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Accounting Questions: Instalment Sales of Securities on Balance-Sheet of Investment Company, Production Costs Where Plant has Been Fully Depreciated, Accounting for Hedging Operations in a Cotton Mill

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Accounting Questions

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INSTALMENT SALES OF SECURITIES ON BALANCE-SHEET OF INVESTMENT COMPANY

Question: We have clients whose business is buying and selling securities. They sold a considerable amount of securities and made an entry charging accounts receivable and crediting security sales. These sales were made on the instalment plan. However, at that time they did not purchase the securities from the syndicate which controls them, nor did they make any commitments of any kind.

At the close of their fiscal year, we find that this security sales account has a credit balance of some $15,000 and as the market has dropped considerably, they could purchase these securities for approximately $5,000, which would leave a profit of $10,000. Bear in mind, however, that they have not purchased these securities and the account as it now stands has a credit balance of $15,000. We would like to know how to handle this item on the balance-sheet.

Answer No. 1: As we understand the question, the company has made short sales of securities. These sales have been made on the instalment plan. Apparently the company's position at the close of the period is that it has instalment accounts receivable of $15,000, less such payments as have been made and has a liability to deliver such securities when paid for by the instalment purchasers.

We believe the corporation's balance-sheet should show the instalment accounts receivable in the usual manner and that on the liability side of the balance-sheet there should be shown an amount of $15,000. It does not appear that any further liability need be shown above the amount of $15,000 at the present time, since the corporation can purchase these securities for less than $15,000. We do not believe that in the circumstances as outlined, the corporation should take up any anticipated profit on the security sales made.

Answer No. 2: It is our opinion that the credit balance of $15,000 should be shown in the balance-sheet, among current liabilities, as follows:

Short sales
(December 31, 1932 (?) market value of securities sold, $5,000)....$15,000

It is also probable, because of the drop in the value of the securities, that a pertinent comment might be necessary with respect to instalment accounts receivable.

PRODUCTION COSTS WHERE PLANT HAS BEEN FULLY DEPRECIATED

Question: In the national recovery act a group of manufacturers may establish a code rule that no member shall sell below cost of reproduction. It transpires that one member of the group has in past years fully depreciated his plant and, therefore, is not now charging depreciation. The question is: Will its costs without the item of depreciation be comparable to the costs of other members of the group, which are properly charging depreciation?

Answer No. 1: Obviously costs of production without an item for depreciation would not be comparable with the costs of other members of the group. Depreciation, through wear and tear, and obsolescence continue uninterruptedly, irrespective of the clerical act of ceasing to retain a value for the plant account upon the company's books.

The mere fact that a concern has fully depreciated its plant in past years and is not therefore charging depreciation as part of its cost of production does not furnish a valid reason for the exclusion of that cost factor. To produce goods the concern must have a plant in operating condition, consequently a proper charge for the use of the plant as part of the cost of production is necessary in order to obtain true costs.

However, in computing a cost of production which may be comparable upon a fair and equitable basis with other members of the group, care should be taken to see that the concern which has fully depreciated its plant in past years is not overburdened with maintenance and repairs. It is frequently found that where a plant has been written off a concern's books, items such as new machinery, which should be charged to plant account and extraordinary repairs which might be charged to reserve for depreciation, in ordinary circumstances, are in fact now being charged to operating expenses.

Answer No. 2: It is possible that although depreciation does not appear in the cost under that title it still might be represented by large charges for repairs or renewals which in effect might be additions to plant, charged off currently. This practice defeats the purpose of depreciation in that in place of a more or less uniform rate of expense to cover depreciation the expense occurs spasmodically, controlled by the physical necessity of alteration or improvement of the plant.

A fully depreciated plant which is still efficiently producing indicates two things: that depreciation has been improperly estimated and prior years overburdened with this overestimated expense and that current additions to plant (which almost any progressive business requires) are being treated in some unorthodox manner. If costs are used for technical and statistical information, conservative overestimates are as bad as underestimates. Occasional revision of depreciation rates to reflect the current circumstances would prevent full depreciation before the useful life of the plant had come to an end.

Should the balance-sheet show a fully depreciated plant this need not preclude taking depreciation as an element of cost in the income account. The net income carried to surplus could be entitled, "Net income after depreciation" and a surplus adjustment would be shown, "Reverse depreciation suffered in this operating period and reflected in income but already charged off in prior periods."

This question leads one to wonder what is the purpose of requiring that no manufacturers may sell below cost of reproduction. Is the purpose to limit each producer to produce only that which he can sell without loss or is the purpose to establish a minimum selling price based on representative costs of the producing group? In both cases costs and their calculation are important; however, should the manufacturer's costs be considered in relation to his own case alone and not compared with or related to the costs of other manufacturers, the need for very specific instructions and regulations as to what these costs should include would be imperative.

The question does not indicate whether the industry under consideration is one that obtains its cost by spreading the total expense over the total units produced (thus getting a unit cost of production where only a few important products are involved) or an industry that has such a diversity of related or unrelated products that the only feasible costs must be built up on a unit basis (with little relation to the total expenditure in that the aim is not to distribute every dollar of expense to some product but to estimate a standard cost).

Should the break-down method of cost be used, the costs on those products where few by-products were involved and where few processes and little overhead was arbitrarily split might be comparable. However, if built-up costs are involved it will, by giving prominence and general consideration to this type of costs, undoubtedly be helpful in the present development of cost accounting, but the great differences of methods and opinions will make the fixing of instructions and regulations extremely difficult.

ACCOUNTING FOR HEDGING OPERATIONS IN A COTTON MILL

Question: In order to protect their position in the cotton market, both with respect to inventory and future requirements, it is the practice of the mills to "hedge" by placing commitments for the purchase or sale of cotton futures. It is understood that the usual practice is to treat the profits and losses at the closing of the future contracts as an adjustment of the cotton-purchase account, thus in effect applying these figures to the cost of sales and inventory remaining at the balance-sheet date. I shall appreciate advice as to whether or not this is the usual practice and, if so, if there is a known method of determining whether or not these operations are for the protection of the firm's position in the cotton market or for purely speculative purposes. It would appear that such transactions carried on for the latter purpose should be treated as other income charges or credits.

With respect to these operations, deposits are made with brokers on account of the future commitments, these balances representing margin deposits only, as neither the brokers' nor the mills' accounts usually show the total purchase or sale price under the future commitments. It appears that in any event the deposits with brokers or their deposits with the mills should be shown as separate items on the balance-sheet. If the present market quotation with respect to future commitments is less than the contract price, it would appear that in stating the deposits with the brokers some description should be made to indicate the loss in these contracts. The question has arisen as to whether or not any notation is necessary on the balance-sheet if future commitments at the balance-sheet date show a profit. In other words, I am interested in knowing what treatment should be accorded items having to do with future commitments both on the balance-sheet and the income statement, either in the case of a favorable or unfavorable position at the balance-sheet date.

Answer No. 1: The hedging operations referred to are quite common among cotton mills and customers fabricating articles in which cotton is a basic factor. It is proper, in our opinion, to absorb the profits or losses arising from these transactions in the purchases or cost of sales accounts so long as the contracts made are intended to cover normal production requirements. It is frequently difficult, however, if not impossible, to determine what constitutes normality or actual requirements because of subsequent changes in customers' specifications. A review of the production schedule with the sales budget should disclose whether speculative contracts are being made or not.

Where purely speculative contracts are entered into without regard to inventory or customers' needs, there is no doubt the results of these transactions should be set up separately in the profit-and-loss account under "Other income" or "Other deductions."

Margins with brokers or deposits with mills against futures should be set up in the balance-sheet as a separate item or under "Other accounts receivable" so as to be kept separate and distinct from the trade receivables, especially if the cotton operations at the date of the balance-sheet show a profit.

If, however, the net contract prices of futures show a loss as compared with market prices, the margins or deposits may be applied as an offset. To cover such a situation, we recommend setting up under liabilities a special item somewhat as follows:

"Reserve for losses (to cover the excess of contract prices over market prices at ———— 193) on raw materials for future delivery (less margin deposits)."

Or the amount may be stated at the gross figure with the foregoing words in parenthesis omitted.

Profits on contracts for future delivery should not be reflected in the accounts, and if a company wishes to give publicity to such a statement of affairs the proper place for such information is in the president's letter accompanying the accounts.

Answer No. 2: (a) *Re* paragraph 1: The profit or loss on hedging should be a part of the cost of sales.

We do not know of any method of determining whether or not a future transaction is a hedge or a speculation other than to ascertain the conditions prevailing when the transaction occurred. For instance, if a mill is overstocked in view of probable sales within a reasonable period, the sale of a future would reduce the long position and would therefore be a cost-of-sale item. The results of the ordinary hedge (such as buying futures upon receipt of sales orders for later production) should also be included in cost of sales.

The purchase of futures in anticipation of orders would be a speculation, inasmuch as it can not be determined, at that time, whether or not the price will be less when the order is received than the cost of the future.

(b) *Re* paragraph 2: Deposits with brokers should be shown as a separate item, with explanations as to the amounts involved.

If the future commitments indicate a loss at the balance-sheet date, the amount of the loss should be indicated or, preferably, a reserve should be provided. If the future commitments indicate a profit, a notation of the amount might be made, but conservative practice would preclude the inclusion of such "profit" in current income.