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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.]

TREATMENT OF DISCOUNT ON SALE OF STOCK

Question: In connection with a refinancing of one of our clients, an interesting question has arisen with respect to the underwriting fees incurred in the sale of stock. We are presenting this problem to you and would appreciate it if you would give us a reaction on the theory of handling this matter.

The client recently brought out an issue of stock which was sold to the public at say $101.00 per share, or $1.00 above par. The underwriting fees were say $3.00 per share, bringing the net proceeds to the company to $98.00 per share, or $2.00 below par.

A number of years ago the company created a capital surplus arising from a reduction in the par value of the common stock then outstanding, the par value of the stock being cut in half. At that time, by action of the board of directors, the existing deficit was transferred to this capital-surplus account created through the reduction in the par value of the stock. There is, however, still remaining an amount of capital surplus and the question has arisen now as to whether the net discount on the sale of the recent issue, say $2.00 per share, can be charged against the capital-surplus account remaining from the reduction in the par value of the capital stock outstanding.

To state this matter in a longer way, we will say that we will credit the $1.00 of premium on the sale of capital stock to the capital-surplus account and charge the $3.00 per share underwriting fees to the capital-surplus account.

The laws of this state are rather specific with regard to the diminution of stated capital, but without regard to the legal side of the question as to whether this could or could not be done, we would appreciate it if you would advise us from the accounting theory if such handling of the underwriting fees is permissible.

Answer No. 1: It appears that in connection with a refinancing a certain corporation sold stock to the public at $101.00 per share, that is $1.00 above par, and that the underwriting fees amounted to $3.00 per share. The net proceeds of the issue were thus $98.00 per share, or $2.00 below par. It appears further that there is a capital surplus resulting from the reduction, some years ago, in the par value of the capital stock, such capital surplus representing the balance after charging there against the deficit existing at the time the capital stock was reduced.

The question which has arisen and concerning which inquiry is made, is whether the net discount of $2.00 per share, as noted above, may be charged against the stated capital surplus, here remarking that for the purposes of the question the legal aspect is disregarded although the inquirer observes in connection therewith that "the laws of this state are rather specific with regard to the diminution of the stated capital."

It seems to us that there is no accounting impropriety in the suggested treatment of the net discount, namely, charging the amount thereof against the capital surplus. Though separate elements, the premium of $1.00 per share paid by the subscribing stockholders and the underwriting fees of $3.00 per share are part of one transaction on capital account and, in our opinion, neither practical considerations nor, except on an unduly rigid interpretation, accepted principles require the alternative treatment of regarding the $1.00 premium as capital surplus while charging the underwriting fees, in one sum or by amortization, against earned surplus.

Answer No. 2: In our opinion, there is no reason whatever from a good accounting viewpoint, why the discount on the new issue of capital stock should not be charged against the old capital surplus. The transaction should, of course, be shown up in any report on financial statements to those affected but the transaction in itself is to our minds one in which this practice is fairly well established by precedent.

Whether there are any legal obstacles in the particular state, your inquirer will have to consider, but we presume there is not in view of the fact that a capital surplus has already been created.

Answer No. 3: So far as we are aware there is no obligation on a company to write off discount on the issue of capital stock against earned surplus, and when the company realized a net amount of $98.00 per share on the original issue of stock, the discount of $2.00 might reasonably be carried as a deferred charge until some action was taken by the directors.

Capital surplus arising from the legal reduction of capital stock may properly be used for wiping out an operating deficit (it is very often created for this very purpose), but full disclosure should, of course, be made in the annual accounts and the transaction recorded in the minutes.

As there is no obligation on behalf of the company to charge off the discount on capital stock to operating surplus, it would appear entirely proper to charge it against the capital surplus account, with disclosure in the annual accounts. If, however, the discount had been on the issue of any class of bonds or on the issue of preferred stock definitely redeemable at a specified date, the treatment would of course be different.

We doubt very much if the above treatment would conflict with any state law with regard to stated capital.

MERCHANDISE IN TRANSIT ON BALANCE-SHEET

Question: The policy of my office for the past thirty years in practice has been to include in the body of the balance-sheet merchandise in transit with corresponding accounts-payable liability, even though, in so doing, I disturb the ratio of quick assets to current liabilities. In some cases we do not distinguish "on hand" from "in transit," and in others we do.

This policy does not apply to merchandise received shortly before the end of a fiscal year with post-dated invoices, which merchandise is for use in a subsequent period. This latter situation we show as a footnote.

It has come to my notice recently that some accounting firms are showing as a footnote merchandise in transit, which merchandise is not for use in a subsequent period, and by so doing are creating an impression that there are two correct ways to show this item.

Answer No. 1: In our opinion, merchandise in transit at the balance-sheet date should be included in the inventory and accounts-payable captions, if title to such goods has passed to the buyer. This method of presentation is more desirable than showing the amount involved as a footnote. In the latter case, the reader is compelled to make a mental adjustment for goods in transit. If the reader is not accounting-minded, he may not appreciate the significance of the footnote and may be misled by the balance-sheet.

Answer No. 2: Below is my opinion as to the correct method of showing merchandise in transit as a balance-sheet item; more particularly, whether the preference extends to showing it in the body of the balance-sheet or as an annotation thereto.

I think we are all agreed that the balance-sheet is a recitation of equities of the proprietary and the creditor interests. Everything that is owned and owed should appear in the body of the balance-sheet.

That which will be owned or owed in the event of a contingency over which the respondent has no control is by common convention relegated to the footnote or explanatory text of the financial statement.

If the title to the merchandise has passed upon its delivery to the carrier, as it presumptively does then pass, it is evident that the respondent's liability therefor arose upon such delivery.

It would be erroneous to exclude the goods and the debt from the body of the balance-sheet on the score that they are equivalent to each other. Even though the goods are subject to the risks of transit, the debt must nevertheless be paid. Moreover, from the subjective standpoint, liabilities must be met at contractual value out of assets which may or may not realize cost.

The test for inclusion in the balance-sheet proper is legal or equitable title in the goods on the date of preparation of the balance-sheet.

It would rest with the judgment of the practitioner whether or not a footnote should cover claims on his client which arise after the balance-sheet date. In the exercise of this judgment, he would obviously be guided by materiality and by the pecuniary interests of all entities who are destined to rely upon the figures submitted.

CONSOLIDATION OF BALANCE-SHEETS OF DOMESTIC CORPORATIONS WITH THOSE OF FOREIGN SUBSIDIARY

Question: Under what circumstances, if any, can the balance-sheets of a domestic corporation having a fiscal year ended August 31st be consolidated with a 100%-owned foreign corporation having a fiscal year ended July 31st be consolidated and shown as a consolidated balance-sheet.

Answer No. 1: It seems to us that under virtually all circumstances it is proper to make such a consolidation. It is quite customary to do so as it is impracticable, in most cases, for a parent company to close its accounts and prepare financial statements promptly at the end of its fiscal year, if the fiscal year of the subsidiary closes on the same date. The only exception that occurs to us would be where the operations of a foreign subsidiary are relatively so important that their inclusion in a consolidation as of a different date might distort the financial showing.

Answer No. 2: The task of preparing consolidated balance-sheets and operating statements for large corporations with foreign subsidiaries is so complicated that it has become almost the universal practice to use the balance-sheets of the foreign subsidiaries of the month next preceding the closing date of the domestic parent corporation. This procedure enables the foreign auditors to complete their work in an orderly manner and still leaves time for their reports to be reviewed by the auditors in this country before inclusion in the consolidated balance-sheet. If this practice be followed consistently from year to year, the consolidated operating statement will contain a full twelve-months operations. In reconciling the intercompany accounts, intercompany transactions of the last month of the parent company's fiscal year are in suspense and must be carefully examined in order to determine the proper classification for them on the consolidated balance-sheet. For example, it would be possible to overstate the consolidated cash in banks. If large remittances to the parent company were made in the last month of the fiscal year, they would appear in foreign cash in banks at the end of the preceding month and in domestic cash in banks at the fiscal year end. The best practice seems to be to subtract such remittances from consolidated cash instead of including them therein with an offsetting deferred credit.