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Accounting Questions

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

INTEREST ON CONSTRUCTION COST

Question. Case 1. Subsidiary A lends money to Subsidiary B for construction purposes at 6% interest. B capitalizes the interest as cost of construction.

(1) To what account does A credit the interest received?

(2) How does the parent company X treat this item of interest on consolidated statements?

Case 2. Subsidiary A uses its own funds for construction. The funds were invested in securities earning 6% and on deposit in bank at 2½%.

(1) What is the practice in capitalizing a fair rate of interest on the money tied up during construction?

(2) If any sum is so capitalized, how is it treated in the parent company's consolidated report?

In answering the questions under case 2 consideration should be given to the fact that the funds used in construction may have arisen

(1) Out of the sale of interest-bearing obligations.

(2) Out of the sale of capital stock.

(3) Out of accumulated net income.

Answer. It is rather difficult to answer the question categorically since several factors are not given; for this reason the reply is made in general terms.

Although, in general, for reasons of conservatism, it is preferable not to capitalize interest during construction in a going business, we are of the opinion that we can not object to its capitalization. This is the case irrespective of whether the corporation borrows money specifically for construction purposes or uses its own funds which had been accumulated previously from profits. Interest so capitalized may be included in current income both on the books of the subsidiary company erecting the building and in the consolidated accounts of the parent corporation.

The rate of interest to be used for this purpose will depend upon circumstances. If use is made of the corporation's own funds (which had accumu-

lated previously from profits or had been derived from the sale of common stock, non-cumulative preferred stock, debenture bonds or similar securities), the rate used should be the prevailing rate for government and municipal securities. It is realized that the corporation may have been earning a higher rate through investment in other types of securities, but such investment had an element of risk which at times would result in reducing the income considerably through losses and this element is entirely lacking in the capitalization of interest. In the case of funds secured through the sale of bonds, cumulative preferred stocks or similar securities, or through borrowings from parent or affiliated corporations, the rate of interest to be used might be increased to the actual rate paid.

In each instance, of course, the existence of corporate entities must be recognized, and if a subsidiary company borrows money either from the parent corporation or from another subsidiary, the interest it pays may be capitalized and included in income; but, on the other hand, an adjustment should be made in the preparation of the consolidated accounts to eliminate, by means of an appropriate reserve, any portion of the interest which has been included at rates higher than those indicated in the preceding paragraph.

The general principle of the propriety of including capitalized interest during construction in income may be subject to an exception in the case of property which is being erected for speculative purposes. Construction of this character partakes of the nature of an inventory and it is not considered good practice to include interest as part of inventory cost and to include income therefrom until the property has been sold.

Answer. Case 1. The question rather implies some impropriety in charging interest to cost of construction. When interest is actually paid for funds used, this is usually considered a reasonable part of the cost of construction, but when a company uses its own funds such a charge is not in line with the most conservative practice, but it is not improper if clearly stated in the published accounts. The principle is not changed, although somewhat obscured by the fact that it involves inter-company transactions.

(1) Company A must credit interest, as an income item, and should show it separately as received from B.

(2) Parent company X, if it accepts the capitalization as proper, takes up the interest as a special item and it should show that it has been capitalized by a subsidiary.

If dissenting, it will, upon consolidating the accounts, offset the income item, setting it up as a reserve against overcharge to capital expenditure by its subsidiary.

Case 2. Generally the position is the same as the foregoing. Specifically, subject to the foregoing, a fair rate depends rather upon the rate regarded as reasonable in the country or state where the company's operations are located than upon the origin of the funds used. If the funds were safely invested at 6% that would seem a fair rate.

Answer. With regard to the questions raised, it does not seem possible to give answers with regard to the treatment of the items in a consolidated report without knowing something about the basis on which the parent company carries its investments in subsidiaries and the basis for the consolidation. It must be recognized that in true consolidations, inter-company transactions are

to be eliminated, and, furthermore, it must be recognized that a profit does not arise from the capitalization of charges which are, in effect, mere bookkeeping entries.

With regard to case 1, question 1, presumably A credits an account of interest earned. The question as to how the parent company X may treat this item in its consolidated statements depends on other factors, none of which is stated in your problem.

With regard to case 2, question 1, we do not know that there is any general practice as to the capitalization of a fair rate of interest on money tied up during construction. Our experience has been that this question is always dependent upon the particular circumstances of the case.

With regard to the second part of case 2, all we can say is that we do not see how a parent company would be entitled to consider as earned income an amount of interest so capitalized.

Answer. Case 1. The interest charged B should be credited by A either to interest received or in reduction of interest paid. On consolidation, the parent company, X, should reserve from surplus the amount of the inter-company charges.

Case 2. In dealing with activities other than public utilities it is generally understood that the interest capitalized during construction should be restricted to the interest actually paid on funds applied to construction purposes.

In the case submitted the interest capitalized under condition 1 would be the amount paid or accrued during the construction period on the interest-bearing obligation out of which the funds were provided, after adjustment for the interest received from the stated securities and deposit. In this case no adjustment would be needed in the consolidated accounts.

If the company's own funds are used, i. e., funds from the sale of capital stock or out of accumulated net income, then, in my opinion, no interest should be added to the construction cost. If, however, a contrary view is taken and, as a matter of fact, interest is capitalized, then, I think, the amount thereof should be credited to capital surplus and not regarded as available for distribution. The consolidated surplus should be adjusted, if necessary, to reflect this condition.

It will be understood that the foregoing has reference to commercial undertakings and not to public utilities whose accounting procedure is necessarily governed by the various regulatory bodies.

CHANGES IN CAPITAL STRUCTURE

Question. (1) The "A" holding company purchases all of the outstanding capital stock of "B" operating company for the sum of $600,000. The par value of the 4,000 shares of stock (all common) acquired amounts to $50 a share or a total of $200,000.

(2) The operating company appraised its physical property, from which it was enabled to create a capital surplus of $350,000.

(3) The holding company, desiring to reduce its own investment in the operating company, arranges that the latter revise its capital structure. The

operating company, therefore, issues new no-par common and preferred stocks to this holding company in exchange for the old stock, as follows:

1,500 shares preferred, stated value $100 a share at $90	$150,000
12,000 shares common, stated value $30 a share	360,000
Total	$510,000

The journal entry recording this is as follows:

Common stock (old)	$200,000	
Capital surplus	295,000	
Deferred charges—discount on preferred stock	15,000	
To preferred stock 1,500 shares		$150,000
Common stock 12,000 shares		360,000

Following this, the operating company reacquires from the holding company 10,500 shares of common, for which it pays in cash the stated value of $30 a share or a total of $315,000. The holding company's investment is, therefore, reduced from $600,000 to $285,000. The operating company obtained the necessary cash by issuing bonds.

(4) The $6 preferred stock issue provides that upon voluntary dissolution and liquidation the stockholders shall receive $105, and upon involuntary dissolution or liquidation the sum of $100.

My main questions concerning the above procedure are:

(a) Is it correct accounting practice for the operating company to set up as a "deferred charge" the discount of $10 on the no-par preferred stock with a stated value of $100 and exchanged on the basis of $90?

(b) Should the preferred-capital-stock account show a balance of $90 a share or a total of $135,000?

(c) Would it be proper to let the preferred-stock account remain at $150,000 and charge the discount to surplus?

I would also appreciate expressions of opinion or criticism with respect to any other feature of the foregoing revision of the operating company's capital structure.

Answer. As we read this proposition, certain essential features appear, namely:

(1) The operating company before revising its capital structure had outstanding common stock in a total amount of	$200,000
Upon appraisal of its physical property there was created a capital surplus of	350,000
Making a total of	$550,000

(2) Upon revising its capital structure, the operating company issued:	
1,500 shares of preferred stock, with a stated value of $100 a share	$150,000
12,000 shares of common stock, with a stated value of $30 a share	360,000
Making a total of	$510,000

(3) The entire issue of new preferred and new common stock was exchanged for the old stock held by the holding company.

It does not appear from your letter why the preferred stock of the operating company should have been issued at $90 a share, and upon consideration there would seem to be a question as to whether the preferred shares were, in fact, issued at the $90 price. We, therefore, do not see that the journal entry placed upon the books of the operating company correctly expresses the transaction, inasmuch as we do not believe that the transaction gave rise to a discount on preferred stock in the amount of $15,000. Without knowing the full particulars as to how the basis of $90 for preferred stock was determined, we can not, of course, say that the journal entry shown is definitely incorrect. We can, however, say that we see no good reason for setting up the discount on the preferred stock in the amount of $15,000. We believe the preferred-capital-stock account of the company should show a balance of $150,000, equal to its stated value. Also, we believe that the so-called "discount on preferred stock" should have been charged against capital surplus.

We trust the foregoing brief expression will be of assistance to you in reaching a proper conclusion. We think, however, that this conclusion can not be reached without knowing why the stated value of $100 was placed upon the preferred stock when it was proposed to exchange it on the basis of $90, and, furthermore, in the mind of the writers, there remains the question whether in fact the preferred stock was issued at $90 and not at $100.

CONTINGENT VS. ACTUAL LIABILITY

Question. Our client has a contract with a manufacturer by which the manufacturer consigns goods to the client. The latter in turn sells the goods to the trade on seventy days' and four months' time. At the maturity date of the invoice, payment to the manufacturer is made by the client, but, for convenience, settlements are made twice a month.

Our client guarantees the account and has to pay it whether it is paid on time by the customer or not. However, our client claims there is not an actual liability until maturity date, whereas we claim that there is a liability when goods are sold and that the customer's account receivable is an asset.

Merchandise may be returned by the customer on account of imperfections, wrong construction, or wrong finish, etc., and when this is done the manufacturer is charged and the customer's account is credited—the goods never being purchased by our client.

Our client claims there is an actual liability only when goods have been sold, the maturity date has arrived and the account is unsettled at any particular time.

Our client also claims that if we place a footnote on the balance-sheet stating that the company is contingently liable for the amount that is not yet due, such information covers the case entirely.

Answer. We are of the opinion that the stand taken by the accountant is correct, namely, that there is a liability when the goods are sold and that the customer's account is an asset. We can not see that the situation as outlined differs from that arising out of any other sale with a seventy days' or four months' maturity. When the sale is made a liability is created to the manufacturer, and this must be paid upon maturity, in any circumstances. That it is not due until some future date, in our opinion, makes no difference.

Answer. We are in agreement with the client that a footnote on the balance-sheet stating that the company is contingently liable for the amount that is not yet due is sufficient. The amount is a contingent liability which is payable by the client only if the customers do not pay.

Answer. We agree with the inquiring member that there is an actual and not a contingent liability in the case.

From the terms of the contract as given in the question, it appears that the client is liable to the manufacturer for all goods sold by him. He makes remittances at certain specified or convenient times, but from the time when he makes a sale until he pays for it (providing the goods are not returned) he is liable to the manufacturer. He has even guaranteed the account. In our opinion it would appear to be merely an account payable but not yet due, and, as such, as stated above, it should be shown on the balance-sheet as a liability.