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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.]

UNAMORTIZED DEBT DISCOUNT, EXPENSE AND PREMIUMS ON BONDS REFUNDED

Question: In view of changed economic conditions, is it now regarded as good accounting practice to carry forward the unamortized debt discount and expense of and premiums paid on bonds refunded and to spread these items over the life of a new refunding bond issue, together with the discount and expense incident to the new issue?

To be more specific, let us assume the following: A company issues $10,000,000 of 3%, 25-year bonds, and the discount and expense incident thereto amount to $300,000. The proceeds of this 3% issue are applied to the redemption, at 104%, of a 6% $10,000,000 prior 20-year issue, which still has 10 years to run and on which the unamortized debt discount and expense amounts to $200,000.

Should the $400,000 premium paid on the old bonds refunded, with the $200,000 balance in the debt discount and expense account, be written off at the time the old bonds are refunded or may the sum of the two, viz., $600,000, be added to the $300,000 discount and expense incident to the new issue and the total, viz., $900,000, be amortized over a period of 25 years, the life of the new bond issue?

Also, if it is not considered proper to carry forward both the debt discount and expense and the premium incident to the old issue, would it be proper to write off the former and to carry forward the latter on the theory that the premium was paid solely as an incident of the new issue?

Also, if the bonds were those of a public-utility corporation, should special consideration be given to that fact?

Answer No. 1: I believe that the correct solution of the problem submitted is in no way affected by economic conditions. It is ordinarily a matter of the proper periodical distribution of the cost of borrowed money. I do not consider in the circumstances cited that it would be proper to charge surplus with the amount of discount and expense remaining unamortized at the date of refunding. To do this would imply that the amount thus written off represented cost of money for the past period whereas, in reality, it represents part of the cost of money for the ten years following. The treatment which should be accorded in respect, not only to the discount and expense remaining but also to the premium paid on the retirement of the old issue, would be to apportion these charges equitably over the period for which the old bonds were still to run.

It is apparent that the new bonds were issued for two reasons: First, to provide funds at a lower cost than was being borne while the old bonds were outstanding and, second, to provide funds for a longer period. The total expense of the new bond issue for discount and expense should, therefore, be equally distributed over the entire period of its life. The effect of this will be to charge the first ten years with part of the cost of the old and part of the cost of the new and to charge the remaining fifteen-year life with an equitable proportion of the cost of the new issue.

It is evident that this is reasonable for, even with the total charge, the cost of money will be less for the first ten years of the new issue than would have been the case if the old bond issue had been allowed to remain in force.

The answer to this question is definitely "yes." The accounts of a public utility corporation are very strictly regulated by the commission under whose jurisdiction it operates, and definite consideration must be given to the regulations which have been prescribed.

Answer No. 2: In our opinion it is permissible to amortize as a financial cost the old discount and expense plus the premium paid on the old bonds refunded over the period covered by the new issue.

There is, however, an important income-tax situation in this problem, which should be considered in the interest of the client. If the new bonds are merely a substitution and were not issued to the public through the usual financial procedure, the deferred discount and expense on the old bonds at the time of refunding will not be allowed as a deduction for income-tax purposes after the refunding date. The treasury department has been upheld in its contention that where a new issue of bonds is used to retire an old issue by substitution only, all deferred discount and expense of the old issue must be regarded as a deduction for income-tax purpose in the period prior to the date of refunding.

OFFICERS' SALARIES IN CONSTRUCTION OF NEW PLANT

Question: A parent company organizes a subsidiary corporation (wholly owned) to construct and operate a new plant. The officers of the parent company devote a considerable time to the new enterprise and, therefore, feel that a part of their salaries and parent company expenses is chargeable as capital cost of constructing the new plant, placing such items in the same category as interest cost of financing during construction. Is this a general and acceptable procedure among companies constructing new plants?

Answer No. 1: We have your request in which is propounded the question of capitalizing part of the time of the principal executives of a company who are removed from supervision of the going plants for a period in order to supervise new capital expenditure, in this particular case related to the establishment of an entirely new plant. While an argument may be adduced in favor of this practice, our general feeling on the subject would be in the negative. We believe that the normal salaries of all executives of a company which must continue in any circumstances, whether these executives are engaged in current operations or in new development, should be looked upon as current necessary costs of the business and as such charged at all times to current profit and loss.

Answer No. 2: We know from actual experience that the general and acceptable procedure among companies constructing new plants is not to capitalize a portion of the salaries of officers engaged partly in supervision of construction. Nevertheless, it appears to us that if it is possible accurately to ascertain the proportionate value of executives' time spent in planning the work of financing and construction of the new plant, it would be proper accounting to capitalize that proportion of executive salaries, together with traveling expenses incurred. It seems to us that the difficulty would be to segregate correctly the executives' time, because it is possible that such time spent at the main office on the company's affairs as a whole had not been impaired; consequently there would be no justification for relieving the current operations of an expense rightfully chargeable to that period.

NOTES PAYABLE AND LIABILITIES ON BALANCE-SHEET

Question: How much of notes payable given for the purchase of equipment, which mature monthly, beginning with February 1, 1936, for a period of eighteen months thereafter, should be included as current liabilities in the preparation of a balance-sheet at December 31, 1935? Should the line be drawn between current liabilities and deferred liabilities at, say, six months or twelve months?

Answer: In our opinion, notes payable maturing within twelve months subsequent to the date of any balance-sheet should be included in such statement as current liabilities, and notes maturing at a period later than twelve months subsequent to the date of the balance-sheet need not be included in current liabilities. This rule may be modified, if warranted by the existence of trade practices in respect to instalment notes.