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Accounting Questions: Treatment of Interest as a Premium; Methods of Journalizing

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ACCOUNTING QUESTIONS

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TREATMENT OF INTEREST AS A PREMIUM

Question

I am interested in procuring an opinion in respect to the following case:

Company X had net outstanding $400,000 (out of an original issue of $1,000,000) of 7½ per cent first mortgage, sinking fund bonds, due May 1, 1942, but callable for sinking fund at 110 to May 1, 1942. That is to say, the annual contributions to, and earnings of, the sinking fund, are used only to buy bonds of the issue, in the specified amounts called for under the indenture, and when called (by lots) the bonds are kept alive in the sinking fund to earn interest to maturity.

The company also had outstanding $300,000 of 7½ per cent preferred stock (that was issued in exchange for a like amount of bonds under the rights given in the indenture), that may be called on any dividend date after the stock has been outstanding three years, at a price of $110 plus accrued dividends.

Recently the company has obtained $2,000,000 of cash in new financing from sale of fifteen-year, 4 per cent, first mortgage bonds. Out of the proceeds, $429,000 was used to retire $390,000 par value of preferred stock that could be called, leaving only $10,000 of the said preferred stock outstanding which cannot be called until 1940. It placed with the trustee under the 7½ per cent bonds, cash, as follows:

$400,000 par value @ 110	$440,000
Interest @ 7½% for 2½ years	75,000
Total	$515,000

The first mortgage 7½ per cent bonds could not be called for retirement except at maturity (5–1–42) or as called for by sinking-fund accumulations. However, with the deposit of the above-mentioned $515,000 with the trustee, the trustee has given a release deed to the properties covered by the 7½ per cent bonds in order that a mortgage could be issued on the properties so as to secure the new 4 per cent bonds.

As of October 1, 1939, the trustee had been successful in actually acquiring "over the counter" $350,000 par value of these 7½ per cent bonds upon the payment therefor of the following amounts:

Par value	$350,000
10% above par, to equal sinking-fund call price	35,000
Interest instalment due November 1, 1939	13,125
Interest due after 1939 to May 1, 1942	52,500
Total payment	$450,625

It is perfectly clear, of course, that the company is paying interest on both classes of bonds during this anticipation period.

It occurs to me that the $52,500 of interest paid for the period after 1949, is, for all practical purposes, in the same category as the 10 per cent premium on par, that is, $35,000, and the whole of the two, namely, $87,500, constitutes a premium paid on the $350,000 par value of bonds acquired. Of course, I am not interested in a discussion as to whether or not this makes excessively high interest rates for the short period of time remaining to the maturity of the 7½ per cent bonds; but even that would seem to be justified when consideration is given to the increased funds received at a favorable interest rate on a much larger issue for a longer period of time.

Would we not be justified in treating the whole of the $87,500 as a premium rather than to amortize the $52,500 interest over the remaining two years?

Answer No. 1

In response to the question contained in your letter, it is our considered opinion, based upon the assumption that the first mortgage 7½ per cent bonds bear interest from November 1, 1939, that the inquirer is justified in treating the whole of the $87,500 as a premium.

Answer No. 2

It is our opinion that this interest should be considered as premium and should be treated in the method described in Accounting Research Bulletin No. 2 of the American Institute of Accountants, dated Sept. 1939.

From the question it would appear that it is contemplated charging the premium to earned surplus, and we can see no objection to treating this interest item in the same manner.

Answer No. 3

It is our opinion that the interest payment of $52,500 should under no circumstances be merged with the premium on the $350,000 par value of bonds purchased by the trustee, and amortized therewith over the life of the new bonds. The $52,500 is clearly a prepayment of interest applicable to the period prior to May 1, 1942, and should be so charged in the books of the issuer.

For further information concerning the amortization of bond premiums, discount and expenses we can do no better than refer the inquirer to Accounting Research Bulletin No. 2 recently issued by the committee on accounting procedure of the American Institute of Accountants.

METHODS OF JOURNALIZING

Question

This office would be glad to know if the old-fashioned form of journal entries are being done away with and a monthly summary journal sheet substituted where results of journal vouchers are listed, classified, totaled, and posted.

We have a client whose journalizing is necessarily large; who has separate sales register and separate purchase register and separate payroll register. From these registers summaries are made and summaries posted directly into general ledger; journal vouchers are used for all other noncash transactions, which journal vouchers contain description of each transaction. The client, in addition to journal voucher, uses the old-fashioned journal, thereby duplicating information and explanations displayed in the journal vouchers. We presume that the old-fashioned journalizing may safely be abandoned and a monthly journal sheet substituted for posting account totals. We find the local railroad office uses the summary list method and we think of little or no disadvantage in its use, for a sizable concern. We are not informed if the plan of journal summary list is in general practice and is generally found acceptable.

Answer No. 1

We know of no reason why one particular form of journal should be preferred to another in this country. In countries such as France, Mexico, and, I believe, other European and South American countries which have their commercial laws modeled on the Code Napoleon, it is required by law to pass all entries through a two-column journal and into a ledger. Even here, the entries are generally in the most summary form, largely because in France and Mexico, at least, the pages of the journal are subject to a tax.

I think we may take the position in this country that there is no legal requirement to use the two-column journal and the two-column journal is merely a form of journal which happens to be the oldest and most common. Certainly where full information is given on the journal voucher there would seem to be no purpose whatever in repeating this in the journal, and I should think that any extension or variation of the two-column journal by increase in the columns for classification or by using totals for posting would be entirely adequate so long as the double-entry or self-balancing character of the book was preserved, that is, so long as the book balanced with itself. For instance, if there were ten columns for debit classifications and twenty columns for credit classifications, as long as the totals of the columns of debits and credits each crossfooted to the same amount, it would seem that the essential double-entry character of the book had been preserved. If, however, both debit and credit postings were made, say, from the total of one column, it would appear that the essential double-entry or self-balancing character of the book had not been maintained and this would appear to be poor practice.

The possibilities of arrangement and classification of columnar journals are unlimited, and convenience and practicality are the only considerations governing the use of this sort of book so long as its essential double-entry or self-balancing character is unchanged.

Answer No. 2

I think that the use of journal summary list has become general practice and is generally found acceptable where there is an adequate system of internal control, particularly with respect to the origin and approval of all journal vouchers. I think that the accountant has to be a little more careful in his review and testing of these vouchers in order to be sure that they have been properly classified on the summary sheets. I do not think that it would be wise to approve of this method of summarizing vouchers unless the internal check and control within the organization were adequate.