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Treatment of Bond Discount

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On the Balance Sheet

There are two methods of recording bond discount on the balance sheet: (1) as a deferred charge on the assets side of the balance sheet or (2) as a deduction from the face value of the liability.

To record this liability at face value and to carry the discount as a deferred charge satisfies the legal concept of a liability as a fixed and determinable amount — par. However, this amount is of small value in any situation except a legal one such as liquidation or foreclosure. In such situations it is seldom that the legal amount is paid anyway.

Furthermore, an amount is being carried on the asset side of the balance sheet that does not conform to the standard of a deferred charge; nothing was expended for it as in the case of organization or development expenses; nothing can be obtained for it upon its surrender as in the case of unexpired insurance. It is, on the other hand, an amount that will be paid at a future date. A future expenditure should scarcely be classified as an asset when it is so clearly a liability that should be accrued over the life of the bonds until its payment is finally due at maturity.

Because of those situations where it is necessary to disclose the legal amount of debt, as in statements issued to the Securities and Exchange Commission and to a public that might later hold responsible for misrepresentations those who fail to make such disclosure, both the legal liability and the unamortized discount should be recorded. The discount can then be deducted from the debt as a valuation account similar to "Reserve for Bad Debts." The latter never purports to equal the amount of debts that will be bad, but the amount that may reasonably be expected to so develop. The deduction of unamortized bond discount does not purport to reduce the legal liability to the present value, but does bring it into reasonable approximation thereof, and if amortized regularly to maturity, will at that time be extinguished so that the liability will then equal par.

When the bonds are bought at various prices for redemption before maturity, a separate account "Premium and Discount on Redemption" should be created for the profit or loss sustained on these transactions. To mingle these with the discount on the original issue is to merge trading profits with interest charges. The original discount was the result of corporate credit standing, the money market at that time, the length and amount of issue, and the coupon rate. The subsequent discount or premium is governed by the added factor of supply and demand of available securities of that issue at the time of each sale. While the entire issue was sold probably at one time (to an investment house) repurchases will be made singly from various sources. Different conditions will govern each purchase, and discounts arising from these should not be mingled with the original discount in attempting to value the outstanding liability.

From the original discount account, the amount applicable to the redeemed securities should be deducted so that it will only reflect conditions relative to the outstanding liability and so that the securities purchased may be charged with their correct sales value. On the balance sheet, the account "Premium and Discount on Redemption" should be classified with surplus because it represents profits and losses similar to those on sales of any other investments. It is akin to a gain or loss on the liquidation of trade accounts payable at more or less than the recorded amount as in a quasi-reorganization, such as is taxable under Section 19122 (a)-14 of the Revenue Act of 1940. However, this amount should not be credited or charged directly to surplus until all the bonds of the issue are finally redeemed, because until then, the transaction is uncompleted.

When bonds have been refunded, any unamortized discount on the original issue should be deducted from the liability in the same manner as discount on the new

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issue. However, because one will probably be written off over a shorter period than the other, they should be itemized.

In Profit and Loss Account

It is generally conceded in accounting literature that the amortization of bond discount (by any accepted method) is an addition to the cost of borrowing the money. The debtor received a net amount of cash which he pays back in addition to another sum called "interest." The amount stated on the face of the bond to be interest is indisputably charged thereto at each payment date. The difference, however, between the cash received at the date of issue and the principal sum to be paid at maturity is not called interest, but "bond discount." Yet its amount is directly dependent upon the coupon interest rate. For instance, a four year, 3% bond sold to yield 4% effective interest will sell at 96.34 while a four year, 3½% bond sold to yield 4% will sell at 98.17. While the cash interest paid on these bonds will be $1.50 and $1.75 respectively for the first six months after issue, the discount to be amortized on each is the same.

The effect of bond discount on the income account is a more important consideration than its bearing on the balance sheet. The method by which the discount is charged to income is not as important as the fact that *all* of it must be charged to income by maturity and over the entire period of the issue. In certain cases where the amount of discount is small in relation to total debits or when it appears that the bonds are likely to be retired before maturity, it may be written off prior to the legal maturity date. However, the practice is not to be resorted to unless substantial grounds exist for it.

On Refunded Issues

The American Institute of Accountants in "Accounting Research Bulletin No. 2" consider the treatment of unamortized discount and redemption premium on bonds refunded before maturity. This bulletin states the three possible means of disposing of this debit:

1. As a direct charge to earned surplus at the time of refunding;
2. Amortization over the life of the original issue;
3. Amortization over the life of the new issue.

The first method is objected to because it tends to produce an understatement of income charges for the cost of borrowed money. By immediate write-off to the current year's earnings, they are understated and considerably distorted. This does, however, conform to the accounting doctrine that a loss or expense should be written off not later than the time when the series of transactions giving rise to it are completed. Those who advocate this method say that the unamortized discount and redemption premium are payments required for a contract no longer profitable, and therefore, no part can properly be carried forward to subsequent periods.

However, writing off the entire amount against income or earned surplus at refunding date creates an abnormal charge. It distorts the income account and produces a surplus that is inequitable because the amount available for dividends is either reduced or exhausted, probably purely at the expense of the preferred equity holders for the benefit of the junior or common stockholders.

Those who advocate carrying forward the amount after refunding takes place argue that the unamortized amount and redemption premium are included in the price of an option to refund when and if such refunding is profitable. The cost of money over the entire period of the original issue is affected by the terms of the original contract. If the cost of anticipating maturity is incurred, it is only because it is advantageous to do so.

However, the preferred method is to spread the cost over the terms of the old issue because:

1. Any benefit to be derived does not cover the entire life of the new issue. It is only that period that corresponds to the life of the old issue that can be benefited because the other years would have had a new issue anyway.
2. There is no relationship between the unamortized discount on the old issue and the terms of the new issue.
3. It is unconservative from both a profit and loss and a balance sheet point of view to carry forward any

amount over a longer period.

4. The cost of retirement is to be regarded more as a cost of terminating an issue that became disadvantageous rather than part of the cost of making a more advantageous arrangement.

In a letter to the editor of the Journal of Accountancy, January, 1940, Page 49-50, George O. May, who was vice-chairman of the committee responsible for "Accounting Research Bulletin No. 2," stated that the predominant motive of refunding is to save the interest charges over the life of that issue except in those cases where maturity is near at hand. Because refinancing arrangements almost never coincide with the maturity date of previous issues, there are cases where this motive is immaterial. Where, however, the unexpired life is so long as to make the saving over that period the presumptive and adequate motive for refinancing, the unamortized discount and cost of refunding should be spread over the life of the old issue.

The Securities and Exchange Commission permits the amortization of any balance of discount and expense applicable to bonds refunded by other evidence of indebtedness, but does not accept similar treatment when funds used to retire existing bonds are derived from the sale of capital stock. In such cases, the expense applicable to the retired bonds is to be written off by a charge to earnings or earned surplus in the accounting period in which the bonds are retired.

Where the stock is retireable or when it has a sinking fund provision, as is frequently true of preferred issues, it seems that the holders thereof are in the same position as borrowers, and should be treated as such. Therefore, in such cases, the treatment should be accorded as if the refinancing was by legal debt. Where the refinancing is by stock that represents true ownership, the unamortized discount and redemption premium should be written off to earnings of the year in which refinancing takes place. Although it will distort earnings that year, it does not represent a cost incurred for the benefits of future periods. It is not necessary to measure the cost of money for that unexpired term because there will be no interest paid on this amount.

The Country Accountant

By NINA HUDSON ARNOLD, C. P. A.

As a Country Accountant I have had brought to my attention a very serious accounting problem. It seems that in a woodworking factory, it was quite necessary to have a cat who was a good ratter so that the Raw Material would not be destroyed before putting into Process. The Treasurer of the Company brought milk from her home to feed the cat, but, during her vacation of two weeks, her husband rebelled and said that he absolutely would not be put to the expense of a pint of milk per day for said cat. Therefore, the factory had to purchase the milk. The question then arose under what *Cat*egory in accounting terminology we should place the expense of the milk. Should it be Overhead Expense, Factory Overhead, or ————? I believe this problem has not as yet been solved.

After one week had passed the factory was in something of a quandary as to what to do about feeding the cat, as it had received this letter from the milk-man: "As the cow has 'droped' off a little on the milk and we have just got a small pig, we will be unable to supply you with milk."

One of my clients spends her leisure (?) time in making quilts. She evidently wished certain cut-outs, and not being able to be furnished with them, she received a letter, in which the factory stated: "We are indeed sorry we do not have an 18-inch Colonial Lady. We have a 12-inch block of the Old Fashioned Lady, but she does not have pantalettes."

But to the serious side of life, would say that I recently attended a meeting of the Connecticut Society of C. P. A.'s and the discussions and lectures were serious to the 'nth degree. We have factories which are doing Defense Work, and even they are having difficulty in getting raw material, which is the cause for shutting down the mills; and, this means that the employees go to other factories. When the raw material arrives, there is the labor question—the old story of "This is the house that Jack built." The small factories that have no Defense Work but have given their employees all the wage that is necessary according to the Wage and Hour Act, will be out of business in 1942, for they absolutely cannot get steel, wire, etc.