus, \$10,000.

As to the manner of showing the minority interest in the consolidated balance-sheet, we believe that the entire amount of the minority interest may be shown in one amount, \$370,000, with an appropriate description such as "minority interest—proportionate equity in capital and surplus of subsidiary company—including preferred stock to be retired in 1938 for \$110,000"; or the four items comprising the minority interest may be listed in detail, with reference to the retirement in 1938 of the preferred stock.

DISCLOSURE OF BORROWINGS ON BALANCE-SHEET OF STOCK BROKER

Question: Information is requested as to the necessity or propriety of disclosing certain information on the balance-sheet of a firm of brokers, registered on the New York stock exchange, the Chicago stock exchange and other exchanges.

The membership on the New York stock exchange was purchased by one of the partners, a portion of the purchase price having been advanced by another firm of brokers registered on the New York stock exchange. The standard subordination agreement was signed by the partner and by the firm advancing a part of the purchase price. This agreement was filed with the exchange with the application for membership.

The brokerage firm includes the full cost of the membership in its assets and the capital account of the partner in whose name the membership is registered reflects the amount of the loan to him by the lending firm of brokers. This partner, as well as the other members of the firm, take the position that the loan was made to the partner and not to the firm, and accordingly, that no reference to the loan should be made on the balance-sheet of the firm as the subordination agreement was between the partner and the lending brokers.

This question, we are informed, arises frequently in accountants' reports on brokerage firms. If you can furnish us information as to the recognized procedure, we shall greatly appreciate your courtesy.

Answer: It is well to indicate that the New York stock exchange questionnaire requests a full disclosure of the facts dealing with subordinated borrow-

Accounting Questions

ings. Thus, under question 5 (d) the respondent is called upon to state separately "any amounts or valuations requested herein resulting from borrowings under subordination agreements or otherwise." By inference, therefore, any borrowings by partners which are credited to their respective individual ledger accounts should also be reported to the exchanges.

While it is true that individual borrowings by partners may not legally involve the partnership unless all the members thereof individually guarantee repayment or act as endorsers, there is a danger that repayment on unsubordinated loans might be demanded by the lender during periods of stress and that such repayments, if made by the firm for the account of the borrowing partner might materially affect the solvency of the partnership.

The purpose of the subordination agreement is to minimize the possibilities of legal action by the lender during the duration of the partnership, but the agreement contains as well the condition that the lender's rights, titles, claims and interest in respect of his loan to the partner, are subordinated to the benefit and interest of firm creditors.

When financial statements are prepared, either as a basis for obtaining day-loan accommodation at banks or to answer the requirements of security and commodity exchanges, the most complete disclosure of material facts is essential to credit determination. In my opinion, the personal borrowings by partners under subordinated agreements or otherwise, where the benefit of such borrowings has been directly passed to the partnership, constitute a material fact and should be disclosed under the requirements of stock exchanges as well as under the accountants' duty to lending banks or other interested creditors of the firm.

ERRATUM

UNAMORTIZED DEBT DISCOUNT EXPENSE AND PREMIUMS ON BONDS REFUNDED

A correspondent draws attention to an error which occurred in this department of *THE JOURNAL OF ACCOUNTANCY* in the June issue. Answer number 2 to the first question on page 474 had been held in type and was published at a time when the conditions had changed so that the answer was erroneous in certain particulars. The answer should have read something like the following:

Answer No. 2: In our opinion, as a matter of accounting, it is permissible to amortize as a financial cost the old discount and expense plus the premium paid on the old bonds refunded over the period covered by the new issue.

It would appear that this course is now permitted under the federal income tax laws, in the decision on March 16, 1936, in the case of *Great Western Power Co. of California, petitioner, v. Commissioner of Internal Revenue*, the opinion of which contains the following words: "If the retired bonds had not been called, the expense items incurred in connection with their issuance would properly be amortized over the remainder of their life. Here the petitioner substituted a new obligation for the old. The remaining unamortized expenses of issue of the original bonds and the expense of the exchange are both expenses attributable to the issuance of the new bonds and should be treated as a part of the cost of obtaining the loan. They should, accordingly, be amortized annually throughout the term of the bonds delivered in exchange for those retired."