Journal of Accountancy

Volume 55 | Issue 3 Article 8

3-1933

Accounting Questions: Treatment of Inventories in Inter-Company Accounts, Capitalization of Bond Discount as Construction Cost

American Institute of Accountants. Bureau of Information

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation

American Institute of Accountants. Bureau of Information (1933) "Accounting Questions: Treatment of Inventories in Inter-Company Accounts, Capitalization of Bond Discount as Construction Cost," *Journal of Accountancy*: Vol. 55 : Iss. 3 , Article 8.
Available at: https://egrove.olemiss.edu/jofa/vol55/iss3/8

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

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.]

TREATMENT OF INVENTORIES IN INTER-COMPANY ACCOUNTS

Question: We find there is a difference of opinion as to the proper treatment of the profit on inventories in consolidated statements when there is a minority interest. We are familiar with the several text-books which treat the subject and with the arguments upon which their several opinions are based. But what we would like to learn is which method is adopted most frequently by accountants who in practice are called upon to handle this question.

The question deals with the following cases, in which a minority interest in the subsidiary is assumed.

A. Inventory in the hands of the subsidiary sold by the holding company.
   Treatment proposed:
   1. Eliminate all the profit against the holding company's surplus.
   2. Eliminate a percentage of profit against the holding company's surplus based on the percentage of subsidiary stock in the holding company's possession.

B. Inventory in the hands of the holding company sold by the subsidiary.
   Treatment proposed:
   1. Eliminate all the profit against the holding company's surplus.
   2. Eliminate all the profit and apply the reduction against the holding company's surplus and the minority interest in amounts proportioned to their respective interests in the subsidiary's surplus.
   3. Eliminate a percentage of profit against the holding company's surplus based on the percentage of subsidiary stock in the holding company's possession.

Answer No. 1: We may say that we have found in each of the two kinds of cases cited that the method most frequently adopted in general practice is to eliminate all the intercompany profit against the holding company's surplus.

Of course, the practice of eliminating all of the unrealized intercompany profit in the cases in question may be criticized on theoretical grounds. However, because of the fact that the accounts of partly owned subsidiary companies are not usually consolidated with the accounts of the parent company, unless the percentage of the minority interest is small, it follows that the amount of intercompany profit in the inventories which would be applicable to such minority interest would also be relatively unimportant.

Answer No. 2: Our policy with respect to the adjustment of inventory valuations of merchandise sold to or purchased from a subsidiary would be to reduce the values of all stocks on hand in the consolidated accounts to either cost or market values, thereby eliminating all inter-company profits, the profit so eliminated to be charged against the parent company's surplus and the inventories correspondingly reduced.

In the consolidated balance-sheet, we would prefer to show under the caption of liabilities, as representing the interests of minority stockholders, such percentage of the capital stock and the subsidiary's surplus as the number of outstanding minority shares represented of the total shares issued by the subsidiary.

We assume that the inter-company billing prices have been made on a reasonably sound basis, not above the realizable prices to customers, and we think in the circumstances the minority stockholders are entitled to their pro-rata share of the surplus indicated on the subsidiary company's books and that this equity should correspond with that shown in the parent company's accounts.

CAPITALIZATION OF BOND DISCOUNT AS CONSTRUCTION COST

Question: A public-utilities corporation undertook the construction of additional facilities for the purpose of effecting greater efficiency and economies in operation. The funds were obtained from temporary loans, the interest being charged to the cost of the project during the period of construction and until the facilities were placed in service. Immediately thereafter it became necessary to re-finance the temporary loans by a bond issue which, owing to the depression in the market, was sold at a discount of 10 per cent. as compared with the usual 5 per cent. under normal conditions. The corporation is of the opinion that the excess of 5 per cent., due to abnormal market conditions, should be capitalized as part of the cost of the project, leaving the residue of 5 per cent. to be amortized over the life of the bonds.

The accountant does not agree and is of the opinion that such treatment is not conservative for the reasons that (1) the cost of the project should include only interest during construction and (2) the project was undertaken with the object of effecting greater economies in operation as reflected in lower operating costs and enhanced net income; consequently, the full discount of 10 per cent., although sustained during a period of depression in the market, is a proper charge to be amortized against the income from operation over the period indicated by the life of the bonds.

Answer No. 1: Utility corporations are usually permitted to capitalize the cost of obtaining money for construction purposes. In the case submitted by your correspondent, however, the whole interest on the temporary loans required for construction purposes was capitalized and therefore it would not

appear proper to capitalize an additional amount of interest. The usual practice would be to amortize the entire discount of 10 per cent. over the life of the bonds. Unless the law and regulations to which the utility in question is subject contain any requirement to the contrary, we think the full discount of 10 per cent. should be amortized over the life of the bonds.

Answer No. 2: We believe that it is difficult, if not impossible, for anyone to state with such exactness that 5 per cent. bond discount is normal and that the remaining 5 per cent. is abnormal. Furthermore, even if 5 per cent. is acknowledged as a normal discount and the remaining 5 per cent. is considered abnormal, such abnormality should not, in our opinion, justify the inclusion of 5 per cent. as a part of the construction cost of the facilities to be amortized or depreciated as a part of such facilities. There is little distinction, so far as the corporation is concerned, between the bond discount and the yearly interest payments on the bonds. Both are cost of money or interest. It follows, therefore, that if the bond issue had been made at the time construction was started, the corporation would have been justified in charging such part of the bond discount amortization as related to the period of construction to the construction cost of the facilities as a part of the interest cost during construction.

The question quoted in your letter does not give the reason or reasons advanced by the corporation in justification of the capitalization of the 5 per cent. bond discount considered as abnormal. Perhaps the reason advanced is that the same conditions which led to an abnormally high bond discount also permitted the corporation to construct the facilities at lower than usual prices. However, this assumption may not be true inasmuch as apparently construction was started without the knowledge that such a discount at 10 per cent. would be required.