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Accounting Questions

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ACCOUNTING FOR DIVIDENDS

Question: I would be obliged if you would obtain for me the proper accounting for dividends received which had been declared prior to the time the stock on which they were declared was purchased.

In other words, if a corporation buys the stock of another corporation or a part of it after a quarterly dividend has been declared, and as a result of the declaration pays a higher price for the stock than it would have paid had the dividend not been declared, should the dividend when received be credited to the cost of the stock or treated as current income from dividends?

Answer No. 1: We understand that the particular case involved is one in which the purchase of stock occurs before the stock sells "ex-dividend" or, if the purchase is made outside an exchange, no suggestion is made that the dividend is being purchased separately.

It is a general practice to consider the entire cost of the stock as an investment and to take up the dividend as income when received, even though the dividend may be paid for as part of the purchase price of the stock. This view is taken by the United States treasury for income-tax purposes, although there is some indication that in a case directly in point the board of tax appeals might adopt the opinion that the dividend in question is a return of capital.

However, the proper accounting practice is to treat any dividend which was declared prior to the purchase of the stock and is payable shortly thereafter as a return of principal rather than income. This practice is in accord with logic as a dividend received would not be an actual "earning" or "income" to the investor when, as a matter of fact, there had been no investment during any substantial period of time antedating the dividend payment.

If the stock is purchased for a stated price and a separate amount is shown as the purchase price of the dividend, then clearly the purchase price of the stock should appear separately in the accounts, and the dividend when received should be credited to the cost of the dividend, with nothing taken up for it in income.

Answer No. 2: It is common practice among stock-exchange houses to credit income account with dividends received on stocks purchased between the date of the dividend declaration and the record or ex-dividend date; dividends on stocks purchased between the ex-dividend date and the date of payment are, of course, received by the seller. In the ordinary case, therefore, the receipt of a quarterly dividend, in circumstances such as these, may be credited to income.

There are many cases, however, when the receipt of a dividend (not necessarily of a liquidating nature) may represent a return of capital to a recent purchaser. Such cases are frequent when control of one company is acquired by another, and the dividend is, in effect, paid out of surplus at acquisition. The circumstances surrounding the acquisition of a substantial block of stock in a company will usually indicate readily whether or not the dividend payment comes within this category, but in cases of this nature the accountant must study the facts carefully before reaching his conclusion.

Answer No. 3: The dividend in question is not income. The amount of it should be credited to the investment if that account has been charged with the full cost of the stock, although a better treatment of the transaction in journal form follows:

On acquisition of stock:		
Dividend receivable......................	$........	
Investment in stock of *Y* Co...............	....	
To cash..............................		$........
On receipt of dividend:		
Cash..................................	$........	
To dividends receivable.................		$........

CLAIM FOR FIRE LOSS

Question: I have been consulted as to whether or not a claim against an insurance company for fire loss can be entered into an account entitled "insurance receivable" or "insurance claims receivable." Are these terms, in your opinion, theoretically correct?

Answer: In our opinion it would be proper to enter such a claim for fire loss in an account entitled either "insurance receivable" or "insurance claims receivable," preferably the latter since the caption is more descriptive.

The status of the claim, however, would have a considerable bearing on the propriety of entering it on the books. If the fire had just occurred and the claim had not been approved by the insurance company the receivable should not be carried on the books. On the other hand, if the claim had been admitted by the insurance company and was merely awaiting the formality of payment, it would be proper to take it up as a receivable and as a current asset. The description of the account is important in clearly disclosing the status of the claim. Until a claim has been recognized, the book loss sustained through fire should be carried in a suspense account, usually entitled "fire-loss account," which would appear in the balance-sheet, among the miscellaneous assets or deferred charges.

COST OF CAPITAL SUPPLIED TO SUBSIDIARIES

Question: A holding company which owns the majority of stock or the controlling interest in several companies operating public utilities provides its constituents with financial, legal, engineering and management services, in return for which its receives a definite percentage of the gross revenue of its operating companies. The magnitude of the operations and the service required by each of the operating companies vary according to the communities served and the services rendered by the holding company. All the operating companies share the management services in a greater or less degree.

The holding company provides the cash funds required annually by each of the operating companies. It finances its own operations through sale of bonds to the public, by loans from bankers and other fiscal sources and by the sale of common stock, the latter frequently at a premium. Bonds have been sold bearing interest at varying rates, not exceeding 5½ per cent. on the nominal value; temporary loans have been raised at generally lower rates and annual dividends of 12 per cent. have been paid on the par value of the common stock.

What should be considered "the cost of capital" supplied to the operating companies in any one year?

Answer No. 1: Assuming that the phrase "cost of capital" is intended to refer to the rate of interest at which subsidiaries should be charged for advances made to them by the holding company throughout a given year, we may say that, in our opinion, where advances made to subsidiaries may be earmarked as representing the proceeds of specific loans, the effective rate of interest payable by the holding company on such loans indicates the cost of the capital and should be charged to the subsidiary. On the other hand, it would seem to us that a reasonable rate of interest, not in excess of the effective rate at which funds might be obtained by the respective subsidiaries in the open market, should be charged in the case of advances made to subsidiaries from the proceeds of sales of common stock or from undistributed profits.

While directly applicable to the capitalizing of interest during construction, the following quotation from the interstate commerce commission's regulations for steam roads, is, we think, pertinent to the present discussion:

> When any bonds, notes, or other evidence of indebtedness are sold, or any interest-bearing debt is incurred . . . the interest accruing on the part of the debt representing the cost of property chargeable to road and equipment accounts (less interest, if any, allowed by depositaries on unexpended balances) . . . and such proportion of the discount and expense on funded debt issued . . . as is equitably assignable . . . may be capitalized. Interest during construction shall include reasonable charges for interest, during the construction period . . . on the carrier's own funds expended for construction purposes.

As to "what should be considered 'the cost' to the holding company of capital supplied to the operating companies in any one year," we do not see that it is possible accurately to determine this in cases wherein such capital represents proceeds from sale of the holding company's common stock and undistributed profits. Any attempt at finding such a cost would necessarily be arbitrary.

Answer No. 2: According to the question the holding company, which provides the cash funds required annually by each of the operating companies, finances its own operations through various sources, namely:

(1) by the sales to the public of bonds bearing interest at varying rates not exceeding 5½ per cent. on the nominal value;
(2) by loans from bankers and other fiscal sources at interest rates generally lower than in (1);
(3) by the sale of common stock, frequently at a premium, annual dividends of 12 per cent. having been paid on the common stock.

The several companies, though separate legal units, comprise, for operating and financial purposes, a composite entity, and the financial requirements of the group are provided out of a common fund. It, therefore, follows that the total cost of capital, the interest, assumed in the first place by the holding company, should be pro-rated to the constituent companies in proportion to the funds used by each of the companies in any year.

In other words, the average rate of interest should be determined on both funded debt and current borrowings and such rate charged on the average balances due from the operating companies, the balance of interest paid being chargeable to the holding company. It does not seem to us that the interest charged by the holding company should be loaded, inasmuch as, apart from other considerations, it undertakes, among other things, to provide financial services for the agreed compensation—though no great objection could be urged against a small increase to the average interest rate mentioned.

Further, the rate of dividends that have been paid on the holding company's common stock is not a factor in the cost of capital. The funds derived from capital stock may be transferred in part to the operating companies but the rate of interest is that at which experience shows the holding company is able to raise funds by the issue of bonds and from current borrowings, as distinct from the rate of income distributed from earnings on proprietors' capital.