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Accounting Questions: Profits on Sales of Securities, Accounting for Credit from Forgiveness of Debt, Interest Paid on Bonds or Notes as Cost of Inventory

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Accounting Questions

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PROFITS ON SALES OF SECURITIES

Question: A corporation has sold securities and has shown a profit on these sales based upon the fact that it has identified certain securities as being the ones most recently purchased. On the basis of the actual facts, a profit is shown. If the average price of the securities in the portfolio had been used, however, the sale of the securities by the corporation would have shown a loss. My problem is to determine the correct accounting principle irrespective of the fact that the corporation sold securities identified as the most recently purchased, which cost, in this case, decidedly less than the average price of the security.

Answer No. 1: In our opinion the cost of sales of securities by the ordinary mercantile corporation should be based on the average cumulative cost of acquiring such securities. It would seem to us that the same principles of accounting would apply in the case of security acquisitions as are involved in the purchase of raw and other materials. While a corporation would have a perfect right to assume that securities sold have been disposed of in the order in which they have been purchased, thereby entitling them to use the same relative cost prices, it is recognized as a practical matter that when securities are accumulated at prices below those shown in respect of earlier acquisitions, the purpose of such later acquisitions is to reduce the average cost of the whole. It would seem illogical, therefore, as well as improper, to apply against the sales of securities the cost prices applicable to the shares most recently acquired.

In the case of investment trusts or corporations engaged primarily in the purchase and sale of securities, the above procedure might not be applicable. It would be necessary to know in precise detail the operating policies of such companies so far as they relate to dealings for or on behalf of clients.

In replying as above to your inquiry, we should like to point out, also, that when looked at from an income-tax standpoint an entirely different method of procedure might be justifiable or advisable.

Answer No. 2: Shares in a corporation represent ownership of a certain percentage of such corporation.

Acquisition of additional shares increases the proportion of the corporation owned and the total cost of such proportion.

Sale of some part of ownership necessitates a proportionate reduction in the cost.

It is our opinion, therefore, that correctly to account for the profit upon a sale of securities from a portfolio (it would seem of an investment trust) the cost of the securities sold should be the average cost of all such securities held and not the cost of the particular shares represented by the certificates delivered.

Should the accounting corporation insist on using the particular cost method in the accounts which it compiles, we conceive it to be the duty of the auditor to require the method of accounting to be stated in the accounts and make his report subject to such method, or he should include in his report a statement of the method and take exception to it.

ACCOUNTING FOR CREDIT FROM FORGIVENESS OF DEBT

Question: A corporation enters into a composition settlement with its creditors whereby it settles with cash and notes for fifty cents on the dollar.

This settlement represents obligations arising out of purchase of merchandise, borrowing of money and sundry expense items? The merchandise and expense items accrued both in the current and prior profit-and-loss period.

How should the amount of the forgiven debt be expressed with reference to the current profit-and-loss and to the surplus accounts? With respect to adjustments made in the surplus account should this appear as earned or special surplus?

Answer No. 1: It would seem obvious that any credit arising from such a transaction could have no relation to current profit-and-loss and it would also seem rather doubtful as an item of earned surplus available for dividends. What has happened is, in effect, not unlike the procedure so frequently met in the case of mining companies where capital stock is issued for mining claims or other property and a large part of such stock is donated to the company's treasury to be resold as a means of obtaining working capital. In this case the creditors make a donation of half their claims to enable the company to pay the other half and to save expenses of administration in receivership or bankruptcy. This, I would say, is the only legal motive for entering into such a settlement, and we must assume that the creditors are all acting legally. The credit, therefore, is a donated or capital surplus.

If the company has an earned surplus, which of course is unlikely, if a composition on a 50 per cent. basis is acceptable to creditors, the credit arising from the forgiveness of the debt should be kept as a separate item. If it were treated as earned surplus it would certainly be odd, to say the least, to see the payment of a dividend to stockholders taking place on the strength of a surplus donated by creditors. This condition, of course, is most unlikely to happen and would tend to indicate that the settlement was not made in good faith.

If the company has no earned surplus or a substantial deficit, which is probably the situation most likely to be found in such a case, there is some question as to whether it might be correct to apply so much of the surplus to the operating deficit as would extinguish it. In no case could any excess of this donated surplus over the operating deficit be considered as available for dividends. However, as the object of the composition is to allow the concern to continue in business and to start off with a clean slate, there is, I think, some ground for holding that the credit arising from the forgiveness of the amounts due creditors could be applied to the accumulated deficit to the extent required to extinguish such deficit.

I think it would be well to point out to your correspondent the rather unsavory implications of treating what is in effect surplus donated by creditors in such a manner as to make it available in any way or at any time for dividends to stockholders. This, I think, is particularly important as there is probably every reason to assume that some of the creditors agreeing to the composition settlement would, in all probability, continue to do business with the company after the settlement was carried out.

Answer No. 2: In our opinion, the difference between the corporation's liabilities and the amount of settlement represents an item of income of such extraordinary character that it should not appear in the current income account. However, we believe it should be credited to earned surplus or as an offset against the accumulated operating deficit account if the corporation had no net amount of earned surplus. Our opinion would be the same with regard to liabilities incurred during the period in which the composition settlement was made.

INTEREST PAID ON BONDS OR NOTES AS COST OF INVENTORY

Question: Why should not interest actually paid on bonds or notes be included in cost of inventory on the balance-sheet? (This has to do with the paragraph on page 10 of the *Verification of Financial Statements* which reads as follows: "That no selling expenses, interest charges, or administrative expenses are included in the factory overhead cost.")

Answer: Interest actually paid on bonds or notes is not to be included in cost of inventory on the balance-sheet because it forms no part of the cost of the inventory of goods. Of course, if interest on notes has been paid in advance, the unexpired portion of such interest may properly be included in the inventory.

The question infers that the inventory referred to is an inventory of goods. Interest on borrowed capital does not form a part of the cost of goods at any time. Some accountants try to include return on the investment as part of the cost of producing goods, but authorities generally agree that return on investment forms no part of the cost of the production and is calculated as part of the profit to be made, rather than a part of the cost.