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Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

ACCOUNTING FOR TREASURY STOCK AND PAYMENT OF DIVIDENDS FROM CAPITAL SURPLUS

Question: A close corporation, incorporated in the state of New York, had capital stock having a par value of $25 a share. It issued 40 shares ($1,000) in exchange for 10 $100 par value shares ($1,000) of another close corporation.

Subsequently a certificate of reduction of capital stock was filed with the secretary of state, the par value having been reduced from $25 to $15 a share. Some time after this change was made the two corporations agreed to cancel the above-mentioned exchange of shares. The 40 shares (now having a par value of $15 each, $600) were received and charged to treasury-stock account, $1,000.

When the par value was reduced a capital surplus account was credited with the full amount of the reduction. Various charges were made to this capital-surplus account at that time, and there still remains a credit balance of a considerable amount. The corporation also has a credit balance in its earned-surplus account.

The question arises as to whether the treasury-stock account should not have been charged with $600, the present face value of the 40 shares and the excess, or $400, charged to either capital surplus or earned surplus. Would it be in order to make such charge to capital surplus without the approval of shareholders, or should it be charged to earned surplus?

Another point relating to these 40 shares of treasury stock is that the corporation is not in the habit of purchasing its own stock, and therefore desires to know whether it would be proper to cancel this certificate and not continue to carry it as treasury stock. If this is permissible, would a resolution by the board of directors be sufficient to effect the cancellation?

When the certificate of reduction of capital stock was ordered filed by the stockholders, they conferred upon the board of directors the authority to pay dividends out of the balance of the capital surplus after charging thereto amounts otherwise authorized at the time. The certificate was filed about two

years ago and no charges were made to capital surplus other than those authorized by the stockholders. After omitting dividends for several years the corporation is about to resume payments to its stockholders. In view of the authority conferred upon the board of directors, will it be in order to charge future cash dividends to the capital-surplus account until the balance in that account is depleted or, since there is an earned surplus, must dividends be charged to that account?

Answer No. 1: In the circumstances set out in your letter, as it is not the company's intention to sell the 40 shares of the company's capital stock acquired, these shares should be reduced to their par value, viz., $600, and the difference, $400, written off against capital surplus created when the par value was reduced. This does not require the approval of the stockholders.

Nothing was said in your inquiry regarding the provisions of the by-laws covering the company's capital stock acquired. In some cases, the by-laws provide that all such stock must be cancelled. In the present case the directors could authorize the cancellation of the treasury stock, obtaining the approval of the stockholders later, or the stock could merely be carried in treasury. The situation should be stated in the company's accounts as follows:

Capital stock:	
Authorized and issued (say)	5,000 shares
Less: in treasury or cancelled	40 "
Outstanding	4,960 shares

Presumably all stock certificates were called in at the time the par value was reduced and endorsed to that effect.

The payment of dividends out of capital surplus is permissible for corporations organized in New York which are permitted to pay dividends out of capital surplus where such surplus arises, as in this instance, out of reduction of par value representing money actually paid in. Such dividends are return of capital, and the recipients of the dividends should be advised that the dividends are return of capital and, therefore, not taxable. However, although the capital surplus was set up with the avowed intention of paying dividends out of it, the federal tax law does not permit any non-taxable dividend to be paid out of any surplus while there is an earned surplus in existence, so that if a dividend be declared, the federal government will interpret it as a payment out of earned surplus as far as the earned surplus suffices to pay it. The question of payment of dividends out of any funds other than earned surplus should always be referred to the company's attorney.

Answer No. 2: 1. In our opinion the excess of the original value of the treasury shares over the present face value, namely $400, may properly be charged to capital surplus. There is nothing unusual in such a treatment and so it does not seem to us that the approval of the shareholders is necessary, though it may be desirable in a close corporation.

2. It would be proper to cancel the stock certificate referred to, a resolution of the board of directors being sufficient, we believe, to effect the cancellation.

3. The question, and all the pertinent facts of the case, should be submitted to competent legal authority. We, ourselves, are of the opinion that such a

distribution as is proposed probably has legal sanction, although the prudent course would be to pay cash dividends out of earned surplus before encroaching on capital surplus. Further, even though the capital surplus referred to be legally available, the propriety of a distribution therefrom is subject to the observance of equitable rights, e.g., creditors', as well as the requirement of prudent business procedure. We should add that the source of the distributions, particularly if made from capital surplus, should be intimated to the stockholders and, further, that for income-tax purposes such distributions of a close corporation would probably be held to have been made from earned surplus to the extent of that surplus.

ACCOUNTING FOR FOREIGN-EXCHANGE CONTRACTS

Question: A manufacturing company in the United States does a considerable volume of business in a number of foreign countries. Most of the sales are payable in United States dollars and present no accounting difficulties. Sales in France, however, are made through an agent and are payable in francs.

Because of the violent fluctuations in foreign exchange the company has adopted the practice of hedging its sales made in French francs by entering into contracts with its banks for the sale of French francs and the delivery of dollars, such delivery to be made at a date corresponding to the maturity of the accounts which are to be hedged.

For purposes of this proposition we assume that the company has accounts receivable payable in francs amounting to one million francs, maturing at various dates within three months following the close of the year and that the United States dollar value of these accounts was covered at $59,000 thus giving an average rate of 5.9 cents per franc. Let us further assume that the company has been in the habit of using a fixed par rate of 4 cents per franc in converting transactions between its French branch and the United States. The actual market value of the franc at December 31, 1933, as quoted in the *Financial Chronicle* was 6.1991 cents per franc. The following questions present themselves to us at this time:

1. What rate should be used in converting these French accounts receivable to United States currency at the close of the year? The usual rule, of course, is that such items should be converted at the current rate at the close of the year, but it seems to us that as the company has limited itself to the amount it will get out of these accounts by selling francs against the forward dollar deliveries these receivables should be converted at the average rate at which the accounts were hedged.

2. As stated earlier in the proposition commitments are made for deliveries of dollars at the approximate maturity of the accounts hedged. It therefore seems evident that the company is protected against exchange losses so long as the accounts are collected on or before the date on which delivery of dollars is to be made. However, if the accounts are not paid the company does not have francs to make delivery against its dollar purchases and it must then either purchase francs or extend the contract. In either case the company will make a profit or a loss, at the time it purchases francs or renews the contract, to the extent of the difference between the rate of exchange then prevailing and the rate prevailing at the time the contract was originally made. Is this recognized as a contingent liability which should be stated in the balance-

sheet? Is there an actual asset in dollars and an actual liability in francs which should be stated?

3. In this particular instance all contracts for future exchange are made by the agent in France and the company does not receive detailed information about these contracts until a considerable time afterward. It is our understanding that the bank makes no charge against the company at the time these contracts are made and the company makes no entry on its books to reflect the existence of these contracts. The only entries appearing on its books are the entries recording the brokerage paid on these contracts when executed and the profit or loss which may be made when contracts are extended because of failure of customers to pay at maturity dates. What is considered to be the best method of recording such exchange contracts in the books?

Answer: 1. In the circumstances it seems to us that the usual rule as to conversion at the current rate does not apply, and we agree that the receivables in question should be converted at the average rate at which the accounts were hedged.

2. If the accounts are not paid at the agreed date, it seems to us, the profit realized on the loss sustained by the company on settling its hedge or renewing the contract should be brought into the accounts as completed transactions. When the maturity date succeeds the date of the balance-sheet so that the customer's failure to pay is not known until after the date of which the accounts are prepared, then we believe provision should be made for the loss, or in the alternative—possibly the preferred treatment—a footnote should be appended to the balance-sheet in some such terms as follows: "At December 31, 1933, the company had exchange commitments in which there is an indicated loss of $......."

3. Record should be made in an appropriate register of such commitments as those referred to, but no entry is required in the books of account until the contracts mature, the further procedure being that outlined in "1" and "2" above.