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Accounting Questions: Operating Deficit on Balance-Sheet, Treatment of Call Premium Upon Exchange of Bonds

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Accounting Questions

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OPERATING DEFICIT ON BALANCE-SHEET

Question: At December 31, 1932, a corporation had an operating deficit of $75,000.

On January 1, 1933, the capital stock, having a par value outstanding of $400,000, was reduced to $200,000 by consent of all the stockholders.

As a result of this authorized reduction of the par value of the outstanding capital stock, on January 1, 1933, capital stock outstanding was charged and capital surplus was credited by $200,000. Also, capital surplus was charged and operating deficit was credited by $75,000.

Immediately after these entries on January 1, 1933, the balance in capital surplus became $125,000, and the operating deficit was cancelled.

Since January 1, 1933, and up to December 31, 1934, the company's net earnings from operations, less dividends paid, have been $50,000.

It is proposed that the balance-sheet show the following items, at December 31, 1934:

Capital surplus (arising from authorized reduction of capital stock on January 1, 1933)	125,000
Surplus (earned since January 1, 1933)	50,000

It is not proposed that the balance-sheet make any reference to the operating deficit which existed at December 31, 1932 (in amount $75,000). But, the balance-sheet will form part of an audit report, and in a subsequent schedule of surplus attached to and forming part of that report, a complete and detailed analysis of the changes in both surplus accounts for the past five years will be stated, and the full facts relating to the operating deficit at December 31, 1932 will be disclosed.

In *Financial Examinations*, page 183, I note that "upon re-organization and by vote of stockholders, capital surplus may be used to absorb a deficit, a net balance being carried forward as capital surplus."

I also note from *Accountants Handbook*, page 966, that "earned surplus accumulates from the date of incorporation or from the date of a recapitalization when a deficit is absorbed by the authorized reduction of the par value of the outstanding capital stock."

If separate certified balance-sheets are requested by the client, to be circulated detached from the complete report of audit, such separate balance-sheets will appear as proposed above, but will be certified "Subject to the qualifications stated in complete report of audit."

It is requested that I be advised whether or not the treatment described above fulfils the necessary requirements of good accounting and of good ethics, or, whether the balance-sheet proper should mention the operating deficit which existed at December 31, 1932.

Answer No. 1: In reply to your inquiry, I would say that the inquirer had done everything necessary when he segregated the capital surplus arising from reduction of capital stock from surplus earned since the date of reorganization. By doing this, the reader of the balance-sheet is put on notice that there was a reorganization and that since the reorganization the company had operated profitably.

If balance-sheets only are to be circulated by the client of the inquirer, it would not be necessary to give an analytical surplus account arranged in chronological order. If income accounts are to be given, the most recent ones would probably be the most significant. If the only qualification in the complete report is that with reference to surplus on reorganization, I do not think that it is necessary to qualify the balance-sheet which is to be circulated independently of the report, as the segregation of surplus gives all the information ordinarily required, and the reader of the balance-sheet will naturally assume that one of the purposes of the reorganization was to do away with a deficit. In other words, the significant factors are net assets and earning power, and the wiping out of a previous deficit has little to do with either of these.

The inquirer appears to be a capable and very conscientious practitioner but I think in this case he is proposing to go a little further than is necessary.

Answer No. 2: We do not approve of the proposed set-up of the balance-sheet in the form indicated for the reason that a definite and complete statement is proposed in the balance-sheet by the inquirer that the capital surplus had arisen from an authorization of a reduction of capital stock on January 1, 1933. Obviously, if the operating deficit of $75,000 is absorbed by the actual capital reduction of $200,000, leaving only $125,000, the balance-sheet narrative attached to the capital surplus is incorrect and liable to mislead one not skilled in the interpretation of accounts.

In our opinion the narrative referred to should be corrected to read, "Arising from authorized reduction of capital stock on January 1, 1933, less operating deficit to that date of $75,000," or, as an alternative, a footnote in somewhat similar language should be made on the balance-sheet, related to the surplus account either by an asterisk or some other symbol of identification. A notation of this character could be no more objectionable to a client than the inquirer's proposal to add the footnote, "Subject to the qualifications stated in the complete report of audit." Both notations at the foot of the balance-sheet are permissible under good accounting practice and there can then be no question of ethics involved.

INCLUSION OF ACCOUNTS RECEIVABLE IN CURRENT ASSETS

Question: A wholesale concern has a customer who buys the greater portion of his merchandise from this wholesale concern, and for several years the account has shown a balance at the end of the year of approximately $25,000. The purchases during the year aggregate more than the balance shown by the account at the close of the year.

About two years ago, the retailer made definite arrangements with his creditors whereby the three largest creditors, including the wholesale concern, agreed to defer collection of their accounts for a period of twenty months to permit the retailer to clear up all the smaller creditors on the basis of 5% to be paid each month, so at the end of the twenty months the only creditors of the retailer would be the three largest, including the wholesale concern. The twenty months' period has now expired, and the wholesaler will begin receiving payments on the old balance in addition to the current purchases.

In making a balance-sheet for the year in which this arrangement was made I insisted that the account was not current and should be included in other assets. The client strenuously objected to this arrangement. His argument is that the retailer makes purchases during the year exceeding the amount of the balance at the close of the prior year, for which he pays cash, and therefore one could consider the payments as applying to the old balance which would make the account collectible within a period of twelve months and that the account was a current asset.

This account amounts to about 16% of the total accounts receivable.

The question is whether or not I am too technical in this particular case and whether the account could with propriety be included among the current assets.

Answer: It seems to us that on the basis of the facts set forth in your letter, the inquirer's position is entirely correct and not at all too technical in holding that the accounts receivable in question should not be included in current assets. It had been definitely agreed to postpone collection on these specific accounts until after the expiration of twenty months and they could, therefore, not be classified as current. The argument that because current annual purchases, paid currently, exceeded the deferred balance, the old account could be included in current assets does not hold good, since it disregards the agreement which would prevent applying the current payments to the old account. It is, of course, true that the wholesale concern will collect during the subsequent year an amount equal to the accounts-receivable balance outstanding, but it is also true that part of these collections would be realized from sales in the subsequent year.

TREATMENT OF CALL PREMIUM UPON EXCHANGE OF BONDS

Question: Bonds are to be called at 110 in exchange for new bonds having a different maturity date and also a different interest rate.

What treatment should be given on the books of account to this premium of 10 points to be paid on the old bonds at call?

Answer No. 1: The 10-points premium paid on the call, with the unamortized discount on the old bonds, should be charged to earned surplus or, as an alternative, to current profit-and-loss as an extraordinary charge.

If the company desires to charge these amounts against capital surplus, such charge may be made only upon vote of the stockholders, inasmuch as the stockholders created the capital surplus by their vote.

The 10-points premium paid on the call, with the unamortized discount on the old bonds, should not be considered as a deferred charge to be written off during the term of the new bonds.

Answer No. 2: The economic justification for such an exchange must be found in the assumption that the annual fixed charges incident to indebtedness would have been greater on the old basis than on the new. The question expressly states that the transaction involves an exchange of bonds, thereby eliminating any doubt that the transactions were definitely related and may not be considered distinct transactions.

The issuance of the new bonds involves the substitution of a new contract, and any expenses incident to the negotiation of such new contract are a cost of the new issue. In our opinion, therefore, the premium to be paid upon the call of the old issue becomes an expense of the new issue, to be amortized over the life of such new issue; the debt service on the new basis comprises both the interest at the adjusted annual rate and the amortization of the deferred charge.

Answer No. 3: We assume that both the change of maturity date and interest rate are advantageous to the issuer of the securities and, such being the case, we believe it fair to consider that the premium paid is part of the cost of the new loan and it would be proper in our opinion to amortize the amount of the premium over the life of the new bonds.