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William M. Lybrand

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*The Accounting of Industrial Enterprises.

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

PART II.

When a holding company purchases the capital stock of another company, the price paid for this capital stock presumably represents the holding company's estimate of the value of the equity in the subsidiary company's assets. This price may be greater than the combined capital stock and surplus account of the subsidiary company, in which event the difference must be assumed to denote the value of the subsidiary company's goodwill, or other assets, not appearing on its balance sheet, otherwise, if they were included there, the cost of the capital stock to the holding company would be exactly equal to the combined capital and surplus of the subsidiary company. On the other hand, if the price paid by the holding company, for the capital stock of the subsidiary company, is less than the combined capital and surplus, the difference must be assumed to express the amount at which the assets of the subsidiary company are overvalued on its books.

In consolidating the "Property" accounts of the subsidiary companies (their property accounts including goodwill, trademarks, franchises, etc., as well as tangible property), the total must, therefore, be increased or reduced by as much as the cost of the capital stocks of the respective subsidiary companies, as at the date of their purchase by the holding company exceeds or falls belows their combined capital and surplus account.

It might seem at first thought that the surplus accounts of the subsidiary companies should not be applied as stated in the foregoing paragraph, but that they together with the surplus accrued subsequent to the purchase by the holding company, should be combined, and their aggregate entered on the consolidated balance sheet as the surplus of the whole undertaking. The fallacy of this statement has been proven in various ways. Perhaps the most simple and direct argument is somewhat along the following lines; the surplus of a corporation, generally speaking, represents the balance of earnings which have accumulated

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from its operations, and which have not been paid out to the stockholders, applied in immediate reduction of valuation of assets or reserved for the ultimate replacement thereof. As a surplus can accrue only during the operating of a company, it is fairly obvious that the holding corporation prior to its organization can not have earned such a fund, and that therefore it would be entitled to merge into its consolidated surplus account only the balances of profits accumulated by the subsidiary companies during the period of their ownership by the holding corporation.

Further, as the amount paid by the holding company for the capital stock of a subsidiary company represents the holding company's estimate of the equity in the subsidiary company, and as that equity is presumed to be represented by its capital stock and surplus account, it follows that in the process of consolidating, the capital stocks of the subsidiary company in the holding company's books will be eliminated, as will be the capital stock and surplus account on the subsidiary company's books. The surplus account being thus absorbed, can not of course, appear again as a surplus in the consolidated balance sheet.

**Inventories.**

The consolidation of the other items of assets, which would be included under the groups noted on a previous page, will probably call for no particular comment, except in the case of the inventories. Some of the industrial enterprises of the present day begin their ownership with the raw materials, and manufacture their output all the way from the first stage to the last. Necessarily this manufacturing can not, in every instance be performed in one continuous operation or by one plant, and there will be constant transfers from one company to another of product finished up to a certain point, but subject to further manipulation in order that it may be disposed of in a different form. At the end of the fiscal year or other balance-sheet period, there will doubtless be a quantity of such merchandise in the inventories of the several subsidiary companies, purchased by one company from another at a price greater than the actual cost of manufacturing. As the companies are entirely distinct from
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each other, it may be argued that the purchasing company will be justified in including such merchandise in its inventory, at the price paid to the company from which it was acquired. The purchase, however, having been made by one subsidiary company from another, is in effect merely a transfer from department to department of virtually the same corporation, and not a sale on which the profit can be said to have been realized. The principle that profits must not be anticipated would seem therefore to be applicable in such instances, and it would follow that a reserve should be provided equal to the amount by which such merchandise at inter-company prices exceeds its actual manufacturing cost.

Too hard and fast a rule should not be drawn, however, even when conditions are such as have been outlined above. In the case of an iron and steel combination, for instance, controlling the manufacture of its product from the ore in the ground to the sale of the finished merchandise, it will be appreciated that there are a number of points in the process of manufacture, where the merchandise reaches a finished and marketable stage. While at each stage in the manufacturing process some of the merchandise is sold to outsiders, much of it is transferred to other mills for further manipulation at a price which includes some profit to the subsidiary company by which it was handled. Is it entirely unreasonable to claim that where the manufacturing processes are distinct and complete, some manufacturing profit shall be taken in the current income account on merchandise finished by one company, but remaining in the inventory of another company while awaiting further transformation? In the balance sheet of a large industrial enterprise, such profits are applied as a separate part of the surplus account, distinct from the ordinary accumulation of surplus, with a note appended setting forth clearly the nature of the item.

**Capital Surplus.**

In the organization of many corporations, it has been the practice to issue bonds or stock equal to the amount at which the property purchased is offered by the vendors, and accepted by the directors, subject to the cash requirement of the State in
which the corporation may have been chartered. In addition, a sum of money is sometimes provided by the vendors for working capital, or a certain number of shares of stock may be turned back into the company's treasury, to be sold and the proceeds used for the same purpose. It has been held by the legal profession, that inasmuch as the property purchased, for which the company's securities were issued, has been declared to be of a reasonable value and necessary for the purposes of the corporation, any contribution which may be made by the vendors is in the nature of a donation, and as such is surplus or profit to the company. While technically, this may be true, yet practically it can not be a profit, first, because a corporation can not earn a profit before it has begun operating, and second, such a return of cash or securities on the part of the vendors is really in the nature of an abatement of the purchase price, and as such would be deductible from the cost of the property acquired. It has been held, that if the item is noted as capital surplus or designated by some synonymous expression which will clearly distinguish it from the surplus accumulated out of the earnings during the operation of the company, this will be sufficient, but it would seem to be more logical to apply it as a reserve or as a deduction from the cost of the properties purchased.

Subsidiary Company Balance Sheet.

In preparing the consolidated balance sheet from the holding company's and subsidiary companies' balance sheets, it is, of course, essential that the latter shall have been correctly stated.

The first item or group of assets in the subsidiary company's balance sheet that claims attention will be the account or accounts representing the fixed assets owned by the corporation, which may appear under the inclusive title of "Property" or which may be entered under the several captions of land, buildings, machinery, goodwill, franchises, etc.

As long as the present method of capitalizing on the basis of earnings is in vogue, and the property acquired by the new corporation is valued at a lump sum, it is improbable that a separation thereof will be made into accounts which will show
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the value of its land, buildings, and other tangible assets, apart from the so called "water." So much loose talk has been indulged in respecting the evils of over capitalization, as to lead to the idea in the mind of the public that the whole difference between the value of the tangible property and total of the property account is "water" only, which ought to be squeezed out.

That there is water in many of the stock issues, no one will deny. Capitalization has been determined in many instances, not on earnings reasonably certain of realization, but on prospective earnings of years to come, or on economies of combination and profits of monopoly that could not possibly be realized. But when the capitalization of a concern is based on an average of earnings, and fixed at such an aggregate sum that reasonable dividends may be paid, proper reserves provided, and a sufficient surplus accumulated, then it can hardly be said that it is over capitalized, even though the value of the tangible assets may not measure up to its capitalization. The difference between the two simply measures the then value of the goodwill, patents, trade marks, franchises, or other intangible assets of the company, but such assets in a case of that kind can not be considered as "water." As long as the business continues under conditions not less favorable than at its beginning, the intangible assets will retain their value. If the business fails, their value will probably disappear, as will also disappear the major part of the value of the so-called tangible assets. The worth of each depends on the continuance of the business, but as it is contemplated that a business will continue there is a real equity existing in such a case which can not be ignored or of which the owners can not justly be deprived.

There is, however, a strong tendency at the present time to attempt, with respect to the railroads at least, an appraisement of their physical property to ascertain how it compares with their capital obligations. How far reaching this movement may prove to be can not be foreseen, but it may not be unsafe to predict that ultimately the capitalization of corporations taking over a going business will represent the actual tangible property plus what the results of past operation will show to be a reasonable amount for goodwill, franchises, etc. When that time is reached
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it will likewise doubtless be required that the balance sheet shall set forth separately each class of property, and the valuation at which it was acquired.

Charges to Fixed Asset Accounts.

Consideration of the accounts of land, buildings, and machinery, arises numerous questions, respecting depreciation, obsolescence, additions, improvements, etc., all of which have a direct bearing on the balance sheet in that the proper valuation of the said assets therein depends on the correct solution of these questions. It is necessarily difficult to disassociate them from the income account as well, because that account will likewise be affected according to the way these questions are decided.

With respect to items which may properly be considered as capital expenditures, it has been suggested as a working basis that no additions should be made to the property accounts unless it can be clearly shown that they have increased the earning capacity of the plant. A simple, positive rule such as this might be all that is required, if the changes in the plant and the resulting increase in earning capacity were occasioned only by actual extensions or additions of property which had never before existed. But such is not the case. In every progressive manufacturing concern, alterations or additions to the plant are constantly being made for the purpose of simplifying the manufacturing processes and thereby increasing the output with the same expenditure for labor and materials, or in order to decrease those operating charges which are in the nature of overhead expenses required to be taken up in the cost of the product. As no alteration or addition to a plant is probably ever undertaken except for the purpose of increasing the earning capacity thereof, directly or indirectly, the literal application of the rule referred to is not possible, and it will be necessary to consider the nature of the various alterations, improvements, and additions, before an intelligent decision can be made as to their ultimate disposition.

At the outset, it may be conceded that actual extensions or additions of plant which did not exist before, will be properly chargeable to capital account, assuming that such additions do not render useless existing but less efficient plant producing a similar kind of product.
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The large class of expenditures consisting not of certain definite additions, but rather of alterations and improvements, is more difficult to deal with. In the case of improved appliances displacing less efficient ones, it has been held that the latter should be written off and the former added to the property account. Technically, this would seem to be correct, and if there is a direct saving in operation, or a relative increase in output, this course would seem to be justifiable. But if the new appliances are required in order to cope with a competitor having like facilities, or to meet the demand of the trade for improved articles at the same price, it would be more conservative to consider such additions as having the nature of extraordinary renewals, whose cost would be charged off within a reasonable period through the depreciation or renewal reserve appropriations.

Improvements to the plant which indirectly tend to simplify manufacturing processes or to lessen fixed operating expenses would also technically be chargeable to capital account, but a conservative application would call for their absorption in the current profit and loss account.

In so far as the records of the foregoing expenditures are concerned, it is clear that the cost of each should be clearly set forth in the accounts, distinct from ordinary renewals and repairs. If one is furnished with a brief explanation of the improvement, the saving sought to be accomplished by its use, the cost of the improvement and the cost of the property displaced, it is possible to decide intelligently whether the item should remain as a permanent capital addition, be absorbed through a renewal reserve fund or be charged off immediately in the current year's operations.

A discussion as to whether or not specific amounts should be written off goodwill, franchises, patents, trademarks, etc., would, under present conditions, probably be little more than academic. Nevertheless, the policy in force in the most conservatively managed of the large corporations of absorbing a part of their earnings in adding to the physical property, is in effect a writing off of such intangible assets. If continued for a sufficient number of years, the additions to the property charged against the surplus account, would ultimately take the place in the property account of the goodwill, franchises, etc., so that the property ac-
count would consist of tangible physical assets only. Assuming that the accounts have been kept in such a manner as to show clearly the cost of the additions so written off this practice is to be commended. The stockholders thereby become accustomed to these charges against the profits, and are less likely to demand larger dividend distributions, while the application of the earnings to the improvement of the property tends to maintain the earning power, admits of continuity and stability in dividend disbursements, and prevents to a considerable extent violent fluctuations in the market values of a corporation's securities.

**Deferred Charges to Operations.**

In the development of a corporation's property and in connection with its current operations, there are frequently certain expenditures made of such a character that they are not justly chargeable immediately to the operating costs, nor on the other hand, should they be included with the permanent property or the current assets. Instances of important items of this class are advance payments of royalties and costs of exploration and testing preliminary to the development of properties containing raw materials. Other examples of relatively less important items are unexpired insurance premiums, rentals paid in advance, prepaid discounts, etc. Advance payments of this character are usually found grouped under the caption of "Deferred Charges to Operations," the purpose being to carry them temporarily as assets, and then charge them off to the operations of the periods during which the benefit of the expenditures is reaped.

In addition to expenditures which are without doubt chargeable against future operations, there are certain others which are not so clearly defined, but which may with some degree of reason, be included therein. Business operations of certain kinds run in seasons—that is, during spring and early summer the whole effort of the sales department and to some extent the administrative forces, may be engaged in booking orders for delivery during the winter. Before the winter delivery begins the end of the fiscal period arrives, with the result that there will appear among the expenses of the fiscal period, a large amount incurred directly in connection with the next season's
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output. It would seem, under such conditions, not unreasonable to carry over such expenses as deferred charges, and write them off during the succeeding year. It may be argued that the expenses of one season will offset another, and that it is easier to absorb such items in the operation of the fiscal period during which they happen to have been incurred. This is unquestionably the more conservative method, but in the event of the transfer of the business at any fiscal period, there is an equity existing not shown on the books, which must be taken into consideration.

Occasionally a corporation, perhaps engaged in the manufacture of some patented or trade-marked article, may inaugurate a campaign of advertising, in which it is proposed to concentrate in one year the advertising that would usually be spread over two or three years. Here again it may be claimed with some show of reason that a part of the advertising cost should be carried over to be charged off in the following years. If there is a reasonable prospect that the effect of the advertising will continue during the succeeding one or two years, probably no valid objection could be made to such an action, provided it is done in good faith.

Discounts on bonds have, in the past, usually been considered a proper charge to capital, and as such have been added to the cost of the property. The price at which a bond may be sold depends primarily on the rate of interest paid and on the security afforded. If the security is unusually good the rate may be low and the bond still sell at par; if the security is good but not unusually so, and the rate fairly low, the bond will sell at a discount; if the security is poor the bond will sell below par, even though the rate is high. The cost to the corporation of obtaining funds from the sale of its bonds therefore depends largely on the assurance which it can afford the investors that the interest payments will be maintained and the principal paid at maturity. Convinced of these two factors, the selling price of the bond becomes to a considerable extent a matter of interest rate. If the rate is high the bond should sell at a premium, in which event the company will receive a sum in excess of the amount it will eventually have to repay, and this excess sum or premium will in effect act in reduction of the high interest rate. If the rate
is low and the bond sold at a discount, the company will be obliged to bear the expense of the interest, and ultimately also the difference between the realization from the bond and its par value—i. e., the discount. A discount on a bond is therefore an adjustment of the interest rate, and as such it should be spread over the term of the bond, the balance not charged off to be carried in the meantime as an asset of the deferred charges class.

LIABILITIES.

In stating the consolidated liabilities, few questions of principle are likely to be encountered. Under capital stocks will be included the stock issues of the holding company, and, separately stated, such part of the stocks of the subsidiary companies as are not owned by the holding company. The balance of the capital stocks of the subsidiary companies, being virtually inter-company accounts, will be eliminated in the process of consolidating.

The bonded debt of the holding company, as well as that of the subsidiary companies, whether guaranteed or not by the holding company, will appear, excepting that bonds of the subsidiary companies owned by the holding company will be eliminated, as it is the purpose of the consolidated balance sheet to show the financial position of the affiliated group of companies with respect to the public and not to each other.

SINKING FUND.

A sinking fund for the redemption of bonds is in effect a surplus accumulation because the fund is not disbursed for current expenses, but is used merely to retire liabilities, thereby increasing the stockholders equity in the property. The usual sinking fund provision requires, however, that a stipulated amount shall be provided out of the profits each year, hence it is necessary that a transfer of the required amount be made from the profit and loss account to a sinking fund reserve. If the sinking fund theory is carried out, funds equal to the amount so transferred will either be paid over to the trustees, placed on deposit and earmarked as being for sinking fund uses, or invested temporarily until required for the redemption of the bonds. If
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the value of the property on which the bonds were based is maintained without impairment, the sinking fund accumulation will, when the bonds are redeemed, properly revert to the surplus account; but if the property is of a wasting character and has depreciated in value to substantially the same amount that the sinking fund account has accumulated, then the latter is really in the nature of a depreciation reserve and should be so applied.

The investments made out of sinking fund accretions and the unexpended balances of cash will appear among the assets under the classification of sinking and reserve fund assets. Bonds redeemed by the trustees of the sinking fund will be applied among the liabilities in reduction of the respective bond issues in which they originated, the effect being to show under the funded debt liability only the balance actually outstanding.

Reserve Accounts.

It is quite likely that among the liabilities will be found, in addition to the sinking fund accounts, numerous reserve accounts accumulated out of current profits or surplus, to provide for renewals or replacements of plant, losses by fire or accidents, shrinkages in receivables, and for any other contingency which may arise.

With respect to these reserves which are collected as a preparation against fire losses, accident claims, bad debts, etc., there are probably no accounting principles involved which merit particular attention. Experience will, no doubt, have demonstrated in each of these cases the amount which should be set aside from year to year to cover losses arising therefrom. It is true that unusual and unexpected losses may be incurred through fires or accidents, but if the reserves therefor are based on sound principles, the amounts set aside and the losses charged against them ought to be fairly equal during a series of years. Even if this should prove not to be the case, the losses from such sources admit of being definitely ascertained after they have been incurred, and the reserve accounts may then be adjusted accordingly. If the reserve is more than exhausted the balance should be written off and not carried forward with the hope that during the succeeding period the losses may be so small that the account will be recouped.