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Accounting Questions: Fixed Charges for Pulp and Paper Mills, Treatment of Treasury Stock on Balance-sheet, Accounting for Bakeries

American Institute of Accountants. Bureau of Information

Accounting Questions

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FIXED CHARGES FOR PULP AND PAPER MILLS

Question: What is the correct method of accounting for the "fixed charges" in the following situation—

A "vertical" merger or combination of pulp and paper mills and timber holdings owns timber limits greatly in excess of the requirements of its present mills. The timber holdings were acquired to assure the raw materials for possible future developments and to prevent their acquirement by competitors. The corporation has outstanding bonds, secured not only by the mill properties but by the timber limits. Consequently the "fixed charges" for bond interest, taxes, etc., are much greater than would normally be found in either pulp or paper mills.

Should these fixed charges be charged against the current operations, thereby showing results which are abnormal, or should such a portion of the charges as may be ascribable to the excess timber holdings be capitalized? To capitalize the charges might appear to be inflating the assets, but there is a normal natural increment of timber through growth and also there is an increasing value of stumpage through depletion.

Answer No. 1: Unless the company is devoting money and effort to the planting, care and development of its timber reserves, we think there would be considerable doubt as to the propriety of capitalizing a portion of the fixed charges or of attempting otherwise to reflect the estimated annual growth in the capital-asset account. While we understand it is the practice of some companies to capitalize taxes, insurance (if any) and expenditures for the care and safeguarding of reserve properties, the capitalization of such items is always subjected to the limitation that the original cost together with the carrying charges should not exceed the market value of the property. We think it is usually considered that a stand of virgin timber does not increase in quantity through growth inasmuch as any growth of young trees is offset by the decay of matured trees.

Your correspondent's letter further states that "the corporation has outstanding bonds secured not only by the mill properties but by the timber limits; consequently, the "fixed charges" for bond interest are much greater than would normally be found in either pulp or paper mills." As will be observed from this quotation, your correspondent does not say that any of the bonds were issued for the acquisition of the timber reserves. We think it would be quite improper to capitalize so-called "constructive interest" if the properties were acquired by an issue of capital stock or for cash derived from the sale of capital stock. While there might perhaps be some justification for capitalizing interest paid on interest-bearing obligations issued in payment for reserve properties, it would also be subject to the limitation already mentioned.

The proper accounting treatment of the "fixed charges" will depend largely upon the special circumstances surrounding the particular company, including those arising either from the provisions of the bond indentures or from company's financial policies in the depletion and replacement of properties, sinking funds, dividends, and distributions from depletion reserves.

Answer No. 2: In our opinion it would be permissible from an accounting standpoint to capitalize that portion of interest paid on bonds which is fairly apportionable to the timber holdings held for future requirements, together with taxes assessed upon said holdings, provided, however, that the capitalization of these fixed charges be limited to such a sum as will not result in an abnormal stumpage charge when the timber is ultimately cut.

We would, however, direct the attention of the inquirer to the fact that from the standpoint of federal taxation there is considerable doubt as to whether carrying charges can be capitalized and included in "cost" for purposes of computing depletion and gain or loss on sale of the timber holdings. It would therefore appear to be advisable to deduct in the federal tax return of the corporation owning the excess timber holdings all interest and taxes paid regardless of their treatment in the accounts of the company.

Answer No. 3: We can hardly see any justification for capitalizing any part of the fixed charges for bond interest, taxes, etc. To do so would create a situation that would be highly artificial. On the other hand it would seem to be proper, if desired, to make some statement in the income account that would show to what extent charges against income for bond interest, taxes, etc. represent carrying charges on the non-productive property.

TREATMENT OF TREASURY STOCK ON BALANCE-SHEET

Question: May I obtain, if possible, an idea as to the position that accountants generally are taking as to the treatment of treasury stock in the preparation of balance-sheets at this particular time.

Proposition

X Company purchased approximately 36,000 shares of its own no-par common capital stock of a total of 400,000 shares outstanding, which is listed on the New York stock exchange, during the period from about October 15 to December 15, 1930. This stock has a book value of $37 a share and was purchased at an average cost of $36 a share. The market value of the shares was $19.50 at December 31, 1930, the date of the balance-sheet to be certified. The total cost of the shares purchased amounted to approximately $1,295,000. The total assets of the corporation amounted to approximately $23,500,000.

The corporation has several subsidiaries and the total assets above stated are the consolidated assets. The consolidated surplus at December 31, 1930, was approximately $1,500,000, of which approximately $200,000 was represented by parent company surplus, the balance by surpluses of subsidiaries. The parent corporation is incorporated under the laws of Delaware. The corporation intends to resell the reacquired stock when market conditions warrant.

At what value should the treasury stock be listed in the balance-sheet at December 31, 1930; or how should this item be treated?

Answer No. 1: This question indicates the fallacy of showing treasury stock among the assets of a corporation. The inclusion of this asset in this position at once raises the question as to what value is to be placed upon it, and with depressed security values indicated by the proposition, a factor is brought into the balance-sheet of the corporation which certainly has no place there.

The market value of the shares of stock of corporation X should certainly have no bearing on the presentation of the balance-sheet of that company whether treasury stock is owned or not.

If the treasury stock is to be deducted from the stock issued at par and the net amount of stock outstanding shown, no question is raised as to what value the treasury stock should be given. In the instant case, there will be an adjustment of surplus measured by the difference between the cost of the treasury stock and its par value.

Answer No. 2: We note that the amount of stock involved is substantial and that the stock is one listed on the New York stock exchange. Your correspondent would therefore doubtless be interested in the following extract from a letter addressed by the stock exchange to a corporation, which recently came to our notice:

"During the last fifteen months, problems arising out of reacquisition of their own securities by listed corporations have forced upon the attention of this committee the necessity for the observance of sound accounting practices in connection therewith.

"Approved practice in this respect is set forth in paragraph 48 of pamphlet entitled, *Verification of Financial Statements* (Revised), a method of procedure submitted by the Federal Reserve Board for the consideration of bankers, accountants and others. This reads:

"'When corporations have temporarily invested funds in the purchase of their own stocks and bonds, these securities technically should be deducted from the corporation's outstanding securities. Custom, however, has sanctioned the inclusion of such temporary holdings as investments, but where they are so held, the fact should be clearly indicated on the balance-sheet. Investments of this kind are not usually regarded as current assets.'

"This committee feels that where a corporation has so reacquired any of its securities and desires to set them up on the asset side of its balance-sheet that the number of shares of each class of stock acquired and the par value of bonds acquired should be shown separately upon the balance-sheet and not as a part of current and working assets. The cost of such reacquired securities should also be shown, but may be shown in the aggregate if more than one class of securities has been reacquired."

Supplementing the above, it seems clear that if the stock is to be regarded as an asset, it can only be regarded as an asset to the extent of its market value. We think that the practice of carrying such stock as an asset is fundamentally unsound and that all accountants should insist on full disclosure if it is followed. This seems to us the more necessary because the purchase on the exchanges of a corporation's own stock, with a view to resale at a profit, is itself a transaction of very questionable soundness.

ACCOUNTING FOR BAKERIES

Question: A large bakery contracts, say, during July, 1929, for a supply of flour at a stated price, to be made and stored by the mill and shipped on order of the bakery. Billing is to be made as shipped.

On or about December 20th, the bakery orders a quantity of this flour to be shipped. Shipment is made, and invoice is rendered as of the date of shipment.

The flour is received January 1st and subsequently.

Shipment is made under negotiable bill of lading, sight draft attached, the mill being both consignor and consignee. Upon payment of the draft, the agent bank negotiates the bill of lading to the bakery.

The foregoing are the facts. The following is the question:

Knowing that this flour was "lifted," is it correct to consider the cost of the flour in transit at December 31st to be a direct liability?

Has the auditor the right to influence his December 31st report by knowledge which he acquires after that date?

Answer: With reference to the first question raised, it is our opinion that the liability for flour in transit should be taken up on the books at December 31st, even though the shipment had been made sight draft, bill of lading attached, to the order of the flour mill. The question as to when the title passed is entirely a legal one, and even if we were to assume that title did not pass, legally, until payment was made to the bank, we do not think that the method of payment fixed by contract should in any way alter the situation with respect to the disclosure of a liability such as is described in your letter.

As to the second question, it is our opinion that the auditor has the right to influence his December 31st report by any knowledge acquired after that date which may affect the assets or liabilities of December 31st.