CORRESPONDENCE

Retail Method of Inventory

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: I have reviewed the question and answers on "Retail Method of Inventory," which appears on page 402 of the December issue of THE JOURNAL, and offer the following comments:

The question is asked as to whether cash as well as trade discounts should be deducted from the inventory at the end of the year. As the usual practice is to deduct trade discounts from the face of the invoice and to charge purchases for only the net amount, the natural result is that the trade discounts are at all times eliminated from the inventory. Therefore, no reserve is necessary to reflect a net inventory insofar as trade discounts are concerned.

Cash discounts may be handled in one of two ways: (1) Invoices may be paid net after deducting cash discounts and only the net amount charged to purchases, or (2) The gross amount of the invoice before deduction of cash discounts may be charged to purchases.

Under the first handling, the cash discounts are automatically eliminated from the inventory figures at all times. This handling is similar to the handling of trade discounts mentioned above and requires no special reserve to eliminate cash discounts from the inventory.

The other handling of cash discounts which requires that purchases be charged for the gross amount before deduction of cash discounts is the usual practice. The reason for following this plan is to provide a means whereby cash discounts earned may be set up in a separate account in order that the financial earnings of the company may be separated from the merchandise earnings. Wherever this plan is followed, it is advisable that the cash discounts deducted when invoices are paid be carried in a deferred earnings account captioned "Cash Discounts Earned." At the end of each accounting period, the cash discounts carried in this account should be apportioned between the merchandise sold and the merchandise still on hand, and only that portion which applies to merchandise sold should be taken as current earnings. The balance in the unearned-discounts account should be deducted from the inventory. This handling credits income for cash discounts only when the merchandise has actually been sold and does not credit earnings with unearned profits which apply on discounts taken on merchandise which is still in the inventory.

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Interest during Construction

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: A letter by Mr. R. Louis Lazo, published in the October, 1938, issue of THE JOURNAL arrested my attention sufficiently to cause me to reread more carefully the question originally raised and published in the August issue, together with the answers thereto.

Mr. Lazo directs his letter to the last question of August's inquirer, to wit: "Do you know of any authority which would defend such a proceeding?" Reference is being made to capitalizing preferred dividends paid during plant construction. For the benefit of this inquirer, sections of instructions relating to interest paid during construction, prescribed by both the Federal Power and the New York State Public Service Commissions are cited by Mr. Lazo. He does not quote these commissions as recommending or suggesting preferred dividends be treated as construction cost. He merely infers confirmation. Whether he is justified in this inference begs the real question, which, as I read it, is this: Are preferred dividends and interest paid on bonds, where both the preferred stock and bonds are issued for the purpose of financing construction, to be treated in the same manner and may either or both items so paid, be capitalized?

Let us try to apply this question to the facts given us by the inquirer. He states there are three classes of capital funds raised, by the sale of bonds, preferred stock, and common stock. The last was sold at a premium of 33⅓ per cent and these common stockholders specifically made this premium available for the payment of preferred-stock dividends. With this money a mill is to be built, the remaining funds to be used for operations when construction is completed.

I think it reasonable to assume the bondholders were secured by a first claim on the assets and earnings, if the preferred stockholders were given to understand the common stockholders assented to payment of dividends out of this premium. The premium was donated to the corporation and the cash became part of its assets and, as such, the bondholders had a first claim upon it. The inquirer does not state the bondholders waived their rights with respect to this paid-in or donated surplus.

It will be easier to demonstrate points I wish to make later in the text, if we assume a set of figures and circumstances reflecting, in the first column, the facts given us by the inquirer:

	At Completion of Financing	1 Year Later Bldg. Completed	2 Years Later Loss $180,000	3 Years Later Loss $130,000
Cash	$2,150,000	$ 310,000	$ 110,000	$ 10,000
Construction costs: Mill		1,750,000	1,750,000	1,750,000
Interest and dividends during construction		90,000	90,000	90,000
Reserve for depreciation (deduct)			40,000*	80,000*
Total Assets	$2,150,000	$2,150,000	$1,910,000	$1,770,000
4% Mortgage bonds	$ 750,000	$ 750,000	$ 750,000	$ 750,000
Accrued bond interest				30,000
6% Cum. preferred stock	1,000,000	1,000,000	1,000,000	†1,000,000
Common stock	300,000	300,000	300,000	300,000
Donated surplus	100,000	100,000	40,000	
Deficit account (deduct)			180,000*	310,000*
Total Liability and Capital	$2,150,000	$2,150,000	$1,910,000	$1,770,000

† Dividend unpaid—$20,000.
* Indicates red.

A brief explanation of the above table is in order. Column 1 reflects the plan envisaged by the inquirer with hypothetical figures inserted. In column 2, we show the completed mill at cost, and a preferred dividend ($60,000) and bond interest ($30,000) paid out with necessary changes in cash. No changes occur in surplus accounts because we are here assuming the capitalization of the sums paid out. Column 3 reflects the situation after a year's operating loss of $150,000. Bond interest due has been paid out and charged to deficit and the preferred dividend paid and charged against the donated surplus. This may be said, I think, to carry out the intention of the inquirer's client. And, finally, column 4 reflects a reduced operating loss of $100,000; bond interest accrued, but unpaid, charged to deficit account; and the preferred dividend paid to the extent of $40,000, charged to donated surplus.

This table shows the corporation's affairs to be very much strained at the end of the third year. Almost no cash is left for operations; on bond interest and preferred dividend payments, there have been defaults. The bondholders' committee, investigating, discovers $160,000 was paid out to the preferred stockholders. At no time were there any accumulated profits out of which to pay such dividends. The original security of the bondholders consisted of all the funds paid into the corporation ($2,150,000). Out of this fund $1,750,000 was paid for a mill. The bondholders got $30,000 interest twice. Whether the first $30,000 is charged to construction is immaterial to the bondholders if a foreclosure takes place at this time, for the bondholders get the property itself, value it as we will, at $1,750,000 or at the higher sum plus any other assets on hand. They have a right to expect the directors have not diminished these assets except through losses suffered in spite of prudent management. Under the circumstances as stated, the fact that the directors paid out $160,000 to preferred stockholders could well lead to suits against the directors. The fact that $60,000 of these preferred dividends was charged to construction account does, in no wise, diminish their fault. At the least, this $60,000 of the bondholders' equity is lost to them through the directors' action.

I concede capitalizing mortgage bond interest during construction is prevailing practice. It is true, interest so paid and capitalized results in no detriment to the bondholders' equity except when losses are incurred and dividends are paid to the stockholders.

Where profits are realized from operations immediately upon completion of the plant, the equities are disturbed, but not so seriously. We will, for the purpose of developing this phase of the argument, assume the same circumstances shown in the table above, columns 1 and 2, except that in the second year after organization a profit is earned sufficient to warrant payment of bond interest, preferred and common dividends.

There being no operating profits the year of construction, the relative equities are the same as previously discussed under losses. With profitable operations in the second year, let us consider the effect of the capitalization of the bond interest and preferred dividends paid out in the first year. To the extent that the earnings are reduced in the second and succeeding years by the depreciation rate on $90,000, the common stockholder is hurt. While the preferred stockholder got his dividend under this set of facts, marketwise his stock may be injured, for many buyers of stock consider the safety margin reported by statistical organizations when making commitments, i.e., income available for preferred dividends. This margin of safety has been whittled down by depreciation on bond interest and preferred dividends capitalized. The preferred stockholder received the dividend and to that extent his injury is tempered, but the depreciation on $30,000 bond interest is a net loss to him.

After the mortgage is paid and retired, the inequity to the common stockholder disappears as between him and the bondholder, but not as between him and the preferred stockholder. The preferred stockholder becomes first lienor in the bondholders' stead and the inequity with respect to the common stockholder continues either until the preferred stock is paid off or until the expiration of the entire plant through depreciation charges.

Theoretically, then, these inequities would be eliminated, but only after the lapse of many years. Actually, the elimination of the inequity to a particular stockholder may never come to pass because stockholders shift and change.

The object of accounting is, in general, to reflect historical costs. I think proponents of the proposition that it is proper to include bond interest and preferred dividends in construction costs are led away from historical costs by the economist's conception. Economists hold a theory that interest is a proper charge to determine costs. If accountants embrace this theory, they must be logical and charge construction costs not only with bond interest and preferred dividends, but also, clearly, with interest on common stockholders' funds to the extent they are used in construction projects. And the accountant with his double-entry set of books, would have to continue until operations produced a profit. This would lead us, as accountants, to a very ludicrous situation: property enhancing in book value through the years of losses.

In Mr. Gilbert R. Byrne's prize-winning essay, "Accounting rules and standards," printed in THE JOURNAL, November, 1937, he expresses himself with respect to what he considers fundamental concepts. If we refer to number 7 on page 372, we read:

> "Earned surplus should represent the accumulated earnings of the business from transactions with the public, less distributions of such earnings to the stockholders."

If we capitalize preferred dividends in construction costs, we certainly will not adhere to this principle.

Persuaded by the basic soundness of Mr. Byrne's proposition and other considerations, I for one cannot subscribe to the proposal of the inquirer in August, 1938, to capitalize preferred dividends during construction, and I see many occasions to question the propriety of the capitalization of bond or other interest paid.

Yours truly,

CHESTER MARTIN

Liberty, N. Y.