Journal of Accountancy

Volume 52 | Issue 5 Article 8

11-1931

Accounting Questions: Operation of Motion-Picture Equipment, Use of Phrase "Less Reserve for Depreciation", Book Value of No-Par Common Stock

American Institute of Accountants. Bureau of Information

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.]

OPERATION OF MOTION-PICTURE EQUIPMENT

Question: We are handling the audit and tax matters for a motion-picture firm which uses a type 2-SX equipment, designed for use with two simple powers of motiograph projection for film and disc reproduction with non-synchronous attachment.

The taxpayers do not acquire title, but, in lieu thereof, have an agreement of licence under which they are to operate the equipment for a term of ten years. The company installing the equipment requires that a weekly service and inspection charge be paid.

Our clients are of the opinion that before the expiration of the ten years, the probabilities are that the equipment now in use will have to be replaced, and, if that is the case, they will not have had returned to them their original cost.

Will you advise me whether any members of the Institute are handling any cases of this nature, and if so, what rates of depreciation or amortization have been used?

Answer: The matters which I have handled in the motion-picture business have involved depreciation only in a secondary way. In the inquiry, depreciation and its running mate, obsolescence, are of prime importance. From our experience it would seem to be wisest to consider the useful life of the machines as not over eight years, making a write-off of 12½ per cent. annually necessary. In the state of the art, with continual changes probable, it is in fact my opinion that the depreciating-balance method should be used, beginning with a credit to the reserve of 25 per cent. in the first year, and continuing with a credit of 25 per cent. of the resulting balance each year. This would result, unless a hurried calculation misleads me, in the balance at the end of the eighth year being 10 per cent. of the asset, and this could be written off equally in the ninth and tenth years. I am aware that the income-tax bureau does not favor this depreciation method, but it seems to me more than usually necessary in this instance, due to the possibilities of re-possession, the necessity for replacement, reconstructing to take advantage of improvements where possible, and so on.

USE OF PHRASE "LESS RESERVE FOR DEPRECIATION"

Question: Which is the proper expression to use: (1) less reserve for depreciation—or (2) less depreciation provision?

Answer No. 1: If our assumption is correct we prefer to use example (1), "Less reserve for depreciation." This terminology has been generally accepted by the leading practitioners and accounting offices as a proper and appropriate definition of the act of setting aside on the books from earnings or surplus, for future use, sums of money to be used for the renewal or replacement of worn out or obsolete buildings, machinery, equipment, etc. While the application or use of the word "reserve" we think describes the procedure more accurately, we should not say that the description in example (2) would be improper.

Answer No. 2: We restrict the use of the word "provision" to the debit side of the entry, and this term would, accordingly, appear in the profit-and-loss account with respect to depreciation provided during the period. On the other hand, we restrict the use of the word "reserve" to the credit side of the entry, and it is in fact the credit side which appears as a deduction from the asset on the balance-sheet. We decidedly prefer the use of the phrase "less reserve for depreciation" as a deduction from capital assets on the balance-sheet, and confidently believe that this is the consensus of opinion among public accountants.

BOOK VALUE OF NO-PAR COMMON STOCK

Question: A, a sole proprietor, decides to incorporate his business and, upon completion of incorporation, turns over to B, an employee, 200 shares of the no-par common stock of the corporation. Subsequently, for services rendered, A gives B 100 additional shares of no-par common stock, making a total of 300 shares then owned by B. Within a year thereafter, A decides to dispense with B's service. B then orally offers to sell to A's company his 300 shares of common stock. A is not interested in the purchase for the account of his company, stating that his company might be interested after the current month's statement of financial condition has been taken off. Immediately after this statement has been completed, B again approaches A and suggests that A name a price at which the company will buy the stock. A does name a price and B accepts and assigns his stock to the corporation. Two months after the consummation of this transaction, B enters suit against A's company, alleging that he had not received a sufficient consideration for his stock and citing the agreement which, in accordance with the certificate of incorporation, was printed on all certificates of common stock. This agreement reads as follows:

"In case any stockholder of this corporation, his executor, administrator or assignee desires to sell, transfer or otherwise dispose of all or any part of his shares of common stock, he shall first notify the secretary of this corporation in writing, stating the number of shares he desires to sell, transfer or otherwise dispose of, and the name of the person to whom they are to be sold or transferred, and, for a period of thirty days following the receipt of such notice by the secretary, this corporation shall have an option to purchase said shares *at the book value thereof.*

"No shares of common stock of this corporation shall be sold, nor transferred upon the books of this corporation, nor shall any purchaser or assignee thereof have any right to demand and require transfer of any shares of common stock of this corporation, attempted to be sold or transferred to him until after notice given in accordance with the preceding paragraph and until after the expiration of the said period of thirty days, during which this corporation's option thereon is held.

"If the said board of directors do not exercise this option within said period of thirty days, such stockholder may sell and assign the number of shares mentioned in this notice to the person named therein, *but to no other person*."

The point involved in this case is the determining of *what is the book value of the no-par common stock* at the date sold to the company. The plaintiff in the case, B, claims that book value represents the difference between the appraised value of the assets of the corporation, as determined by competent appraisers, and the actual liabilities of the corporation at the date of appraisal. He also contends that the value of goodwill should be included as an intangible asset before computing the book value of common stock, even though no goodwill appears on the books.

Personally I would define book value to mean exactly what the name implies, viz., the value as reflected in the financial records of the corporation, such records having been kept and maintained in accordance with sound accounting principles.

There is no question of misrepresentation of the value of the stock. There is simply an offer to purchase, an acceptance thereof on the part of the seller and the subsequent dissatisfaction of the seller with the price received.

Answer: The agreement embodying this option is printed on the stock certificate "in accordance with the certificate of incorporation"; and if the option is not exercised within thirty days then the transfer shall be made to the person designated but to no other.

B, having sold his shares to the company at an agreed price, is dissatisfied with the amount received and now contends that the book value is represented by "the difference between the appraised value of the assets of the corporation, as determined by competent appraisers, and the actual liabilities of the corporation at the date of appraisal." He also contends "that the value of goodwill should be included as an intangible asset before computing the book value of common stock, even though no goodwill appears on the books."

From the facts submitted it would seem that the stated option is not involved in the purchase and sale of the shares in question: apparently it was a direct purchase by the company at an agreed price. This phase of the question, however, is essentially one for competent legal opinion.

Coming now to "the point involved in the case—the determination of what is the book value of the no-par common stock" it is our opinion that the "book value" within the terms of the related agreement is the value as reflected by the financial records which, the question states, have been kept and maintained in accordance with sound accounting principles. In other words, the accounts being accepted as complete and accurate, as is indicated, the stockholders' total equity consists of the aggregate credit to capital stock together with surplus, and the value of a share is computed on that basis.