PROBLEM 5.

At the end of 1920 the Trustees of the Sinking Fund of a city found that in order to be in a position to retire $100,000 of the city's bonds in the spring of 1935, they had purchased in 1919 out of the general sinking fund moneys. only a small moiety of which appertained to the $100,000 bond issue, $60,000 of 1934 Victory Bonds, which at the time of the preparation of their 1920 balance sheet were quoted around 90. Should the bonds be shown in the balance sheet at market or cost price?

ANSWER. The general rule in accounting is to exhibit assets at cost or market price, whichever at the time is the lower. But it is not a rule incapable of variation, and undoubtedly variation is necessary in this case.

The rule referred to is accepted because it is designed to prevent inflation of profits by means of inflation of assets. Unless such a rule was in existence there would be nothing to prevent a mercantile concern inflating its closing inventories to selling instead of cost price. The rule is further designed to so provide that, in case the bottom drops out of the market for a certain class of goods, mercantile concerns should take their loss, and display the fact in their statement. If the market soared, however, cost should still be adhered to in valuing inventories, and the gain thus not be shown as anticipated profits, but the profit recorded when actually made by the disposal of the goods at the enhanced price.

In the case quoted, however, the cost or market price rule would not appear to apply, inasmuch as the inventory in this case is not of goods or assets held for sale, but, on the contrary, for retention. The tests in this case are whether the earning power of the bonds is affected, and whether the ultimate redemption of the victory bonds at maturity is questionable. As both these questions can be answered in the negative, the answer to the original question is—"Cost price."

The source from which the funds to purchase the bonds were obtained, does not enter into the question at all.