

ADVANCED ACCOUNTING

Leopold A. Bernstein
Calvin Engler

ADVANCED ACCOUNTING

Leopold A. Bernstein, Ph.D., CPA

*Professor of Accounting
Baruch College
of the City University of New York*

Calvin Engler, Ph.D., CPA

*Professor of Accounting
Iona College*



1982

RICHARD D. IRWIN, INC. Homewood, Illinois 60430

Material from Uniform CPA Examination Questions and Unofficial Answers, copyright © 1957, 1961, 1962, 1963, 1964, 1965, 1966, 1967, 1968, 1969, 1970, 1972, 1973, 1974, 1975, 1976, 1977, 1978, 1979, 1980 by the American Institute of Certified Public Accountants, Inc., is reprinted (or adapted) with permission.

© RICHARD D. IRWIN, INC., 1982

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher.

ISBN 0-256-02456-1

Library of Congress Catalog Card No. 81-82998

Printed in the United States of America

1 2 3 4 5 6 7 8 9 0 RRD 9 8 7 6 5 4 3 2

Preface

Authors of an advanced accounting text for the 1980s and beyond face a number of significant challenges. First, the considerable complexity of the subject matter does cause serious learning difficulties to many students. At the same time, larger than usual enrollments and class sizes require now, more than ever, that the writing style and the exposition of the text be as helpful to individual study effort as possible. Second, the subject matter to be covered is growing at an unprecedented rate, and many traditional as well as new topics vie for inclusion in this often terminal course of the accounting sequence. Third are the pedagogical considerations which determine the optimal blend of theory and practice and of concepts and procedures.

As to the first challenge, the authors have endeavored to follow in each chapter a step-by-step approach which explains to the student the underlying theory as well as the why and the how of the subject matter. Widespread use is made of examples and detailed illustrations. Each chapter begins with an overview section of the subject matter and ends with a series of questions which should be helpful to the student in testing study coverage and comprehension. The basic approach is to expose the student to a gradual development of the subjects covered in a comprehensive yet easy to follow and to absorb manner.

The second challenge is met by including in the text not only the traditional subjects associated with the advanced accounting area, but also newer areas such as SEC accounting and accounting for a wider variety of nonbusiness organizations. An earnings per share chapter, whose coverage is consistent with an advanced-level text, is included because this subject often cannot be accommodated in the already overburdened intermediate level courses. The watchword here is *flexibility*. The selection of topics and their organization affords instructors the maximum leeway in teaching an advanced course consisting of subject matter configurations best suited to their students' objectives. To this end, specialized or difficult subject matter has been moved to appropriate end-of-chapter appendixes, thus affording the instructor the easiest choice for their inclusion or exclusion.

The third challenge was met by what the authors believe is a good blend of emphasis on theory and practice. Throughout the text we have endeav-

ored to explain the theory behind procedures as well as a variety of viewpoints, while always clearly identifying the generally accepted accounting standards in current use. To heighten student interest, the text is illustrated with a variety of treatments used in published financial statements.

Every effort was made to render this text as up to date as possible. All chapters incorporate the latest professional pronouncements. Thus, the chapter on accounting for foreign operations incorporates the latest approach reconsidered by the FASB in June 1981 while retaining the presently authoritative *SFAS No. 8* in an appendix. There is a rich mix of exercises and problems to cover both approaches. As the expected shift from *SFAS No. 8* to the new approach occurs, the instructor will find that the teaching focus can be changed with ease.

The chapters on accounting for state and local governments as well as other nonbusiness organizations reflect the latest pronouncements by the Financial Accounting Standards Board, the Municipal Finance Officers Association of the United States and Canada, the National Council on Governmental Accounting, and the American Institute of Certified Public Accountants.

The chapter on SEC accounting includes the provisions of the SEC's new 1980 integrated disclosure system as well as an appendix which illustrates comprehensive financial statements included in filings with the commission. Chapter 20, Corporate Reorganizations and Liquidations, contains a modern version of the realization and liquidation account which replaces the now-archaic T-account version. This chapter also contains the provisions of the recently enacted Bankruptcy Act.

The first 11 chapters contain a comprehensive discussion of business combinations and consolidated statements. The current trend in accounting for investments by parent companies is to use what we call the "complete equity" method. When this method is used, the parent company records on its books all of the entries that affect consolidated net income. These entries are reflected in the carrying value of the Investment in Subsidiary account. Thus, the parent company's net income is the same as consolidated net income. This method of accounting for investments in subsidiaries gives the reader a preview of all of the adjusting entries that will be required in the preparation of consolidated working papers. Accordingly, we use this method for all illustrations contained in the consolidation chapters.

Other methods used in practice, principally the "cost" method and the "modified equity" method (we prefer the designation of "incomplete equity" method) are also covered in this text. To provide the user of this text with the greatest degree of flexibility, we provide parallel treatments for these methods by using the same illustrations used for the "complete equity" method. The "cost method" is contained in a separate appendix at the end of each chapter, where appropriate. Similar treatment—a separate appendix—is given the "incomplete equity" method, thus enabling users to select either method or both.

To provide additional flexibility for the users of this text, the chapter content was designed to exclude the more complex areas from the chapter and to provide these areas as self-contained appendixes. Thus, separate appendixes are provided for (1) tax aspects of mergers; (2) elimination entries on a

net-of-tax basis when consolidated income tax returns are filed; (3) elimination entries on a net-of-tax basis when separate income tax returns are filed; (4) income tax requirements for filing consolidated income tax returns; (5) fractional elimination; (6) alternate methods of attributing gains and losses on the purchase of intercompany bonds; (7) trial balance working papers; and (8) "push down" theory. The latter theory has recently received some attention by the Accounting Standards Executive Committee of the AICPA.

Also provided in the consolidation chapters are published Consolidated Statements of Changes in Financial Position. The published statements illustrate the treatment of minority interest net income, dividends received by the parent company, equity in earnings of investees, and other matters. A discussion of these items and how they affect the preparation of the statement is also included.

Following this major area are a variety of specified topics which can be used by the instructor in any sequence that is desired. In our treatment of partnership accounting, we cover the tax basis of a partnership interest and the taxable gain or loss on the sale of a partnership interest. These matters are presented in a self-contained appendix, since we believe that some users prefer to cover this topic while others do not.

The exercises and problems which follow most chapters and are designed to reinforce the learning process have been class-tested; they reflect a variety of levels of complexity. A significant number of exercises and problems are based on recent CPA examinations.

Acknowledgments

While there are many to whom we are indebted for the encouragement and assistance rendered to us which enabled us to undertake and complete this project, our first and foremost debt is to Distinguished University Professor Emanuel Saxe. We were both privileged to have been students of his and we both count him as one of our dearest friends. Those who have benefited from his constructive and analytical reviews can fully appreciate the impact of Professor Saxe's review of portions of this work.

Naming everyone who assisted us in this project would make this section unwieldy. However, there are those who must be singled out. Among those to whom we wish to express our sincerest appreciation for reading portions of this manuscript are Robert N. Anthony, Harvard University; Martin Mellman, Harry Davis, Abraham N. Tawil, Hugo Nurnberg and Victor Pastena of Baruch College of the City University of New York; Terry Arndt, Ball State University; Roy E. Baker, University of Missouri; Galen D. Hadley, University of South Dakota; Orville Keister, University of Akron; Abdel M. Agami, Old Dominion University; Abraham J. Simon, Queens College of the City University of New York; Fred Spindel, partner, Coopers & Lybrand; Michael L. Ferrante, partner, Ernst and Whinney; and E. Raymond Simpson, project director, Financial Accounting Standards Board.

The authors are also greatly indebted to the American Institute of Certified Public Accountants for granting permission to use problems from the certified public accountant examinations and to quote material from its publications; the Municipal Finance Officers Association of the United States and

Canada for permitting us to reproduce exhibits and financial statements for state and local governments; the National Association of College and University Business Officers for granting permission to use some of their material; the United Way of America for permitting the reproduction of illustrations from *Accounting and Financial Reporting: A Guide for United Ways and Not-For-Profit Human Service Organizations*; and the American Law Institute and the National Conference of Commissioners on Uniform State Laws for allowing us to reproduce the Uniform Partnership Act.

Finally, we wish to express our appreciation to our wives, Cynthia and Phyllis, for their patience and understanding while this was being written and for their valuable editorial assistance. Our children, Debbie and Jeffrey and Linda and Mitchell, rendered assistance with various stages of typing and proofreading of the manuscript.

We sincerely solicit comments and suggestions for improving this text from users and others.

Leopold A. Bernstein
Calvin Engler

Contents

1. An introduction to accounting for multi-unit enterprises: Home office and branch accounting 2

Agencies. Branch operations: *Shipments to branch—at cost. Shipments to branch—billed price in excess of cost. Financial statements. Reconciliation of reciprocal accounts. Inter-branch freight charges.*

2. Business combinations 26

Reasons for combinations. Legal forms of business combinations: *Statutory merger. Statutory consolidation. Acquisition.* Directional and anti-trust considerations: *Horizontal combinations. Vertical combinations. Conglomerate combinations. Circular combinations.* METHODS OF ACCOUNTING FOR BUSINESS COMBINATIONS. Purchase accounting. Pooling accounting. Historical development of pooling accounting. Revised opinions on accounting for business combinations: *Conditions for the pooling of interests method. Application of the purchase method. Pro forma supplementary disclosure.* Costs and expenses of consummating the combination. Taxable versus nontaxable exchanges. Illustration of accounting mechanics: Purchase versus pooling accounting. Dissenting shareholders. Application of the 90 percent rule. Operating results.

Appendix: Tax aspects of business combinations, 47

3. Consolidated statements—date of acquisition 60

Reasons for consolidated statements. Purchase of a wholly owned subsidiary at book value.

Purchase of a wholly owned subsidiary at other than book value. Negative goodwill. Purchase of a partially owned subsidiary at book value. Purchase of a partially owned subsidiary at other than book value.

4. Consolidated statements—subsequent to date of acquisition 90

Equity method. Cost method. Unconsolidated subsidiaries. CONSOLIDATION PROCEDURES SUBSEQUENT TO DATE OF ACQUISITION. Partially owned subsidiary using the complete equity method. Minority interest. Intercompany transactions.

Appendix 4-A: Income tax implications between parents and subsidiaries, 108

Appendix 4-B: Incomplete equity method, 110

Appendix 4-C: Cost method—partially owned subsidiaries, 114

Appendix 4-D: Trial balance working papers, 118

5. Consolidated statements—intercompany profits on inventories 138

Billing above cost. Unconfirmed (unrealized) profits—sales by parent company (downstream): *First year. Second year.* Unconfirmed profits—sales by subsidiaries (upstream): *First year. Second year.* Inventories—unconfirmed profits—comprehensive illustration. Sales between subsidiaries of one affiliated group—lateral sales. Reductions of inventories—lower of cost or market write-downs. Gross profit versus net profit. Disclosure of consolidation policies.

| | |
|--|---|
| <p>Appendix 5-A: Income tax considerations for consolidated financial statements, 158</p> <p>Appendix 5-B: Partial (fractional) elimination of intercompany profits—inventories, 162</p> <p>Appendix 5-C: Incomplete equity method—intercompany profit on inventories, 166</p> <p>Appendix 5-D: Cost methods—intercompany profit on inventories, 173</p> | <p>Piecemeal acquisitions. Conversion from cost method to equity method. Purchase of shares from a subsidiary. Purchases of stock at interim dates—purchase accounting. Preferred stock purchases on interim dates. POOLING ACCOUNTING. Acquisition on an interim date. Intercompany transactions.</p> <p>Appendix: Preacquisition income—cost method, 301</p> |
| <p>6. Consolidated statements—intercompany profit on plant asset transfers and other related matters 192</p> <p>Sales of plant assets by subsidiaries subsequent to the date of acquisition. Intercompany sales of plant assets. Plant asset sale by parent company—downstream sale. Intercompany sale of manufacturing equipment. Sale of equipment prior to expiration of useful life. Sale by parent of nondepreciable assets. Plant assets—sale by subsidiaries—upstream sale. Sales of assets at other than end of a year—upstream sale. Balance sheet only working papers.</p> <p>Appendix: Consolidated statements—provision for income taxes on consolidated income tax returns involving intercompany profits on asset transfers, 211</p> | <p>9. Consolidated statements—decreases in parent's (investor's) share of ownership and other related matters 322</p> <p>Sale of shares by subsidiary to third parties: <i>At book value. At a price in excess of book value. At a price below book value.</i> Sales by investors of investee's stock—equity method. Sales by an investor of part of its investment in a subsidiary or affiliate. Treasury stock transactions—subsidiary's purchase of shares from third parties. Stock dividends.</p> <p>Appendix: Decreases in parent's ownership percentage—cost method, 334</p> |
| <p>7. Consolidated statements—transactions in intercompany bonds and preferred stock 234</p> <p>Overview of accounting for the retirement of treasury bonds. Purchase of intercompany bonds. Treatment of gain or loss on consolidated statements. Subsidiary purchases parent's bonds. Parent purchases subsidiary's bonds. Purchase between interest dates. PREFERRED STOCK. Investments in preferred stock. Allocation of retained earnings. Income apportionment.</p> <p>Appendix 7-A: Gain or loss on purchase of intercompany bonds attributable to issuer—complete equity method, 258</p> <p>Appendix 7-B: Intercompany bond transactions—cost method, 261</p> | <p>10. Consolidated statements—complex affiliation structures 350</p> <p>Lineal structures. MUTUAL HOLDINGS. Treasury stock approach—equity method. Indirect holdings of less than 50 percent—consolidated statements.</p> <p>Appendix: Reciprocal holdings—algebraic solution, 365</p> |
| <p>8. Consolidated statements—increases in parent's percentages of ownership by purchases of stock 248</p> | <p>11. Consolidated statements—consolidation theories and other topics 382</p> <p>The entity method. <i>Discussion. Entity method—date of acquisition. Entity method—subsequent to date of acquisition.</i> Limitations of consolidated statements: <i>Minority interest stockholders. Creditors of subsidiary companies. Creditors of the parent company. Financial statement ratios. Consolidated retained earnings. Consolidated statement of changes in financial position.</i></p> <p>Appendix: Push-down theory, 396</p> |
| | <p>12. Accounting for foreign operations . . . 410</p> <p><i>Foreign accounting practices. Efforts to develop</i></p> |

worldwide accounting standards. Transactions in foreign currencies: *Import and export transactions. Conducting foreign operations. Measured versus denominated. Conversion versus translation. Currency exchange rates. Accounting for foreign currency transactions: Unsettled transactions in foreign currency. Forward exchange contracts. Accounting for forward exchange contracts. Accounting for a hedge on a foreign currency net asset or liability position. Accounting for a hedge of an identifiable foreign currency commitment. Transaction gains and losses to be excluded from determination of net income. Accounting for gains and losses on speculative forward exchange contracts. Translation of foreign currency financial statements: Evolution of the accounting for foreign exchange translation. Statement of Financial Accounting Standards 52: Basic objectives. Major provisions. Accounting for investment by parent company. Accounting when an investment in subsidiary is sold or liquidated. Disclosure requirements. Exposure to foreign exchange losses.*

Appendix: The temporal method of translation (the methodology of SFAS 8) 430

13. Segment reporting by diversified enterprise 452

The evolving interest in segmental reporting. SEC reporting requirements. FASB SFAS 14, "Financial reporting for segments of a business enterprise." Objectives of segment disclosure. Applicable accounting standards. Unconsolidated investments. Areas covered by segmental disclosures. Operations in different industries: Revenue test. Operating profit test. Asset test. Evaluation of reportable segments. Dominant segments. Operation in different industries—criteria for disclosure. Foreign operations: Disclosure requirements. Export sales. Major customers. The SEC's position on segmental reporting. Problem areas of segmental reporting.

14. Interim financial reporting 470

The need for interim reports. Problem areas. Two divergent views. APB Opinion 28. Standards for interim reporting of revenues, costs, and expenses: Illustration of the application of the lower of cost or market rule to interim reporting. Income taxes in interim statements: Illus-

tration of the computation of interim statement tax provision. Illustration of interim tax provision when losses occur. Reporting of accounting changes and extraordinary and other nonoperating items. Disclosure of summarized interim financial data. SEC disclosure requirements.

15. Earnings per share 486

Evolution of the earnings per share computation. Major provisions of APB Opinion 15. Simple capital structure. Computation of weighted average of common shares outstanding. Complex capital structure: Primary EPS. Options and warrants: Fully diluted EPS. Illustration of the computation of primary and fully diluted EPS. More complex aspects of the computation of earnings per share: Illustration of classification of contingently issuable shares. Illustration of option agreements in the computation of EPS. Computations involving changing conversion rates or exercise prices. Examples of EPS computations in a period during which a business combination occurs. EPS computations of investor companies with affiliates. Illustration of EPS computation involving an affiliate. Restatement of prior period EPS. Illustration of prior period EPS restatement. Requirements for additional disclosures in conjunction with the presentation of EPS data. Alleged weaknesses of APB Opinion 15.

16. Partnerships—formation and operation 516

Definitions and features of partnerships: Mutual agency. Unlimited liability. Assignment of partner's interest. Limited life. Taxation. Entity versus proprietorship theories. Initial contributions to capital. Written partnership agreements. DIVISION OF OPERATING RESULTS. Salaries to partners. Interest on capital and loan accounts. Division of income in capital ratio. Bonus to partners. Financial statements.

Appendix 16-A: Selected principles of partnership taxation and basis of partnership interests, 528

Appendix 16-B: Uniform Partnership Act, 530

17. Partnerships—changes in ownership . 546

Changes in the profit and loss ratios. Admission of a partner—purchase from existing partners. Admission of a partner—investment into the partnership. Admission of a partner—investment at other than book value—profit and loss ratio and capital ratio coincide. Admission of a partner—profit and loss ratios and capital ratios are different. Retirement of a partner. Death of a partner. Incorporation of a partnership.

18. Partnerships—liquidation and dissolution 568

Rights of partners in liquidation. LIQUIDATION IN ONE TRANSACTION. Partners' capital and loan accounts sufficient to absorb losses. Partners' capital and loan accounts insufficient to absorb losses. Marshaling of assets. LIQUIDATION IN INSTALLMENTS. Advance cash distribution plans. Loan balances.

19. Accounting for estates and trusts . . . 588

Estate planning. Legal aspects of estate administration: *Inventory of assets. Claims against the estate. The settlement of an estate.* The classifications of legacies. Accounting aspects of estate administration: *The distinction between principal and income.* Depreciation and depletion. Accounting and reporting for estates: *Accounts relating to principal. Accounts relating to income. Reporting.* Accounting for an estate—an illustration. Legal and accounting aspects of trusts.

20. Corporate reorganizations and liquidations 606

Enterprises in financial difficulty. Insolvency. Enterprises in financial difficulty—available options: *The nonjudicial route. The judicial route.* Bankruptcy Reform Act of 1978. Reorganizations. Accounting for a reorganization. Liquidations. Trustee in bankruptcy. Distribution of the estate in bankruptcy. Accounting and reporting for a liquidation. The statement of affairs: *Statement of affairs format. Illustration of the statement of affairs.* Statement of realization and liquidation: *Illustrative example.*

21. Accounting for nonbusiness organizations: State and local governments—general fund 626

Conceptual matters. Dichotomy of nonbusiness accounting. FUND ACCOUNTING—STATE AND LOCAL GOVERNMENTS. Definition and types of funds. Number of funds. Accounting for fixed assets and long-term liabilities. Valuation of fixed assets. Depreciation of fixed assets. Basis of accounting—accrual basis in governmental accounting. Budgeting, account classification, terminology, and financial reporting: *Budgeting, budgetary control, and budgetary reporting. Transfer, revenue, expenditure, and expense account classifications. Common terminology and classification. Interim and annual financial reports.* BUDGETING, CONTROL, AND REPORTING. Budgeting. Encumbrances and expenditures. Comprehensive illustration—general fund. Inventory of supplies. Financial statements.

22. Accounting for state and local governments—special funds 656

Special Revenue Funds. Capital Projects Fund. Debt Service Fund. Special Assessment Funds. Internal Service Funds. Enterprise Funds. Fiduciary Funds. Agency Funds. Trust Funds: *Accounting for Nonexpendable Trust Funds.* General fixed assets account group. General long-term debt account group.

Appendix: Financial statements for a state or local government, 680

23. Accounting for colleges, hospitals, and welfare organizations 712

Colleges and universities: *Illustrative entries. Current Fund—restricted. Closing entries. Depreciation. Loan Funds. Endowment and similar funds. Annuity and Life Income Funds. Financial statements.* Hospital accounting: *Revenues. Expenses. Depreciation. Journal entries. Financial statements.* Accounting for voluntary health and welfare organizations: *Funds. Revenues. Donated services. Expenses. Depreciation. Closing entries. Financial statements.*

24. Regulation of accounting by the SEC 758

Origins of the SEC. Organization of the SEC. Principal acts administered by the SEC: The Securities Exchange Act of 1934. Accountant involvement. Accounting Series Releases. The

principal registration statement—Form S-1. Reporting and disclosure requirements. The SEC's influence on accounting theory and practice: The SEC's position on the promulgation of accounting standards. Leadership in promoting change in financial accounting and reporting. Reporting of leases. Leadership of the SEC in requiring analytically oriented data.

Appendix 24—A: Selected pages from joint proxy statement of Mattel,

Inc., and Western Publishing Company, Inc., 773

Appendix 24—B: Galveston Houston Company—Management's discussion and analysis of financial condition and results of operation, 791

Index 795

Advanced Accounting

1

An introduction to accounting for multi-unit enterprises: Home office and branch accounting

OVERVIEW

Most large business enterprises operate in a multi-unit mode. The most popular form of multi-unit operation is that of one or more corporations owning a majority interest in one or more other corporations. This form of operation is referred to as a parent-subsidary relationship.

Another form of multi-unit operation is that of a home office with one or more branches. In this type of operation, one corporation encompasses all units, instead of separate corporations as in a parent-subsidary relationship.

Regardless of which form of operation is used, the financial statements of each separate unit is combined with that of the controlling unit which then results in a single set of financial statements for the economic entity as a whole.

Except for small, localized business organizations, businesses usually have operations in more than one location. A vertically integrated business is one that engages in more than one level of activity, such as mining, refining, fabricating, wholesaling, and retailing. A horizontally integrated business is one that has more than one location on the same level of operations, such as a series of retail stores as in a supermarket chain. A business organization can be both vertically integrated and horizontally integrated. Many oil refineries have multiple locations for refining operations as well as multiple retail gasoline filling stations.

Forms of ownership may vary. When separate corporate existence prevails, the corporation owning the shares of other corporations in an affiliated group of companies is called the *parent* company, and a parent-subsidiary relationship exists between the companies. For this purpose, a controlling interest of more than 50 percent is required. Another form of ownership is one where all locations, including the main location, are part of one legal entity, usually a corporation. In organizations of this type, one location is usually the dominant one and is referred to as the *home office*. The remaining locations are either referred to as *agencies* or *branches*, depending upon the function and mode of operation of each location.

A major emphasis of this text is on the preparation of consolidated financial statements for a parent company and its subsidiary or subsidiaries. The most common form of corporate organization found in practice is that of parent and subsidiary companies rather than that of home office and branch(es). Portions of this text are also devoted to ancillary problems concerning multinational ownerships (foreign subsidiaries and branches) and segment reporting by multiproduct companies.

The procedures used in the preparation of consolidated working papers are often complex. Many problems are present in parent-subsidiary relationships that require sophisticated problem-solving techniques not usually required in home office and branch relationships. Examples include: less than 100 percent owned subsidiaries (the noncontrolling stockholders are referred to as *minority interests*); sales of additional shares by subsidiaries; purchases of a parent company's stock by a subsidiary (referred to as *mutual* or *reciprocal* holdings); and others. The development of the theories and problem-solving techniques associated with consolidation accounting (parent-subsidiary relationships) usually requires 10 or more chapters while the accounting for branches and agencies rarely requires more than one chapter. The distinction between agencies and branches, and the accounting for them, will form our beginning discussion since they do provide a good introductory framework to the principles of consolidation accounting.

AGENCIES

Agencies and branches are entirely different types of operations. An agency is merely an office in which orders are taken and then transmitted to the home office for processing, billing, and the actual shipment of the merchandise. The agency office usually is limited to a samples inventory and does not carry any merchandise for shipment. Usually, the number of employees working in an agency office are few. The agency very rarely collects cash

from customers; rather, the funds are normally remitted by customers directly to the home office. An example of an agency operation might be that of a dress manufacturer whose offices and factory are located in a midwestern state. The manufacturer might have a showroom in the garment center of New York City. Buyers would visit the showroom office in New York and purchase selected garments from the samples; shipment as well as billing would emanate from the factory and offices located in the midwestern state. In an operation such as this one, the agency would possess some furniture, some samples, and possibly a small amount of cash to take care of daily out-of-pocket expenses such as freight, postage, fares, and other small expenditures. If we assume that the Superior Dress Manufacturing Company, Inc., operates the Able Agency in New York City, typical entries on the books of the Superior Dress Manufacturing Company, Inc. (hereinafter referred to as the home office), might appear as follows:

| | | |
|--|---------|---------|
| Furniture and Fixtures (Able Agency) | 20,000 | |
| Cash | | 20,000 |
| Samples Inventory (Able Agency) | 10,000 | |
| Merchandise Inventory | | 10,000 |
| Working Capital Fund (Able Agency) | 1,000 | |
| Cash | | 1,000 |
| Accounts Receivable | 150,000 | |
| Sales (Able Agency) | | 150,000 |
| Rent Expense, Etc. (Able Agency) | 30,000 | |
| Cash | | 30,000 |
| Cost of Goods Sold (Able Agency) | 60,000 | |
| Merchandise Inventory | | 60,000 |
| Transportation Costs, Etc. (Able Agency) | 350 | |
| Cash | | 350 |
| To reimburse the Able Agency for out-of-pocket expenditures. | | |

From the foregoing illustrative entries it can be seen that the operations of the agency will be recorded on the books of the home office. The home office will usually segregate the transactions that pertain to the agency throughout the year; and then at year's end, it will have, in effect, a summary of the sales generated by the agency as well as the costs associated with making those sales. This will enable the home office to evaluate the success of the operation of the agency office.

BRANCH OPERATIONS

A branch office is quite different from that of an agency office. A branch office usually carries a complete inventory of its own from which it delivers merchandise to its customers. In addition, the branch usually keeps records of its own accounts receivable, collects funds from its customers, and deposits the funds in a bank account. It will pay its vendors, and it will remit to the home office amounts not needed for continuing operations.

There are two approaches that can be used to account for a branch's

accounting function. One method is to have the branch summarize all of its transactions on a daily basis and remit these summaries to the home office. The home office will then be responsible for the record-keeping function of the branch. The other method is to have the branch keep its own set of accounting and bookkeeping records. Under this approach, the branch would record all of its entries as if it were a separate accounting entity. However, certain entries will interact with the books of the home office, and for this reason it is necessary to create a set of reciprocal accounts. Therefore, on the books of the branch an account will be opened labeled Home Office Control. On the home office books, however, the reciprocal account will be labeled Branch Control (in the actual account title, the word "Office" is often omitted). Whenever a transaction involves both sets of books, the reciprocal accounts will be used in the following fashion:

| <i>Home Office Books</i> | | | |
|---|--------|--------|--------|
| Branch Control | 20,000 | | |
| Cash | | 20,000 | |
| To record a cash advance to the Better Branch. | | | |
| <i>Branch Books</i> | | | |
| Cash | 20,000 | | |
| Home Office Control | | | 20,000 |
| To record the receipt of a cash advance from the home office. | | | |

From the above entries it is evident that not only should the reciprocal accounts always be in balance but this format will also facilitate the integration of the home office and branch trial balances by canceling out these reciprocal accounts. By a comprehensive example we will now illustrate the use of the two sets of books when the branch does its own bookkeeping on an autonomous basis.

Shipments to branch— at cost

Shipments by a home office to a branch can be made at different prices. The possibilities are:

1. Shipments to the branch at the branch's selling price.
2. Shipments to the branch at the home office's cost.
3. Shipments to the branch at a price in excess of cost (hereinafter the *billed price*).

The first category (*selling price*) is not one in wide use since it allows for no gross profit for the branch. When this approach is used, the branch operation will always operate at a loss, and the amount of the loss will always be equal to the operating expenses of the branch. This approach provides very little useful information from a control or management viewpoint. For this reason we will not illustrate this method. The other two approaches are used extensively in practice. The third approach (*billed price in excess of cost*) involves complexities not found in the second method and, therefore, will be discussed in a later section of this chapter.

Illustration 1-1 contains representative summary entries of the second method (*billed at cost*). The closing entries for the home office are assumed