Accounting Questions

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REPURCHASE OF STOCK FROM STOCKHOLDERS

Question: A corporation is chartered under the laws of New Jersey, but is located and doing business in Pennsylvania. The authorized capital is 500 shares of common stock at a par value of $100, all of which were issued.

Under a written agreement the company will purchase from any stockholder his share or shares if he desires to divorce himself from the business. The company agrees to pay an amount equal to the book value of such share or shares at the closing date of the prior fiscal period.

Since the date of organization the company has purchased, at various times, in various lots, 551 shares for an aggregate amount of $288,173.28 and resold 111 shares for an aggregate of $33,235.19. The remaining 440 shares not resold by the company are represented by a net cost of $254,938.09 or $210,938.09 in excess of par value. At the last fiscal closing of the books there were outstanding 60 shares or $6,000 and a surplus of $87,280.21.

What is the value per share of the capital stock at the last fiscal closing?

How shall the 440 shares remaining not resold be shown on a balance-sheet and at what value?

Should the company have issued stock certificates to itself when the shares were purchased or merely retired the shares?

Answer No. 1: It is difficult from the question to determine whether the amount described as surplus, $87,280.21, is surplus after charging excess of cost over par value of treasury stock or not. If this represents earned surplus and if treasury stock is carried as an asset, the balance-sheet would look something like this:

Capital stock—authorized and issued—500 shares of $100 par value each	$ 50,000.00

Surplus—earned	87,280.21
Excess of liabilities over assets	117,658.88
Cost of treasury stock	$254,938.09

If this is the situation, the corporation has obviously been paying more for reacquired stock than it was worth, and the 60 shares still outstanding not only have no value, but the directors and officers may be liable to stockholders and creditors for getting the company into such a state. This is the situation which seems to be presented, as it is stated that the stock is represented by a net cost of $254,938.09.

It is hardly reasonable to think that if the excess of cost over par of treasury stock had been charged to surplus the inquirer would have stated that the treasury stock is "represented by a net cost." On this basis the answer to question No. 1 is "none." The answer to question No. 2 is: The difference between cost or par should be shown as a deficit arising from excess of cost of treasury stock over par. In answer to question No. 3, the company could not retire the stock without action by the stockholders followed by the necessary legal procedure to reduce the company's authorized capital. Whether or not the company issues certificates to itself is not material. I see no value in it even for purposes of record.

If this interpretation of the situation is correct, the directors and officers of the company would do well to consider their position in regard to creditors and stockholders and it would seem to be prudent to get legal advice on this without delay.

If we assume that the surplus is earned surplus remaining after charging cost of treasury stock over par, the company's balance-sheet would look somewhat as follows:

Capital stock:			
Authorized	$50,000		
Held in treasury	44,000		
Issued			$ 6,000.00
Surplus—earned		$298,218.30	
Less: Cost of treasury stock over par		210,938.09	87,280.21
Excess of assets over liabilities			$93,280.21
Value per share			$ 1,554.67

The foregoing gives the answer to questions Nos. 1 and 2, and the answer to question No. 3 would be the same as above.

While the second solution does not conform to the wording of the inquiry so closely, it seems more reasonable and in accordance with what the facts probably are.

EXCHANGE OF MORTGAGE FOR H. O. L. C. BONDS

Question: A fiduciary trust had a mortgage, past due, of $5,000 with accumulated interest of $600.

The trust received in exchange $5,150 face value of H. O. L. C. bonds. The trust credited $5,000 to principal and $150 to interest.

The bonds were sold shortly afterwards for, approximately, 95.

The trust wishes to distribute $142.50 to the beneficiaries as interest, this amount being the net proceeds of the $150 face value of bonds considered by them as interest income.

It is my opinion that the entire net proceeds from the sale of H. O. L. C. bonds, or $4,892.50, should be credited to principal, because this amount is less than the cost of the original mortgage of $5,000 for which the H. O. L. C. bonds were received.

Answer: It is our opinion that the trust may properly make the proposed distribution as income.

No doubt the treatment affords room for debate, but from the facts submitted it seems to us that a reasonable interpretation of the transactions is that, the original mortgage of $5,000 having been replaced by H. O. L. C. bonds, the loss on sale of such bonds is a loss of capital. In other words, when $5,000 H. O. L. C. bonds were received in exchange for a $5,000 mortgage there was a substitution of security but no impairment of principal: the loss of capital resulted from the subsequent sale of the bonds then forming the principal.

On the other hand, the proceeds of $150 H. O. L. C. bonds received in payment of interest continues to be income, the amount of which does not fall to be applied against the loss of principal.

The contra view, disregarding a completed exchange of securities, rests on the premise that any impairment of principal relates back to the original security. That premise, it seems to us, is not sustained by the facts submitted or by the attendant circumstances.

BASIS FOR COMPUTING DEPRECIATION

Question: Should depreciation be computed on the basis of utilization instead of time? Please will you tell me in what degree the public accountants permit such a depreciation policy.

Answer No. 1: It seems to us that there is no novel principle projected and that, despite the apparent misconception there is at bottom merely a change of terminology with no change of meaning. "Utilization," as the basis of the charge for plant facilities consumed in production, is really the application of the so-called production method of computing depreciation—that method, namely, whereby the life of the instrument of production is estimated in terms of units of product, the depreciation per unit being thus determined.

If, then, the public accountant is satisfied that, however computed, the provision for depreciation is adequate he may with propriety approve. To this we may add without irrelevance that functional depreciation may be an important element no less than the physical depreciation.

Answer No. 2: Schemes of depreciation under which charges vary with production are common and may be regarded theoretically as one degree more scientific than those based on lapse of time alone. Under such schemes the effect on the income account is to provide more for depreciation in times of prosperity than in unprosperous times. In pure theory, the propriety of this policy is justified, but it is hardly practicable to estimate the proportions of periods of prosperous times and unprosperous times during the useful life of property.

It is well known that depreciation goes on even though the machinery is idle, and it might well be that the depreciation in some cases is actually greater when the machinery is idle than when it is being used. This factor may well be ignored in a rigid scheme of providing for depreciation on the production basis alone. If so, owing particularly to protracted periods of relatively low production, there is the danger of failing to accumulate from earnings in the required time the funds needed to replace the machinery when it is exhausted or rendered obsolete. It has been our experience that corporations that have used this basis in providing for depreciation both in times of prosperity and unprosperous times are mindful of its dangers and have consistently followed the practice of keeping the annual provisions, as a whole, within a reasonable proportion of the amounts required on the basis of lapse of time and taking into consideration the factor of obsolescence.