Journal of Accountancy

Volume 59 | Issue 3 Article 10

3-1935

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American Institute of Accountants. Bureau of Information

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Recommended Citation

American Institute of Accountants. Bureau of Information (1935) "Accounting Questions: Disposition of Excess Credit from Sale of Stock, Notation of Endorsement of Notes on Balance-Sheet," *Journal of Accountancy*: Vol. 59 : Iss. 3 , Article 10.
Available at: https://egrove.olemiss.edu/jofa/vol59/iss3/10

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Accounting Questions

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DISPOSITION OF EXCESS CREDIT FROM SALE OF STOCK

Question: We propose to acquire the consent of our stockholders for reducing the authorized no-par shares to the extent of our treasury stock on hand.

We are incorporated under the laws of New Jersey and I am informed that it is compulsory under the law that when stock is legally cancelled the capital stock account must be reduced by the original amount set up as a credit when such stock was issued for value received.

Our treasury stock was purchased at a price somewhat below the amount we received when originally issued; and practically my whole question is the disposition of this excess credit figure on deleting our treasury stock account carried at cost.

It is understood that there is, of course, only one account to which this excess credit can be placed, viz., surplus. But is it an earned surplus available for dividends or must it remain as a capital surplus comparable to paid-in surplus?

It has been my understanding that the sale of treasury stock would create either a profit or a loss affecting the earned surplus of a corporation, and it might seem that a similar profit or loss would be created on a legal reduction of the authorized capital stock via cancelling and deleting the treasury stock owned from our assets.

Answer No. 1: We would state that the well recognized accounting rule is to credit capital surplus, and not earned surplus available for dividends, with the excess of the par, or original issue price, over the cost of capital stock purchased and cancelled. "Profit and loss" arising from the sale of treasury stock is similarly treated; namely, credited or charged to capital surplus and not to earned surplus available for dividends. This rule is based upon the principle that it is not the business of a corporation to deal in its own shares.

Answer No. 2: In our opinion, this difference should be credited to capital surplus and not to earned surplus. We do not believe the situation with respect to profit or loss upon sale of treasury stock is the same as the situation with respect to the purchase and cancellation of treasury stock.

The question as to the availability of the difference between cost and original issue price of treasury stock for the payment of dividends is a legal one, the answer to which depends largely upon the laws of the state involved.

NOTATION OF ENDORSEMENT OF NOTES ON BALANCE-SHEET

Question: The A corporation issued its note payable for $7,500 to the D national bank. The president of the A corporation, at the solicitation of the bank, personally endorsed the A corporation's note. The board of directors of the A corporation authorized the corporation to turn over to the president certain notes receivable of the A corporation amounting to $20,000. These notes are to be held by the president to protect him in the case of liability arising from the note endorsement. The question is: Should the balance-sheet of the corporation indicate that the note payable is secured by the president's endorsement or will it be satisfactory to have the balance-sheet set up as follows:

Notes receivable—Pledged to secure payment of note payable contra	$20,000
Notes payable: To bank—Secured by pledge of $20,000 of notes receivable per contra	7,500

Answer No. 1: We think that the items in question should not be set up as in the question but as follows:

Notes receivable—Pledged with endorser of note payable, contra	$20,000
Note payable: To bank—See notes receivable, contra, pledged to secure endorser of this note	7,500

There is no need to disclose the identity of the endorser, nor is it usually necessary to disclose even the fact that the note is endorsed. It is the manner in which the assets of the corporation were pledged that requires the notation of the endorsement on the balance-sheet. From the set-up suggested in the question, it is fair to assume that the collateral was pledged with the bank, which is not the case.

The set-up suggested in the question is probably sufficient disclosure for all practical purposes where the integrity of the holder of the collateral is above question.

Answer No. 2: The treatment suggested in the text of the question appears to us to be misleading. A person reading the balance-sheet set up in the suggested fashion would be led to believe that the notes receivable were pledged to and held by the bank, which, of course, is not in accord with the facts.

As an alternative we suggest the following treatment:

Notes receivable—pledged with officer as endorser of note payable, contra	$20,000
Notes payable to bank	7,500

DEPRECIATION OF PLANT AND EQUIPMENT

Question: The state tax department seems to take the stand that fixed assets can not be depreciated beyond 50 per cent. of their book value and still be usable in a business, and for that reason has questioned several such assets that we have depreciated beyond the 50 per cent. figure. It is a question of obsolescence with us, inasmuch as numerous machines have been superseded by

others, and in arriving at their valuation we have set up an additional reserve to take care of that condition.

Answer No. 1: As to the depreciation question, we know of no state tax department ruling to the effect that depreciation is not properly allowable where a plant as a whole has been depreciated beyond 50 per cent and is still usable in a business. We think there is some confusion of thought between what may be termed to be the engineering conception of plant efficiency as affected by depreciation and the necessity for providing depreciation in the accounts. While it may be true that certain plants may not be efficiently operated if they are, say, 50 per cent. depreciated, at the same time it is widely recognized that many classes of assets continue to depreciate irrespective of the amounts expended for repairs, and it is further recognized as sound accounting policy to provide in each year's accounts for the exhaustion of the investment in depreciable property.

We think that most of the states that impose an income tax or a franchise tax based on income follow the bureau of internal revenue's interpretation of the income tax law with respect to depreciation as well as in many other respects. It will be of interest to note that the federal income-tax regulations and bulletin "F" clearly set forth that allowance for depreciation should be made each year for the purpose of recovering the investment in the property; furthermore, the bureau is quite definite in stating its preference for accounting for the depreciation allowance by items or groups of items, apparently irrespective of the state of efficiency or the depreciation of the plant as a whole.