Journal of Accountancy

Volume 66 | Issue 4 | Article 6

10-1938

Correspondence: Dealings in Treasury Stock; Definition of Current Assets; Interest During Construction

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Dealings in Treasury Stock

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: After following carefully the discussion of the nature and results of a corporation's dealings in its own stock, published in the August and prior issues of THE JOURNAL, the writer is moved to suggest the consideration of an exaggerated example as illustrative of the issues involved in every purchase and resale of treasury stock. This is propounded solely as the question of a student, with full deference to the views of those better qualified to continue the discussion.

Let it be assumed that a corporation has net assets whose fair market value is 4, that its capital stock, owned in equal amounts by A and B, represents paid-in capital of 2, and that there is an earned surplus of 2. It would then follow that the original investment of 1 by each of the two stockholders is now represented by a value of 2.

If the corporation now, as a separate entity, is able to acquire A's stock for 1, the amount of A's investment, the corporation's assets are reduced to 3 and the capital stock to 1, while surplus remains 2. No "profit" can be recorded on the books, but the value of B's investment has increased from 2 to 3. B has benefited by A's sacrifice, and the corporation has effected a partial liquidation in which A was "short-changed."

If B should now let the corporation sell this stock to C for 2, the price which A should have received, the assets would be 5, capital stock would be restored to 2, and surplus (of one kind or another) would be increased to 3. This set of facts would lead accountants of one school of thought to say that the corporation had made a profit of 1.

Looking at the transaction from B's standpoint, however, it is evident that B has now "short-changed" himself, for the value of his investment has shrunk from 3 to 2½. C was let in at too cheap a price.

No matter how much insistence may correctly be placed on the separate nature of the corporate entity, it seems inconsistent to hold that the corporation can "profit" by a deal with an outsider which results in a direct loss to the sole stockholder. However small or detached the treasury-stock deal may be, the stockholders, and only they, are the ones who gain or lose when a share of stock is repurchased or resold. Since the corporation cannot in actuality own its own stock, its position is comparable to that of a stockbroker, dealing at the risk of the stockholders, and charging or crediting them with the results of the transaction.

Following this line of thought, it appears incorrect to show treasury stock on the asset side of a balance-sheet unless it is carried at the book value per share of the total stock of its class. As to do this would require constant adjustment, the most practical method is to deduct it from stock issued to show stock outstanding, supporting the viewpoint that it is not an asset. If transactions are numerous, premiums and discounts may be carried temporarily in a suspense account, but the net balance is purely a surplus item. It should be closed out to surplus in preparing statements, but not through the profit-and-loss account.

Yours truly,

RAYMOND P. WELLS

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Definition of Current Assets

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: In *A Statement of Accounting Principles*, on page 70, current assets are defined as "those assets which in the regular course of business will be converted into cash and those assets acquired with a view to their availability for conversion into cash." An original definition published by me in 1920 defines them as "cash and those assets which in the ordinary course of business will be converted into cash" (*Theory of Accounts*, Volume I of *Business Accounting*, page 65). The change of "ordinary" to "regular" may or may not have been an improvement but the omission of cash from the definition seems to have been an inadvertent oversight.

So far as I know, I was the first person to define current assets in this way. Professor Hatfield in 1909 had defined them as "cash, realizable securities and accounts, or merchandise or material to be currently consumed" (*Modern Accounting*, page 46). Homer S. Pace in 1912 had defined them as "those that are held in realized form, such as cash, or are held merely for the purpose of realization, such as raw material, inventory, bills receivable and accounts receivable" ("Corporations"—lecture 3 in *Advanced Theory and Practice of Accounts*, page 30). While the latter definition seemed preferable to the former, it still seemed that students could be warned more pointedly not to include such a realizable account as unexpired insurance. Hence my definition which stressed the requirement that nothing, other than cash itself, is a current asset unless in the *ordinary* course of business it will be converted into cash. An asset cannot qualify as current merely because it is realizable and in *extraordinary* circumstances can be converted into cash.

Yours truly,
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Interest During Construction

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: The section on Accounting Questions in the August issue of THE JOURNAL, on the subject of interest during construction, prompts me to offer some comments.

I believe it is generally recognized that public-utility accounting, as prescribed by regulatory bodies, is based upon sound principles of accounting and that conservatism and fundamental accounting theory has been used through the prescribed systems of accounts.

The various regulatory bodies recognize and permit the capitalization of interest during construction. While it is customary to issue bonds to finance construction, and bond interest is then considered a part of the cost of construction, if preferred stock is issued for the same purpose, dividends on the preferred stock seem to me to be as much "cost of borrowed money" as bond interest which may be capitalized without violating sound accounting principles.

The following is quoted from the section of instructions of the uniform system of accounts prescribed for public utilities and licensees, issued by the Federal Power Commission as of January 1, 1937. Identical instructions are contained in the uniform system prescribed by the New York State Public Service Commission:

"Interest during construction (as a component of construction cost) includes the net cost of borrowed funds used for construction purposes and a reasonable rate upon the utility's own funds when so used. Interest during construction shall be charged to the individual job upon which the funds are expended and shall be credited to account 536—interest charged to construction—credit. The period for which interest may be capitalized shall be limited to the period of construction. No interest shall be included in these accounts upon expenditures for construction projects which have been abandoned."

A footnote to the above reads as follows:

"When a part only of a plant or project is placed in operation or is completed and ready for service but the construction work as a whole is incomplete, that part of the cost of the property placed in operation or ready for service, shall be treated as 'electric plant in service' and interest thereon as a charge to construction will cease. Interest on that part of the cost of the plant which is incomplete may be continued as a charge to construction until such time as it is placed in operation or is ready for service."

The usual method of calculating the amount of interest to be capitalized as part of the cost of construction (and the same would apply to dividends on preferred stock) is to charge the job order or work order interest at a reasonable rate on the open balance at the end of the month preceding. In that manner only actual interest on funds expended to date is capitalized.

If the proceeds of the bond or preferred stock issue are kept in a fund to be expended eventually, construction should only be burdened with interest (or preferred dividends) on the funds actually expended on the project. This avoids overcapitalizing interest.

I trust that the foregoing may be of some service to your correspondent.

Yours truly,
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