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Accounting Questions: Valuation of Inventories of Metal Mining Companies; Classification of Funded Debt

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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.]

VALUATION OF INVENTORIES OF METAL MINING COMPANIES

Question: A company in the metal mining and milling business has its stock listed on the New York stock exchange and is required to report quarterly to the exchange the net income and the amount of net income a share on the outstanding stock. The company's finished product is concentrates, which customarily are shipped under contract to the smelter as soon as they are produced. Recently the company has stored part of its production in expectation of better metal prices, and the stored concentrates are valued in the company's accounts at mining and milling cost, which is less than market. During a period in which the stored concentrates increase, the net income is less than it would be if the concentrates had all been sold or if net income had been computed on the basis of valuing them at market. Conversely, for a period in which the inventories of stored concentrates are reduced by shipments to the smelter, income is greater than if it were computed on the market value of the stored concentrates.

The officers of the company feel that a statement of net income computed on the basis of inventories stated at cost has the effect of distorting the income from what is actually made as the produce is readily marketable and sold as soon as placed on the cars for shipment at the price determined by the market quotations of the various metals.

The question concerning which we desire your opinion and suggestions relates to the presentation of operating results so as to avoid misleading investors and stockholders and, in particular, we would be much obliged to be informed if it would be proper and is customary with metal mining companies to state inventories at market. We believe this practice was followed in earlier years by large operators but has largely been discontinued on account of income-tax regulations which prohibit the use of inventories at a higher value than cost.

We have suggested to the company that report be made to the New York stock exchange along the lines of the following paragraph and would appreciate your opinion as to the propriety of such a statement in which income is taken into account before fully realized:

> "The .... Mining Company for the quarter ended June 30 made a net profit of $.......... after taxes and depreciation but before depletion, which is equal to $.......... a share on the .... shares of $.......... par common outstanding. During the quarter inventories of concentrates which are being stored in anticipation of higher metal prices and are valued at cost were increased. Net income for the quarter based on valuing inventories of concentrates at market was $ .... which is equal to $.......... a share on the outstanding common."

During periods of decreasing inventories the report would indicate conversely a smaller net income on basis of inventories at market than at cost.

Answer No. 1: It is not customary for mining companies to value their inventories at market except in the case of by-products such as precious metals produced with the mining of copper, lead, zinc or other primary metals. The exception to this is that when the market value is less than cost the inventories are usually reduced to market.

In the case of your client we believe the net profit should be shown on the cost basis. It also seems proper to us to give the additional information shown in the second part of your proposed paragraph. This is on the assumption that both beginning and end inventories are valued for this purpose on the basis of the market price at the respective dates.

Would it not be better to make the last sentence of your paragraph read "Net income for the quarter if calculated on a basis of valuing inventories of unsold concentrates at market values both at the beginning and end of the period was $.......... which is equal to $.......... a share on the outstanding common stock"?

The net income of a company which stores metals such as you have described will necessarily be made up of two elements, the profit on operations based on the market price of the product at the time of production and a speculative profit or loss reflecting the difference between this market value and the amount eventually realized for the product. Although it is not usual to recognize such a segregation either in the accounts or in reports to stockholders in certain circumstances, it would seem that such a segregation might be necessary to give proper information as to the results of operations.

> "Two other members of the Institute have submitted suggestions for the last sentence in the proposed report of the company to the New York stock exchange as follows:
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> 1. Net income for the quarter based on valuing inventories of concentrates at market rather than cost would have been $.........., which would be equal to $.......... a share on the outstanding common stock.
> 2. Net income for the quarter would have been increased by $.......... if the increase in the inventories of concentrates had been valued at market instead of at cost."

Answer No. 2: From the standpoint both of income taxes and financial accounting, it is in our opinion best to state inventories of concentrates at cost rather than at market value. Market would of course be used if lower than cost at the date of a balance-sheet.

While we understand that the concentrates could be readily sold, the same would be true of many items in the finished-goods inventories of most companies, and it does not seem advisable in the circumstances mentioned to depart from the usual practice of carrying inventories at cost if cost is below market and stating income accordingly.

We approve the idea of a special statement to the New York stock exchange setting forth the facts and calling attention to the difference of earnings if the inventories of concentrates were valued at market rather than cost, but we recommend that the last sentence should read as follows:

> "Net income for the quarter based on valuing inventories of concentrates at market rather than cost would have been $.........., which would be equal to $.......... a share on the outstanding common stock."

CLASSIFICATION OF FUNDED DEBT

The following letter did not pass through the bureau of information of the American Institute of Accountants but was written by the chairman of the special committee on accounting procedure in response to an inquiry. Its general interest merits publication, but it must not be regarded as an official expression of the Institute:

Answering your request for an authoritative opinion on the procedure considered preferable for disclosing and classifying funded debt falling due within one year from the date of the balance-sheet, it appears that most accountants do not take serious objection to either of the methods outlined by you, namely: (1) classifying all instalments on bonds due within one year as current liabilities or (2) showing the total funded debt as a deferred obligation with proper notations describing the sinking fund or serial maturities to be met in the coming year. However, certain accountants have expressed a preference for one or the other of these two methods, and an attempt will be made to summarize the reasons which they have advanced in support of their views.

At the outset, it should be pointed out that the regulations of the securities and exchange commission require instalments of funded debt due within one year to be classified as current liabilities but do not require sinking-fund payments to be so classified. This classification is followed by a number of companies and is advocated in the pamphlet *Reports to Stockholders.* It must, therefore, be recognized that this procedure is considered acceptable accounting practice.

The arguments of those who support this view may be summarized as follows:

Serial maturities of funded debt maturing within one year should be classified as current liabilities, unless there is definite knowledge that they are not to be paid—which is seldom the case. As to entire issues maturing during the year, the treatment depends upon whether or not the bonds are expected to be paid or may be refunded in some manner. They should be treated as current liabilities unless there is reason to believe that they will not be paid, and in that case, it is desirable to state in the balance-sheet that the total of current liabilities is exclusive of funded debt maturing within a year. The question of real-estate mortgages—which are practically in the same category as funded debt—is sometimes a troublesome one. Frequently, we have real-estate mortgages which are even past due but are not expected to be paid in the near future. Superficially, these are demand obligations, but practically, in many cases, it is unfair to the client to treat them as current liabilities. In such cases, at least the amounts and dates of current maturities should be disclosed, and in many, if not all, of such cases the total current liabilities should be qualified as excluding past-due mortgages or those maturing within a year.

Manifestly, if any bonds which mature within a year are held in the treasury, they should be deducted from those which are to be shown as current liabilities. Also, if there are deposits with trustees which can be definitely identified with bonds maturing within a year, and such bonds are classified as current liabilities, the deposits should be classified as current assets.

The following is a summary of the views of those who advocate showing the total funded debt as a deferred obligation with suitable notations as to maturities.

A balance-sheet would appear to be more informative when the total of one kind of liability, such as a class of bonds, is included as one amount with suitable notations as to maturities. It does not seem desirable to follow literally the rule that all amounts due within one year should be included in current liabilities. The current liabilities can not be considered to represent the cash outlay which will have to be made in the next year and the changes in almost all of the balance-sheet accounts will be affected by the payment of the liabilities and by other transactions of the year. The funds to pay an instalment of a debt when it becomes due may be the result of profits earned subsequent to the date of the balance-sheet. An interpretation of a balance-sheet depends upon comparisons and analyses, only one of which is the ascertainment of the ratio of current assets to current liabilities; and due consideration must be given to other factors.

There seems to be general agreement that no different treatment of funded debt instalments due within a year should be adopted as between companies earning a profit and those which are not.