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The Accounting of Industrial Enterprises.*

By William M. Lybrand, C.P.A.

While it may be true that many of the industrial enterprises now in existence remain as partnerships or as independent corporations, a very large number of undertakings of that character have been consolidated into that form of organization represented by the holding companies. It is with accounts of the latter class of industrial enterprises, therefore, that this paper will deal principally, because accounting principles, if sound, do not change with their application to any particular form of accounts, while accounting methods, if good, when modified to conform to the requirements of the different kinds of business operations, are applicable to small as well as to large undertakings.

Pools.

In the revival of industry which succeeded the industrial depression of 1873, the corporate form of organization began to be used more and more. The holding company had not then made its appearance and the great combinations of the present day did not then exist. In the meantime, the corporations, not having consolidated, and therefore being competitors, were led to adopt various devices designed to eliminate the evils of competition from which they suffered. The formation of pools was one of the commonest and most popular methods employed. The pools were associations of manufacturers who agreed to place the marketing of their product under some central association, hoping thereby to secure the benefits of stable prices and a regulated output. The inherent weakness of the pools was that their provisions were not enforceable at common law, and good faith on the part of the members could be compelled only by the forfeiture of deposits, the imposition of fines and expedients of a similar character. Mutual distrust was apt to exist, withdrawal of members was possible, and in times of depression, when business at profitable prices was hard to obtain,

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and when the pool was most needed, it was usually most difficult to control the members or to keep them together.

Trusts.

The failure of the pools to accomplish the object for which they were organized, led to the creation of a form of organization which was intended to have a legal foundation and a permanent existence, namely, the Trust. Under the trust form, the capital stocks of the constituent companies were assigned to a board of trustees, who issued trust certificates in lieu of the shares so assigned. The trustees, having been vested with the control of the corporations through the assignment of their capital stocks, became responsible for the management of the several companies and were thus in a position to adopt a settled policy in all matters pertaining to the limitation of output and the upholding of prices. The trust, as an expedient for lessening or obviating the evil of competition, and for securing the benefits of consolidation, was by reason of its authority, stability and permanent organization a decided advance over the temporary and ineffective pool. Its legal position was, however, found to be open to attack, and adverse judicial decisions in cases brought to test whether or not it was a combination in restraint of trade finally drove the trust out of existence as a legal means of effecting combinations.

Holding Companies.

About the time that the test cases to prove whether or not the trust was to be allowed to exist were in progress, a new legal expedient for accomplishing combination was provided through the enactment by the State of New Jersey of a revised General Corporation Act, under which the right was granted to one corporation to purchase and hold stocks of another, a right which prior to that time seems to have been held by the corporations only by virtue of their being organized under special laws. It has been said that, “for momentous consequences, this statute of New Jersey is hardly equaled in the annals of legislation; corporate organization could henceforth be promoted, not to serve
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The ends of industrial management, but solely in order that financial combinations might indirectly control operating companies through ownership of their capital stock. Thus the holding company originated, and under this law one consolidation followed another, until at the present time there exist the gigantic industrial combinations which virtually control the several lines of industry in which they are engaged.

Advantages of Combination.

The principal factor leading to the formation of the industrial combinations was doubtless the desire to eliminate ruinous competition by obtaining so large a control over any one class of merchandise that it was possible virtually to regulate the price at which it could be sold. Contrary to the accepted idea, the control of prices does not necessarily mean their exorbitant advancement, but under enlightened management, exemplified, we believe, in one of our largest combinations, it enforces a policy of stability in prices, under which business in times of depression suffers vastly less than if indiscriminate price cutting were in effect. However, other causes than the control of prices were instrumental in hastening the formation of combinations. In a territory as extensive as the United States, the transportation of raw materials to the seat of manufacture, and the finished product thence to the place of its disposal, constitutes a large element of cost. Under a combination, the orders may be so distributed that the mills most advantageously situated as respects transportation facilities can be worked to their full capacity, while others less favorably located may, except in times of unusual activity, be closed temporarily. Orders for certain classes of merchandise may be concentrated in one plant so that it may run continuously with few changes of appliances, and thus turn out the largest output at a minimum of cost. Sources of raw materials may be controlled through the large financial resources of the combination, or by the amalgamation with it of the companies controlling such raw materials. Labor may be dealt with in larger groups and more advantageously; expenses of distribution of goods may be curtailed by dispensing with salesmen who traverse each other's territory; duplicate offices
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may be eliminated; stocks of merchandise may be reduced; management and office expenses may be decreased by concentration—all these are some of the other advantages which it was believed would accrue to the properly constituted combinations, and which have in many instances, doubtless, been realized to a considerable extent.

Evils of Monopoly.

Without devoting undue space to a discussion of the ethical features of trusts or combinations, it may not be inappropriate to consider for a moment the evils which in the public mind seem to be indissolubly associated with them. First of all is the dread of monopoly. To what extent this fear is justifiable it is difficult to determine. Even where a combination has a virtual monopoly, there is a practical limit beyond which it cannot advance its prices. If this limit is exceeded, demand for the article ceases, substitutes therefore are devised, or the pressure of public opinion becomes so great that the most strongly entrenched monopoly must be affected by it. On the other hand a monopoly is probably effective in influencing prices in that they can be maintained at substantially the same level, in the face of reduced costs of production due to the introduction of improved manufacturing processes, thus depriving the consumer of the benefit of at least a part of the widening margin between cost and selling price which would probably accrue to him under the regime of competition. It will be argued by others, however, that the greater profit results entirely from the economies of combination, and that therefore the additional margin equitably belongs to the producer, as the consumer, under competition, would have been no better off than is now the case.

At a meeting for the discussion of economic questions, a prominent socialist recently described the material advantages which, he argued, would accrue to the workingmen, if the productive agencies of the industrial world were placed under their control and operated for their benefit. A well-known political economist in reply expressed his belief that if these agencies were so controlled and operated, the net results under the relatively unskillful management that would then ensue would
be so much less than under the present conditions, that each workingman would receive no more than he does at the present time. The same thought may be true as to prices; if under competition there is economic waste, and in combination there is economy, would not the increase in costs under the former necessitate prices equal to those under a monopolistic regime? These questions of costs, prices, and monopoly are, of course, too far-reaching to be properly discussed within the limits of a paragraph, but they are now the source of so much public debate, with the possibility of an attempted public control, that they demand our thoughtful consideration.

The temptations of fraudulent promotion and speculative management are other evils ascribed to the combinations. It is claimed that earnings which were used as a basis of capitalization have been overstated, either intentionally or ignorantly, by the failure to include among the expenses of operating the full cost of maintaining the property, or a proper provision for renewal of the plant through whose operation the earnings were produced, but which must obviously deteriorate in value because of that use, or become obsolete through the introduction of improved appliances. The more serious charge has been made and proved to the satisfaction of many, that constituent companies acquired at one price by the members of a syndicate have been sold directly or indirectly to themselves as directors of the holding company at greatly enhanced amounts. Speculative management, with one eye on the ticker, and the other on the profit and loss statement, has been alleged, with the attendant evils of a property "skinned" to show large earnings, or the payment of dividends unearned, or at least unwarranted from the standpoint of financial expediency.

It is alleged that the holding company adds to the complexity of corporate organization, admits of the accumulation of debts in the affiliated companies, the piling up of deficits in some companies without provision therefor in the accounts of the parent company, and by other devices tends to obscure the real profits or losses, thus leaving the stockholder utterly in the dark as to the actual value of his holdings.

Numerous remedies have been proposed to prevent some of the foregoing evils. The trend of public opinion at present seems
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to be toward federal regulation and compulsory publicity. It would appear that a reasonable degree of federal supervision, or at least the issuance of a federal license to do business, would be welcomed by the larger corporations in preference to regulation by the individual states, each one imposing different conditions. Publicity, within reasonable limits, is rapidly being voluntarily adopted, and it seems reasonably certain that corporations conducted as "blind pools" will ultimately be relegated to the past.

Accounts of a Corporation.

It was stated at the beginning of this paper that accounting principles, if sound, are applicable to any particular form of accounts; therefore, with a subject as comprehensive as the one now under consideration, it does not seem feasible to do more than discuss those accounting principles which should control in the inauguration, administration and presentation of the accounts of industrial enterprises, without attempting to deal with details or to describe the particular form which the accounts should assume.

The accounts of a corporation may be called the history of its financial transactions, or, as the writer's perceptor was accustomed to remind him constantly, they should be "records of the facts." A fact would seem to be capable of but one interpretation, and we should therefore, if not otherwise informed, be led to expect that a statement prepared from the books would be an exact reflection of the facts of its financial transactions. But in practice no such simple or ideal condition will be found to exist. The modern business organization is so complex, and its transactions so numerous and so varied, that the facts are sometimes difficult to ascertain, and frequently are of such a character that they fall under the category of opinions rather than certainties. Further, the operations of a business are intended to be continuous, and at no time is it contemplated that there will be a final cleaning up in which every asset will be realized on and every liability disposed of; therefore, while the fact as to the current transaction may be known, the amount to be ultimately realized may be uncertain, and the best that can be done with the accounts.
is to organize them intelligently and administer them on sound accounting principles, so that when a statement is prepared it will reflect an honest opinion as to the company's financial position and the results of its operations.

**Balance Sheet of Holding Company.**

The principal accounts of a corporation, or, at least, those which are perhaps of the greatest interest to the management, are the balance sheet and the income and profit and loss statement.

The balance sheet of a holding company is not necessarily a particularly complicated statement. If the holding or parent corporation is a finance company simply, as distinguished from an operating company, its chief assets will usually consist of the securities of the subsidiary companies of which it is the owner. Quite frequently the entire capital stocks of these subsidiary companies will have been acquired by the parent company, and the latter may also be in possession of some of the bonds which lie against the property of the subsidiary companies.

Frequently, other large items of assets are advances made to the subsidiary companies for which the latter may have issued their notes in favor of the parent company. Such advances are usually made to provide for extensions or additions to the plants of the subsidiary companies after they have been acquired by the holding company, or they may have been made for the purpose of furnishing additional funds to purchase larger stocks of materials, to carry contracts requiring considerable time to complete, or for any other legitimate business purpose. If the moneys advanced have been for the purpose of adding to the plants of the subsidiary companies, it may be that these loans will subsequently be funded by the subsidiary companies through the medium of mortgage bonds, which if sold to the public will enable the subsidiary companies to discharge their debts to the parent company. Or possibly, if the whole of the authorized stock of the subsidiary company is not outstanding, a further amount may be issued and delivered to the parent company in settlement of the advances, thus changing the form of the asset on the holding company's books from an account receivable to a security
ownership. It is improbable that such a course would be pursued except in very special instances, as the holding company would doubtless prefer to appear as a creditor of the subsidiary company, rather than as an owner of more shares of its capital stock, because, if the subsidiary company were unprofitable and it became necessary to wind it up, the holding company would claim, with the other creditors, its proportion of the realizations from the subsidiary company’s assets. Such a position, we believe, would be assumed by the holding company in the absence of direct ruling to the contrary, but serious doubt has been cast recently on the ability of a holding company to sustain such a contention, where it is the owner of the entire capital stock issue of the underlying company.

Advances made by a parent company to its subsidiary companies are not always represented in the latter by tangible property. Such advances may have been made to recoup the subsidiary company for losses sustained by it in operating. The advances appearing on the books of the parent company would, under such conditions, be nominal assets only, and as such, in a balance sheet of the holding company they should be offset by a reserve sufficient to provide for the whole or such part of them as may be represented by losses.

It is probable that among the assets of the holding company there will be included capital stocks of companies, a minority interest in which may be all that is owned by the holding company, or at most it may be a majority holding and not a complete ownership. Unless there has been a marked depreciation in the value of such holdings, they would be included in the balance sheet at their respective costs, but if it is apparent that they have suffered a radical and permanent decline, they should be written down to an amount which will represent their actual worth.

The liabilities usually call for no particular comment, as, if they are clearly stated, they will be self-explanatory. The capital stocks and bonds issued by the company will generally appear as major items, followed by loans payable and accounts payable due by the company. It is possible that some of the subsidiary companies may, through funding operations have acquired a temporary surplus of cash, which they have deposited with the parent
company, and which consequently will appear as liabilities of the latter. The other liabilities will include the reserve and sinking fund accounts and miscellaneous items.

Consolidated Balance Sheet.

The foregoing remarks are intended to apply to the balance sheet of the holding company per se. It is now very generally recognized, however, that the submission of the balance sheet of the holding company only, does not furnish the owners of the company with the information as to its real financial position to which they may justly consider themselves entitled.

The holding company was, as heretofore stated, organized for the purpose of acquiring the capital stocks of affiliated companies, and thus effecting a combination which would bear the test of adverse legal scrutiny. While each company under this scheme retains its corporate identity, and is in the eyes of the law a separate corporation, yet there is a virtual consolidation of ownership, the results of which can be properly expressed in a statement of their accounts only by consolidating the balance sheets of all the companies into one balance sheet, eliminating therefrom the inter-company stocks, bonds and accounts, which indicate the relation of one company to another, and not to the public.

A consolidated balance sheet therefore is intended to reflect the financial position of the whole group of affiliated companies, considered as one undertaking. In a typical balance sheet of this character, the following grouping and arrangement of the assets and liabilities has been adopted.

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Liabilities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Charges to Operation.</td>
<td>Capital Stocks of Subsidiary Companies not owned by Holding Corporation.</td>
</tr>
<tr>
<td>Investments.</td>
<td>Bonded Indebtedness.</td>
</tr>
<tr>
<td>Current Assets.</td>
<td>Sinking and Reserve Funds.</td>
</tr>
<tr>
<td></td>
<td>Surplus.</td>
</tr>
</tbody>
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(To be continued)