Accounting Treatment of Securities (Retirable) Discount and Expense

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This paper will be limited to the discount and expenses arising in connection with the sale of bond issues and preferred stock issues to the investing public. To avoid confusion the comments will be limited to retirable securities as distinguished from non-retirable securities.

The items coming under the caption of discount and expense are well known. By the term "discount" is meant the excess of the par value of the securities issued over the actual cash value of the consideration received for such securities. By the term "expense" is meant all costs in connection with the issue and initial sale of the securities, such as fees for drafting the documents, filing fees, cost of printing securities, commissions paid brokers for marketing the securities, etc.

Assuming that the items to be included under the heading of discount and expense have been satisfactorily arrived at, the question arises as to what disposition should be made of the total, first, in the case of debt issues and, second, in the case of preferred stock issues. I shall also assume that we are not limited by any regulatory commissions or inherited opinions, but that the questions arising are to be considered de novo. For the purpose of arriving at sound conclusions the first step is to review the various cases which may arise; the second step is to formulate the principles to be followed. I shall take the easier problem first; namely, debt issues.

CASE 1

Facts: "X" Electric Company, on April 1st, borrowed $100,000 from the First National Bank for 60 days at 6%, no commission. The interest for the 60 days was $1,000. The bank deducted it from the loan and credited the company with $99,000.

Question: How should the discount of $1,000 have been dealt with in the monthly statements?

Answer: The answer to this problem is to set up a prepaid expense as of April 1st, and charge off one half thereof, or $500

*An address delivered before the accounting section of the National Electric Light Association at Atlantic City, June 5, 1928.

against April, and the remaining 50% against May. The reason for this procedure is that each month had equal use of the funds and therefore should bear equally the expense of obtaining the use of the funds.

CASE 2

Facts: To meet the notes coming due "X" Electric Company on June 1st sells $100,000, 5%, one-year notes to its bankers at 95½, interest payable semi-annually.

Question: How should the $4,500 commission to the bankers be dealt with in the monthly statements?

Answer: Following the reasoning in case 1, the answer to this problem is to set up a prepaid expense of $4,500 as of June 1st, and write off 1/12 thereof, or $375, against each of the twelve months commencing June 1st.

CASE 3

Facts: Assume that in case 2 the expenses arising from the issue, such as legal opinion, printing the notes, etc., aggregated $1,200.

Question: What disposition should be made of these expenses?

Answer: While these items are frequently charged off when the bills are paid it is obvious that such items are just as much a part of the expenses of obtaining the funds through one-year notes as the bankers' discount. Hence, the more accurate method is to treat the discount and expenses alike; namely, as a prepaid expense to be spread over the life of the issue. On this basis, the monthly charge to income is $475. The ratio of this monthly charge to the average monthly borrowings gives the true rate of interest paid on borrowed money, the latter being an important factor in forming an opinion as to the company's financial condition. The interest rate can be worked out on an actuarial basis in those cases where a high degree of accuracy is desired.

CASE 4

Facts: To meet the one-year notes at maturity "X" Electric Company decided to issue 75-year first mortgage 5% bonds. The bond indenture contains the usual clauses as to security, earnings, sinking fund, additional issues, etc., etc. To carry out this programme the one-year notes are called April 1st at 102, the 75-year bonds are sold to the bankers at 95 and the expenses aggregate $2,500.

Question: What disposition is to be made of the 2-point premium on the one-year notes; namely, $2,000?

Answer: The usual answer is to charge the premium on the notes against the income of the month in which the notes are retired. Further consideration indicates that there was no reason to accrue the premium during the prior months because there was no contract obligation to retire the notes prior to maturity. Moreover, there was no certainty that the notes would be called as a matter of good business, and even if the company had in mind to call them, the amount of premium to be paid is usually unknown until the call date is fixed.

Before accepting this routine answer, consideration should be given to the reason for calling the one-year notes. It will be admitted that the borrower is not handing out a $2,000 gift to the note holders. It follows then that the calling of the one-year notes was an unavoidable element in the issuance of the 75-year bonds. If this be true, why is not the expense of calling the notes part of the cost of issuing the new bonds? If the answer to this query is yes, then it follows that the premium on the called issue becomes part of the debt discount and expense of the new issue.

CASE 5

Facts: Case 4 involves an additional point not heretofore mentioned. On April 1st when the one-year notes are called at 102 there are two months' unamortized discount and expense aggregating $950.

Question: What disposition should be made of the $950 unamortized discount and expense?

Answer: The orthodox answer is to charge off to surplus the amount of discount and expense unamortized when the notes are called.

However, in case 4 it was stated that the premium on the called issue may be treated as part of the debt discount and expense of new issue. If this reasoning is sound, then it follows that the unamortized discount and expense of the old issue also becomes part of the debt discount and expense of the new issue.

CASE 6

Facts: Assume that instead of issuing 75-year bonds the "X" Electric Company decides to issue a modern investment preferred stock with the usual clauses as to security, earnings, sinking fund, etc. Assume further that this sinking fund would retire this preferred issue during the same period as in the case of the bonds, namely, the next 75 years. This issue is sold to the bankers at 95 and the expense aggregates $2,500.

Question: What disposition is to be made of the discount and expense aggregating $7,500?

Answer: The usual procedure is to charge this item to preferred stock discount and expense account, a sub-account under unadjusted debits or deferred charges. This account stands unchanged until offset by premiums on other issues of preferred stock or the board of directors charges it off against surplus or profit and loss, either in total or in instalments.

However, if the facts be studied more closely it will be noted that the only difference between the bond and the preferred stock is legal: the first is a creditor relationship and the latter is an ownership relationship. From a business standpoint the bond and preferred stock issues are identical; both the bonds and the preferred stock are redeemable securities; the money is obtained at the same rate and will be paid back at exactly the same dates; the clauses as to interest or dividends, additional securities, etc., are the same. It is submitted that the primary function of accounting statements is to record the results from business operations as accurately as possible and to accomplish this purpose legal technicalities may be ignored provided no rights are disturbed. If this proposition is agreed to, then it follows that for accounting purposes the legal distinction between the bond and the preferred stock may be ignored; that the preferred stock discount and expense should be spread over the 75 years; that by so doing the monthly income statements will disclose the true cost to "X" Electric Company of the borrowed funds used in the business.

CONCLUSIONS

Study of the foregoing cases leads to the following conclusions, viz.: (1) that the accounting treatment of preferred stock discount and expense should be the same as debt discount and expense in those cases where preferred stockholders are in fact lenders rather than borrowers. This situation usually arises when the preferred stock is retirable either by call or through the sinking fund. (2) That the premium paid on the called issue together with the unamortized discount and expense applicable to the called issue are part of the debt discount and expense of the refunding issue. This treatment is required to obtain the true rate of interest paid on borrowed money.

However, it should be borne in mind that the foregoing suggestions are contrary to orthodox treatment and the regulations issued by the interstate commerce commission, as well as the various state commissions; but it is difficult to find any reason supporting the present procedure except the overworked adage that it is best business practice to be conservative.