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Accounting Questions: Dividends Paid During Construction; Valuation of Repossessed Goods

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ACCOUNTING QUESTIONS

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DIVIDENDS PAID DURING CONSTRUCTION

Question

Is it permissible or justifiable under sound accounting practice to capitalize preferred dividends paid during the period of construction when the proceeds from the sale of this preferred stock were definitely used to defray a portion of the cost of the construction program?

In the case to which we refer, a corporation was formed for the purpose of building and operating a mill. Bonds and preferred stock were sold, as well as common stock, the proceeds from all three issues furnishing the funds with which the plant of the corporation was to be built. The common stock was sold at a premium of 33⅓ per cent, which constituted paid-in or donated surplus and was made available for the payment of preferred dividends by specific action of the common stockholders.

The first year of the corporation's existence was spent in the construction of its plant. During this period, under prevalent sound practice, all expenses, with the exception of those relating directly to future operations, were added to the cost of the plant. During the same period, regular preferred dividends were declared and paid out of the above-mentioned surplus.

Now, in order to conserve this surplus for future contingencies, it would be desirable to capitalize these dividends, just as have been bond interest and other expenses incurred during the construction period.

Do you know of any authority which would defend such a proceeding?

Answer No. 1

Your correspondent is unable to find anything in the works of a number of authorities which bears directly on this question. However, Montgomery, in his *Auditing Theory and Practice*, has the following to say on page 261 with respect to the capitalization of interest on income bonds, which perhaps is somewhat analogous:

"When income bonds are outstanding during construction periods and it is believed that the interest will be paid, it is proper to capitalize the interest, even though its legal accrual depends on (1) sufficient income to pay the interest and (2) the authorization of the payments by the directors. The subject is too complicated to discuss at length."

Your correspondent is of the opinion that, if it is permissible to capitalize interest merely on the ground of the belief that it will be paid, then it is permissible to capitalize dividends paid on preferred stock out of paid-in surplus. At any rate, the payment in either case is made out of the equity of the holders of the common stock.

The inquirer did not ask about the federal income-tax aspects of this situation, but some mention of the tax possibilities of the matter probably is in order. This raises two principal questions. First, would the dividends be deductible in determining the amount of net income subject to the undistributed-profits tax? Second, would the Bureau of Internal Revenue permit any part of the dividends to be added to the depreciable assets of the corporation?

The first question probably has nothing more than an academic significance, because from the facts given it would appear that the corporation did not have any operations during the period of construction and, therefore, would have no income subject to any of the federal taxes on income. However, it is obvious from the decisions on the subject that a dividend paid out of paid-in surplus is not a taxable dividend and, therefore, could not be deducted in determining the amount of income subject to the undistributed-profits tax.

Decisions appear to be lacking on the question whether any portion of the dividends may be added to the cost of the depreciable assets of the corporation. Your correspondent hesitates to offer an answer to this question, but does venture the suggestion that the Bureau of Internal Revenue would not permit any part of the dividends to be charged to the depreciable assets of the corporation without disallowance and conference thereon.

The question whether charges not directly related to construction, but incurred during the period of construction, should be charged to construction account is a troublesome one. The weight of authoritative opinion is that such charges generally may be added to the cost of construction. It is to be noted, however, that whether such charges are to be added to the cost of construction is a matter of discretion.

Your correspondent does not presume to set himself up in opposition to the weight of authority, but he is of the minority group who are not convinced that it is proper to add anything to the cost of construction which is not directly related to construction. It has always seemed anomalous to him to permit the capitalization of items which are peculiar to the method of financing, when under another form of financing such charges would not be incurred.

For instance, a plant financed with the proceeds from the sale of bonds, the cost of which is artificially increased by interest paid on the bonds during the construction period, has no more intrinsic value than a duplicate thereof financed with the proceeds from the sale of common stock. Furthermore, no more real depreciation is sustained in the first case than in the second. Yet the charge for depreciation would be higher in the first case than in the second because of the addition of interest to the cost of construction.

Answer No. 2

This letter is in reply to yours, in the first paragraph of which the following inquiry appears:

"Is it permissible or justifiable under sound accounting practice to capitalize preferred dividends paid during the period of construction when the proceeds from the sale of this preferred stock were definitely used to defray a portion of the cost of the construction program?"

In my opinion the answer to the foregoing inquiry is "No."

When earnings or earned surplus are available for payment of dividends on preferred stock, and when the financial condition of the issuing company is such as to permit payment of the dividends, there would appear to be no objection to making the payment; however, the payment would represent a distribution of earnings or earned surplus, and not a "cost" of construction of a plant or any kind of "cost" which should be charged to an asset account.

Where no earnings or earned surplus are available for payment of dividends on preferred stock, but there is a paid-in surplus, it may in some cases be legal and proper to pay a dividend, although there is more likely to be reason for objection than if the dividend could be paid from earnings. Assuming that there is no legal or other obstacle in the way of paying such a dividend, still the dividend does not represent a "cost" of construction or of any operation in which the payor corporation has engaged, but represents a return by the corporation of any amount previously paid in to it as capital or paid-in surplus. Any attempt to "conserve this surplus for future contingencies" by bookkeeping entries, after amounts from which the credit to surplus arose have in fact been returned by the corporation, seems little, if at all, short of clear misstatement in the accounts.

Answer No. 3

In a regulated industry where the cost of the property is one of the elements in determining the earnings, it is more important to include all the elements of cost in the property account than it is in industries not so regulated. The capitalization of interest does not produce any cash, and it is only through the provisions for depreciation that the business ultimately retains cash equal to the credit made to earnings some years prior for the capitalization of interest. It is probably because of this fact, and the fact that a stockholder, being the owner of the company, invests his money to obtain a return from the operations of the business, that interest during construction is not capitalized in all cases.

In this particular case, it would seem that the preferable treatment would be to capitalize actual interest cost during the period of construction and to charge the dividends on preferred stock to paid-in or donated surplus which has been created for that purpose by common stockholders. If, however, the company elects to capitalize the preferred-stock dividends, the accountant should insist on a full disclosure of the policy followed, but in our opinion, he has no basis for qualifying the certificate.

VALUATION OF REPOSSESSED GOODS

Question

How should repossessed goods be valued when placed in the inventory? Please use the following information as a basis:

Selling price—new	100%
Manufactured cost	50%
Sales and administrative expense (excluding commission)	20%
Commission	20%
	90%
Profit	10%
Article sold new for	$200.00
Unpaid balance when repossessed	150.00
Estimated resale value	140.00
Commission on resales	20%

Our contention is that, in the illustration, the goods should be valued at $75, which would give the company the same gross profit realization on disposition of the used equipment as on the new, and that the profit or loss on the initial sale should be determined at the time of repossession and not upon disposition of the repossessed equipment.

Answer No. 1

In our opinion, the basis proposed, that is, the proportion of manufactured cost which the unpaid balance of the account when repossession occurs bears to the price at which the article was sold, is sound. It is assumed, of course, that in no event will the inventory value be higher than the estimated sale value, less commission and any other expense relating to the resale.

Answer No. 2

The letter indicates that the company makes a gross profit of 50 per cent, that a new article is sold for $200, that the unpaid balance at the time of repossession is $150, and that the estimated resale value is $140. The contention is that the goods should be valued at $75, "which would give the company the same gross profit realization on disposition of the used equipment as on the new." We agree with the principle enunciated by your questioner, namely, that the estimated resale value should be reduced by the percentage of gross profit, but this would give an inventory price of $70 and not $75. We also agree that the profit or loss on the initial sale should be determined at the time of repossession, and not upon disposition of the repossessed equipment.

Nothing is stated in the question with regard to the cost of reconditioning, if any, of repossessed equipment. Obviously, if there is such a cost, it would further reduce the figure of $70.