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Students' Department

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Students' Department

EDITED BY SEYMOUR WALTON

(ASSISTED BY H. A. FINNEY)

The issue of THE JOURNAL OF ACCOUNTANCY for May, 1919, contains a very interesting article by William A. Paton on *Some Phases of Capital Stock,* in which some deductions are made with which this department cannot entirely agree.

DISCOUNT ON CAPITAL STOCK

Mr. Paton makes the claim that when a corporation sells its stock at a discount, it is a misnomer to call the discount an asset. It does not need any argument to show that he is right in this and also in his contention that the discount really belongs to the proprietary and liability side of the balance-sheet as a deduction from the capital stock item.

It is to the later treatment of the discount that we are inclined to object. He says in discussing the disposition that should be made of the discounts:

"If discounts are to be written off, then the concurrent charges must be to current net income or accumulated income.

"But what is the effect of such accounting procedure? Writing off discounts in this manner obscures two of the most important facts which a balance-sheet should show: (1) original proprietary investment (including additions made subsequent to the period of organization) and (2) accumulated earnings.

"Adams, in *Railway Accounting,* says:

"'The fundamental balances to which all accounting records contribute . . . are four in number, namely, the balance which measures the cost of the property, the balance which measures net operating revenues, the balance which measures the current surplus or deficit, and the balance-sheet statement of accumulated profit or loss. . . . They are guides for the judgment of the investor and a measure for those who desire to know the degree of prosperity which has attended the operation of a property. . . . The degree of confidence which may be placed in the integrity of the four balances named is one of the accepted tests of sound accounting.'

"Neither of these highly significant balances can be determined from a financial statement if any stock discounts have been written off. As stated above, when stocks are issued below par and par is retained as a balance-sheet fact, the original investment can be determined only by deducting the amount of the discount from the total par value of the outstanding capital stock or, in other words, by reading the capital stock and discount on stock accounts together. If a stock discount is eliminated by charges against income the balance-sheet certainly does not show the amount of the investment or the extent to which earnings have been retained in the business. Total proprietorship is still correctly stated, it is true, but the separation of the two important divisions of the proprietary equity is not maintained."

It appears to us that Mr. Paton has taken an entirely wrong view of the functions of a balance-sheet. It is true as he says that "the primary purpose of the balance-sheet in any case is to furnish essential informa-

tion about the financial status of a business enterprise to the manager, present and prospective stockholder, creditor and other interested parties," but it is not so clear that the elimination of stock discounts by charging them off against surplus is a practice inconsistent with this purpose, as he claims that it is. It is also true that the earning power of a concern is an important item. The mistake that he makes is in the assumption that a balance-sheet should show not only the financial status of a business, but also how it reached the condition that is now set forth.

The truth of the matter is that a balance-sheet is an exhibit of the condition of a business at a specified date. It is a snap-shot of the business as it is passing, and, like the photograph of a person, it tells nothing whatever of past history except the present results.

To illustrate how little information is to be gained as to the past from a study of the balance-sheet, let us assume that three companies A, B and C start in the same kind of business on the same day, each of them with a paid-in capital of $100,000.00. At the end of ten years their respective balance-sheets show the following credit balances:

	A	B	C
Capital stock	100,000.00	100,000.00	100,000.00
Surplus	15,000.00	25,000.00	120,000.00

According to Mr. Paton the information to be gained from these balance-sheet figures is that C has been by far the most prosperous company, while A has barely been able to hold its own. An examination of the income statements of these companies will show that this deduction is entirely wrong, for it will disclose the information that the net profits of each of the companies have been the same for the period, namely $120,-000.00, and that A has paid dividends of $105,000.00, that B has a paid-in surplus of $25,000.00 and has paid out all its profits of $120,000.00 in dividends, and that C has paid no dividends at all. Absolutely the only information to be obtained from the balance-sheets is that the book values are respectively 115, 125 and 220 at the present moment.

A point which appears to be very important to Mr. Paton is the necessity of preserving a record in all subsequent balance-sheets of the amount of the original capital investment, but he does not state why this necessity exists, nor how he would show original investment in the present balance-sheet if the capital had been increased other than by the accumulated surplus.

There are only two important points to be considered by either creditors or stockholders, namely, the present condition of solvency as evidenced by the proprietary accounts of capital and surplus and the prospect of the continuance of a favorable condition by the ability to earn profits to a reasonably certain extent. No one statement will show both these points: both the balance-sheet and the revenue statement are necessary.

The charging off against surplus of the discount on stock does not affect the value of the balance-sheet as an exhibit of present conditions. In the example given by Mr. Paton, the two balance sheets are

Property	120,000.00	Capital stock	100,000.00
Discount on Stock	30,000.00	Surplus	50,000.00
	150,000.00		150,000.00

If the discount items were now extinguished the statement would appear as follows:

Property	120,000.00	Capital stock	100,000.00
		Surplus	20,000.00
	120,000.00		120,000.00

"Is this last statement a strictly legitimate balance-sheet? Would not the stockholder who read this balance-sheet naturally conclude that the original investment totaled $100,000, and that the company had accumulated profits to the extent of $20,000 when, as a matter of fact the original investment was only $70,000 and earnings retained in the business amounted to $50,000"?

The answer is that the stockholders would have no warrant to come to any such conclusion. As far as the balance-sheet is concerned the facts may have been that the original investment was only $50,000 fully paid in and that profits had been accumulated to the extent of $70,000, out of which a stock dividend of $50,000 had been declared. There are no end of other conclusions that might be made. The plain fact is that both balance-sheets give all the information that is possible to that form of statement. The only difference is that one gives the present proprietary interest as 100,000 — 30,000 + 50,000 and the other expresses it as 100,000 + 20,000. In either event, to find out how the $50,000 or the $20,000 is reached will necessitate a scrutiny of the surplus statement in order to ascertain whether any dividends have been paid or extraneous profits or losses have been made, since it is only operating profit that determines the actual earning power.

This is not a matter of merely academic value: it may seriously affect the interests of the stockholder in those states which make the holder liable to creditors for the discount on stock that has never been paid up in full.

An Illinois instance of this occurred in the case of a bicycle manufacturing company, a number of years ago. At the beginning of the big boom in that business a wealthy man was induced to buy a large block of original (not treasury) stock at a heavy discount. During the first two years the concern made unquestioned profits, out of which in addition to large cash dividends the directors declared a special dividend which extinguished the discount on stock account by a debit to surplus and a credit to discount on stock. When the tremendous slump occurred in the

bicycle business the concern lost so heavily that it could not pay its creditors, who sued the wealthy man for the amount of the discount that had been given him on his stock. They lost the suit, because it was easily proved that the discount had been charged off against a surplus that was a real one and that therefore the stock had been fully paid up out of earnings. It would have cost this man a good many thousand dollars if the directors had taken the other view of a balance-sheet.

This point will be made clear if we refer again to the two balance-sheets quoted. In the second one the capital stock appears as $100,000 fully paid up and the surplus as $20,000. Assuming that the surplus is genuine, the stockholders are now relieved of their liability to creditors for $30,000. If at this point the business goes to smash and there are losses aggregating $135,000, the stockholders will lose their investment but will not have to pay any more. If the entry had not been made by which the discount was extinguished and the stock thereby paid up, the first balance-sheet would be the correct one, showing a credit to surplus of $50,000 and a debit to discount on stock of $30,000. Charging off the loss of $135,000 will extinguish the surplus and will reduce the capital account to $15,000. It is too late now for the stockholders to claim that the stock had really been paid up at the time of the first balance-sheet quoted. They can console themselves with the thought that they have continued to show on the balance-sheets the original condition of the stock, but it is doubtful whether they would consider that this piece of useless information was worth quite as much as the $15,000 that they are now called upon to contribute, because they did not take the profits when they had the right to do so.

Treasury Stock

In his treatment of treasury stock Mr. Paton seems also to have overlooked some essential features. He correctly states that when treasury stock is acquired "the corporation has come into possession of its own stock, and this stock instead of being an asset is virtually a deduction from the outstanding capital stock, whether formally retired or not." This condition is acknowledged by all good accountants who do not list treasury stock as an asset in the balance-sheet, but deduct its par value from the total capital stock, carrying out the net stock as the outstanding amount. If the acquired stock is cancelled the amount is actually charged against the capital stock account and the outstanding stock is shown as a single balance, not as the net of two balances.

This is not the difference between Tweedledum and Tweedledee—it is rather the distinction between life and death. Treasury stock is like a plant that has been carefully removed from its usual position with its roots still attached and covered with earth. For the time being it is inert and has ceased to function as a plant, but it is not dead. It needs only proper

treatment to become an active, living plant again. Cancelled stock is like a plant that has been uprooted and left to die. It cannot be used again but must be replaced by an entirely new plant.

It is this latent life that is the important point about treasury stock, as well as the universally recognized advantage of its being available for sale at a discount when necessary. A company that owns treasury stock is in a position to increase its cash capital by selling the stock at once. Of course it has the same privilege with unissued stock, and to that extent there is no difference between treasury and unissued stock. If the stock has been cancelled it will be necessary to take the proper legal steps to increase the capital, if it is desired to replace it—a procedure which takes time and costs money.

It is when it is necessary to sell stock at a discount that the distinction between treasury stock and unissued original stock becomes important. In many states the transfer of property, especially mining claims, is recognized as giving full value for all the stock issued therefor. Having once been paid in full, this stock when acquired in the treasury may be sold at a discount without imposing any liability upon the purchaser.

The truth of the matter seems to be that while it is wrong to call treasury stock an actual asset, it is also wrong to treat it as being the same as either unissued or cancelled stock. There does not seem to be any possible objection to the practice followed by the best accountants of showing treasury stock as a deduction from the total capitalization. In the meantime it is temporarily carried on the books as a debit balance. It is as legitimate to carry a deduction from a liability as a debit balance as it is to carry a credit balance of reserve for depreciation, which is not a liability, but a deduction from a fixed asset.

This covers another point brought up by the article. Treasury stock must be carried at par. When a company pays $210,000 for stock of a par value of $140,000, it has not acquired an asset of $210,000, but has paid off two items of capital liability; $140,000 of capital stock and $70,000 of surplus. If the stock is ever re-issued it must be for its face amount of $140,000, a record of which must therefore be kept, but the surplus to be regained is not fixed. In fact the stock may be distributed at par among the remaining stockholders as a stock dividend and the surplus never be repaid. Therefore it is proper to charge off the $70,000 against the surplus, while the $140,000 is retained on the books. If the stock is sold to outside parties the amount realized above par would be credited to surplus, whether it were more or less that $70,000.

Transactions Between Partner and Firm

The strange reluctance that many persons show to acknowledge that a man may act in a dual capacity leads to some curious results when applied to the relation that exists between a partner and the firm of which he is a member. This is illustrated in the article entitled *Transactions Between Partner and Firm* in the Journal of Accountancy for July, in dealing with the borrowing of $20,000 by partner B from the

firm of A & B. It is stated that "if handled in the regular way the amount of the note would be charged to notes receivable, as in the case of a note made by an outsider." To this we absolutely object. It must be charged to an account such as "B note," which will plainly designate its character as a withdrawal for the time being of $20,000 of B's capital, as the article correctly claims that it is. The reason for putting the matter in the shape of a note instead of making a debit to B's capital account is not known to us. It may be that the firm does not at present make 6 per cent. on its capital and is therefore willing to let some one have the use of part of it for a year, when it will presumably be needed in the business again. In any event it is immaterial from an accounting standpoint whether the money is a loan to B or X, Y or Z. It is important from the standpoint of the firm's financial condition, and therefore it is imperative that it be clearly shown that there has been a withdrawal of part of the firm's capital, but that the withdrawal is for a limited time only, since it is represented by a note that is presumably to be repaid, instead of by a reduction of capital which may be permanent. The article hints at this, but does not say that it is obligatory.

The point with which we take issue is the reasoning in regard to the effect of the payment of interest by B. At the end of six months B owes $600 interest. As it is not convenient for him to pay in cash, he authorizes a charge to his capital account. The article then says:

"The concurrent credit in such a case is usually to the interest revenue account, and if this procedure is followed the entries giving effect to this agreement would be:

B capital	$600.00	
Interest		$600.00

"The credit to interest is ostensibly a revenue item, but a careful examination of the case discloses the fact that no revenue whatever is involved and that the essence of this transaction is simply an adjustment between the two partners. This can perhaps be best shown by an examination of hypothetical balance-sheets as affected by this transaction alone.

"Let us assume that the balance-sheet just after B borrows the sum of $20,000 stands as follows:

Various assets	$60,000	A, capital	$40,000
Loan to B	20,000	B, capital	40,000
	$80,000		$80,000

"Ignoring all other possible transactions, and assuming that A and B share income in proportion to respective investments, the item of interest revenue recognized in the above entries might now be divided and credited to the partners' capital accounts. The entries would be:

Interest	$600.00	
A, capital		$300.00
B, capital		300.00

"The balance-sheet, as affected only by these entries, would now appear as follows:

Various assets	$60,000	A, capital	$40,300
Loan to B	20,000	B, capital	39,700
	$80,000		$80,000

"A comparison of the two balance-sheets shows very clearly that no revenue whatever has been realized since asset and equity totals remain unchanged. The introduction of the interest account is evidently a bit of formal procedure which has nothing to do with actual income. The net effect of the whole transaction is an adjustment between the partners: an item of B's equity, $300, is transferred to A's capital account. Total proprietorship, however, is not affected, and hence no profit has been realized. B's equity has declined and A's equity shows a corresponding increase; the partnership as an enterprise, however, has neither suffered a loss nor realized a gain. The debit and credit entries to the interest account might indeed have been omitted; and in this case the transaction would be recorded as follows:

B, capital	$600.00	
A, capital		$300.00
B, capital		300.00

or simply,

B, capital	$300.00	
A, capital		$300.00

* * * *

It cannot be too strongly emphasized that a comparison of two balance-sheets does not show anything whatever in regard to the intermediate profit or loss. If it did, there would be proof of a loss of $600 if A had withdrawn that much of his capital to offset the amount withdrawn by B. The comparison as given above would also show that "no revenue whatever had been realized," if the firm had made net profits of $10,000 of which A had withdrawn $4,700 and B in one way or another had taken out $5,300. It would also show the same lack of revenue if the loan of $20,000 had not been made to B, but to an outsider X who had paid the interest in cash and B had withdrawn $600, which was charged to his capital account.

It might appear as if this latter condition could be paralleled by the simple expedient of having B pay his interest in cash, even if he afterwards withdrew $600 of his capital in money. But our author will not allow this, for he says, assuming that B did not withdraw anything:

"Even if B had actually paid in cash the amount of the interest due $600, at the end of six months, it is doubtful if this should be considered a revenue transaction from the point of view of the partnership. Certainly such a transaction has no reference to earnings or operation in the usual sense. There is, in this case, an actual increase in total assets; but if the concurrent credit is made to interest this means that the partnership has actually earned $600, and since B has a half interest in all income the amount of $300 must ultimately find its way to his capital account as

a credit. As far as B is concerned, then, the amount of $300 is virtually transferred from one pocket to another—from outside interests to the partnership—and really represents new investment. A has actually earned $300, however, as a result of permitting $10,000 of his funds to be used by B for six months. But has the partnership as an enterprise earned anything?

"The foregoing brief discussion would seem at least to indicate that there is good reason for viewing all transactions between partner and partnership as of a distinct type, and that to avoid misconceptions all such transactions might well be handled through special accounts."

This shows the curious results that follow from the unwillingness to allow B, the borrower, to have a status independent of B, the partner. There does not seem to be the same objection to having cash perform two functions. The half of the $600 which goes to A is revenue, but the other half of the same sum is new investment for B. Again, B personally pays $600 interest, of which our author says that A received $300 as a result of permitting B to use $10,000 of A's funds. This is not strictly true, because B borrowed $20,000 from the firm, not $10,000 from each of two partners, as we will show later. But allowing the point for the time being, it must be conceded that B paid the other $300 to some one for the use of the other $10,000. If not, what did he pay it for? The fact that $10,000 of B's money was lent to some one entitles B to the interest on it. That B pays $600 out of one pocket and receives $300 in another pocket does not prove anything except that the two pockets represent two entirely different personalities from an accounting standpoint. B, as a partner, is deprived of the use of his share of the $20,000; he is in exactly the same position as A, and he is equally entitled to a recompense. That he has to get it out of his own payment of interest does not change the situation.

That B did not borrow $10,000 from each of the two partners would be clear if the division of profits were on the basis of A 60 per cent. and B 40 per cent. In that case A would receive $360 and B only $240, which means that B was obliged to pay A interest at the rate of 7.2 per cent., but received only 4.8 per cent. on his own half.

Let us take an analogous case. B is a contractor who uses a large amount of the material dealt in by the firm of A & B, of which he is an equal partner. He carries out a contract on which he makes $25,000. On the material which he bought from A & B the firm makes a profit of $10,000. Everybody agrees that A is entitled to $5,000 as a profit of the firm, but those who agree with our author claim that B could not have also made the same profit, because he was himself the source from which the profit came. Or if one does not so claim, he should, to be consistent. What is B to do? He knows that he has received from the firm $5,000 in money or credit that he did not put into it. His common-sense tells him that as a member of the firm he has made that much profit in spite of the fact that he as a contractor was the cause of the profit, but he is told that common-sense is not recognized as a guide by some accountants and that he must open a special account for the $5,000.

After due deliberation he decides to credit the amount to an account called "manna," on the ground that it must have dropped from heaven, since there appears no earthly way of accounting for it.

Everyone recognizes the fact that a person who deals with a corporation in which he holds stock is acting in a dual capacity, but there are too many who cannot see that the same principle holds good in the case of a person and the firm in which he is a partner.*

A Good Suggestion

Editor, Students' Department:

Sir: The writer a few days ago started to index The Journal of Accountancy since Volume 1, No. 1, and has a suggestion to offer fellow students. Let them do likewise, and I venture to state that they will not complete an index without having virtually been forced to stop "by the wayside" as it were, to read various interesting and timely articles. A student will come across articles and hints that he did not dream existed in these valuable volumes. Try it.

Yours very truly,
W. O. Hoag.

Miles City, Montana.

This is an excellent idea. In making such an index it is better to err on the safe side by listing every subject discussed, although not the main subject of an article. In fact the subsidiary subjects are the most important ones to be noted, since the main subjects can be found without much trouble in the indexes in each volume.

A card index is the best, because it can be added to indefinitely. The same card can be used for all the references to any one subject. Even if a person does not possess all the volumes such an index would be valuable. With even a few volumes it is often difficult to trace some article, still more some portion of an article, which one may wish to consult.

Stock Not Fully Paid

Editor, Students' Department:

Sir: Will you kindly define "stockholder." In other words, is a person a stockholder from the date of subscription or from the date when stock certificate is issued?

Is a stockholder entitled to dividends on the par value of his stock accrued from the date of subscription, or is he only entitled to such dividends from the date when the stock is fully paid?

Is it legal for directors of a corporation to pay dividends, or to allow them to accrue to subscribers on the par value of the stock subscribed for but not fully paid?

There is no Missouri statute covering this point.

Yours very truly,
J. C. M.

Kansas City, Missouri.

A stockholder is a person who owns an undivided equity in the net assets and profits of an incorporated company. At the date of his subscription he merely acquires the right to become a stockholder. He be-

* The above was written before the correspondence in regard to the stock discount appeared, but was crowded out by the discussion of the examination questions. It is published now to put us on record, although to a certain extent it duplicates Mr. Boyle's letter.—*Editor, Students' Department.*

comes a stockholder when he has made any payments called for by terms of subscription. These terms may deprive him of his right to vote if he is in arrears, and may even forfeit what he has already paid, if he continues in default after due notice.

A person is not a full stockholder until he has paid for all his stock. Title to the stock consists of the credit on the stock ledger. The stock certificate is the receipt for that credit, and is not the stock itself. A person may own stock without having a certificate.

A dividend must be voted by the directors before any one has a right to it. Then it depends on conditions. If all the stock is being paid in instalments, the dividend may be made payable on the par value or on the amount paid by each one, and it may be paid in cash or may be applied on the unpaid instalments. Or the directors may declare a dividend payable only to those who are not in arrears.

There are so many different conditions governing the dividends as determined by the board of directors that it is impossible to note them all.

Interest as an Element of Cost

Editor, Students' Department:

SIR: I would appreciate very much your opinion on the following:

A firm I am interested in conducts chain stores (retail) and when purchasing stock and fixtures for them, gives notes in payment. It also purchases the real estate and building in most cases, giving notes in part payment, which sometimes extend over a period of 5 years.

The question at issue is: Should the interest on these notes, which is paid at the same time each note matures and is taken up, be charged to interest account as an operating expense, or be properly charged to cost of merchandise, store equipment and fixtures and real estate and buildings accounts?

Very truly yours,

E. G.

The only way in which interest could be legitimately charged to the value of any articles mentioned would be to prove that the articles were more valuable because they were paid for with notes that bore interests than they would have been if they had been bought for cash. Of course, this is an untenable proposition.

In any event, interest is not an operating expense. Only those items are operating expenses which are necessities of the business. A concern with sufficient capital need not pay interest, therefore interest is caused by lack of capital, not by operating processes. After operating profit is ascertained, interest is deducted as a financial expense.

Future Value of Real Estate

Editor, Students' Department:

SIR: A manufacturing corporation carries on its books at the present time land at $75,000 and buildings at $250,000. The location is unsuited to the company's present and apparently immediate future needs. A large tract of land has been acquired and modern buildings are now being erected thereon to house new equipment. The company has an opportunity at the present time to dispose of the old buildings and the ground

they occupy for $150,000 in cash and occupy the building for another ten years at an annual rental not to exceed ten per centum of the selling price plus the maintenance charges.

The company is sound financially and prosperous to the extent that a large portion of its earnings would be taxed at the highest rates of income and excess profits taxes. The management is divided as to which is the better plan, to sell now and sustain a loss of $75,000 or keep the property for a period of ten years and then try to dispose of it.

Assuming that the property could be disposed of at the end of ten years at its present book value, less the usual depreciation charge on the buildings, which would be the better plan: sell now for $150,000 in cash and pay rent or sell at the end of ten years at the figure above stated?

The writer has been asked to draw up a brief statement of both propositions and has done so from his point of view. I would be extremely grateful, however, if you would inform me either through the next issue of your JOURNAL or by direct reply of the correct solution from your point of view.

Yours truly,
T. W. L.

There are several elements in the question submitted about which no information is given, that would affect the answer. Some of them are:

Is the proposed rental a fair one, or is it more or less than the property ought to yield?

Can the company use the old plan advantageously, in view of the fact that it is building a new factory?

If not, can it rent the property at the same rate it pays or at a higher rate?

Is the valuation of $250,000 placed on the buildings cost or has adequate depreciation been charged off?

What rate of depreciation is to be allowed on the buildings for the ten years?

Supposing that the rental is a fair one, and that the company can use the property, there would be no gain or loss in holding the property. If the rate of depreciation on the buildings is 5 per cent. on the diminishing value, the buildings would be carried at $149,684.24 at the end of ten years. The depreciation of $100,315.76 is not a loss. It is an expense for rent, being presumably included in the word "maintenance." If not so included, it should be added before answer is made as to the fairness of the rental.

Adding the land at $75,000 to the depreciated value of the buildings, $149,684.24, the amount realizable at the end of ten years would be $224,684.24.

The problem then resolves itself into deciding whether it is better to have $150,000 now or $224,684.24 at the end of ten years. This cannot be definitely answered, unless we know what rate of interest can be realized by present cash, if it is accepted, or what rate the company itself will allow, if the $150,000 is credited to property reserve and is credited with interest yearly on the increasing balance, the land and buildings accounts remaining as they are, less depreciation.

If interest on the reserve is at 5 per cent, the reserve or the invested funds at the end of 10 years will amount to $244,334.25. If the interest is 4 per cent., the accumulation will yield $222,036.60. In one case there is a profit of $19,650.01 and in the other a loss of $2,647.64.

As there is no certainty that the property can be sold at the end of ten years, and as the results of the lump sum if invested in Liberty loan 4¼ per cents are certain, I should advise the acceptance of the $150,000 provided the answer to the questions asked do not disclose conditions that would change the calculations.

At the same time it must be remembered that the question of future real estate values is one that must be left to individual judgment. No one can be positive about the future of such property.

Depreciation Reserve in Sale of Factory

Editor, Students' Department:

Sir: Will you kindly give me some information regarding the following transactions?

The company by which I am employed (we will call it the Jones Company of Illinois) has bought out a factory in the state of New York (the Jones Company of New York), which is a separate corporation entirely, although the stockholders of both companies are the same.

The books of the New York company have been turned over to me to close. The plant and equipment account is shown on the New York books at $47,320.27, and in the sale to the Illinois company, the price is shown as $31,349.69.

I have made the following entry to cover this.

Jones Company of Illinois, d.	$31,349.69
To sundry gains	31,349.69
Sundry losses, dr.	47,320.27
To plan and equipment account	47,320.27

Is the above correct?

Two years' depreciation have been entered on the New York books, $4,732.02 having been credited to depreciation reserve.

In closing the books, I have been also charged depreciation (which on the books in question is thrown directly into profit and loss) for one-third of a year, as the sale is dated as of April 30th, and I have credited depreciation reserve with $788.67.

Should any more depreciation reserve than for the two years and four months be entered?

It has been suggested to me that the depreciation reserve account must balance the plant and equipment account. If this is the case, should a further entry be made to make the balance of the depreciation reserve $47,320.27, the full amount of the original plant and equipment account?

When the proper entries have been made for the depreciation reserve, all the accounts will be closed on the New York books except the following:

Depreciation reserve.
Capital stock
Undivided profits
Jones Company of Illinois.

The accounts will be transferred to our general officers to take care of on their private ledger.

Will you kindly advise me what is the final disposition of the depreciation reserve account when a business is closed out entirely?

I have tried to find the information desired in the text-books at my command, but none of them seems quite to fit the case. If this informa-

tion is outside the jurisdiction of your department, perhaps you will be kind enough to refer me to some text-book which will help me.

Very truly yours,
M. C. C.

You have made an error in stating the plant and equipment account as shown on the books. The value on those books was not $47,320.27 but $42,588.25. The depreciation reserve of $4,732.02 should have been charged and plant and equipment credited before any entry transferring the latter account was made. You have left the reserve account on the New York books without any excuse for its existence, since there is no asset to which it applies. An account of reserve for depreciation is only the credit side of the asset account, kept in a separate account for convenience, so that original cost may not be lost sight of. In view of the sale, there was no occasion for the entry of $788.67. If it is left as made, the value of the plant and equipment is reduced to $41,799.58.

You say that the Illinois company bought the New York factory. This is too indefinite a statement. As the New York books are to be closed, you may mean closed out, winding up the New York company, or only closed as to profit and loss. As you say that the stockholders of the two companies are the same, it is to be presumed that the Illinois company bought the New York company—that is, the stock of that company which still continues to exist. This is indicated also by the list of accounts still open on the New York books.

The entries for the sale of the factory mean that the Illinois company made a present of $31,349.69 to the New York company and that the latter company wrote off its plant and equipment as a loss of $47,320.27 in spite of the fact that $5,520.69 had already been written off.

The proper entries would have been:

Jones Co. of Illinois	$31,349.69	
Plant and equipment		$31,349.69
To record sale to Illinois company as per minutes of directors on............1919.		
Reserve for depreciation	$5,520.69	
Plant and equipment		$5,520.69
To bring latter account to its real balance		
Undivided profits (should be surplus)	$10,449.89	
Plant and equipment		$10,449.89
To write off loss on sale of plant.		

We do not know what other entries there may be, because we do not know what was done. The above apply only in case the factory was bought, but they do not show any payment for it.

If, when you say that the depreciation reserve should balance the plant and equipment account, you mean that it should be the same amount, you are wrong. This would not be the case until the physical deterioration of the plant was equal to its total value—in other words, until the plant was all gone. Those who made the suggestion probably meant what we have said, that the reserve was part of the plant and equipment account.