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American Institute of Accountants. Bureau of Information

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## Accounting Questions

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### PRESERVATION OF PAID CHEQUES

*Question:* The question has arisen—How long should paid cheques be retained on file?

In the instant case, during the period from 1906 to 1925, the corporation has paid a total of 51 cash dividends for an aggregate sum of \$10,940,000, all of which has been sent to shareholders through the mails by cheques. Of the aggregate sum all but approximately \$5,000 has been paid by the company's bank, while cheques for an aggregate of the above small amount have not been cashed.

The company maintains a book record of the names of all shareholders at the time each dividend is paid. There are thousands of these names. Each item is checked off when the cheque is returned by the bank as paid. It follows that the several items, which are not checked off in this record, are the outstanding unpaid items. A list of these outstanding cheques (unpaid dividends) made each year, agrees with the balance of a special bank account maintained for the separate purpose of paying these dividends.

The paid cheques covering dividends have always been kept, although as it happens they have seldom been referred to as proof of payment. These paid dividend cheques, together with certain other old and equally useless records, take up a great deal of space, which is needed for other uses. The question arises how many years back is it safe to destroy these dividend cheques.

The company is willing—indeed it is eager—to pay any of these cheques which may be sent in for collection, however old they may be. Indeed the company has lately paid a group of old cheques which had been found by a shareholder of record and sent in for collection. The company will not be embarrassed when cheques turn up for payment. The only purpose for which any of the paid dividend cheques can be needed would be as evidence that dividends had been paid, if anyone should wrongfully claim not to have received the dividend.

*Answer:* The general answer to this question is for all years in respect of which the statute of limitations has run against the stockholders. The ques-

tion of when the statute of limitations has run apparently varies in different states and also depends upon the provisions of the by-laws of the company.

As the question at issue appears to be one of law rather than of accounting, we referred the matter to a lawyer who furnished us with the opinion given below from which it appears that each case has to be considered on its merits. We would, therefore, suggest that your inquirer should advise his client to submit all the relevant facts in the case to an attorney, and be guided by his opinion.

“In England, the rule is that when a dividend is declared, the statute begins to run in favor of the corporation from the time that the stockholder is entitled to demand and receive his share, and this rule has been adopted in some jurisdictions in this country, even though it is recognized that no action for recovery of the dividend could be maintained without demand by the stockholder and refusal by the corporation. However, in other jurisdictions it has been held that the statute does not begin to run until a stockholder has actually made a demand and been refused. There are variations to this rule and a split of authority seems to be that where the action of the corporation in declaring a dividend is recorded in writing, the statute of limitations governing actions on written obligations for the payment of money will apply.

“The statute applicable is ordinarily the statute on written obligations for the payment of money, as stated above, but if at the time the dividend is declared the stockholder is not recognized by the corporation, or if a stockholder is by the terms of the declaration unlawfully excluded from participation in a dividend, the statute of limitations on contracts not in writing sometimes applies.”

*Answer:* In the circumstances stated in your letter, apparently the only question is as to the position of the company where it is called upon to pay particular dividends, although cheques in payment of such dividends have been issued and paid by the bank. We understand that where a claim is made for payment of a particular dividend and the company's records show that the cheque issued in payment thereof has not been returned as paid, the company will pay the amount of such cheque upon presentation without hesitation.

In those cases, therefore, where unwarranted demands are made, the question becomes a matter entirely of proof. Of course, in those cases where the statutory period of limitation for the collection of the debt has expired, the company could content itself with setting up that defense, but we take it that the company would not do so, as a matter of policy and good faith toward its stockholders.

As a matter of proof of payment, the canceled cheque would be the best evidence of payment, but as a matter of reasonable defense against a claim for payment, there is no doubt whatever in our minds that the courts would not expect a company to keep canceled cheques for twenty-four years, i. e. from 1906, which is the earliest date you mention, or even for more than ten years at the outside, and would accept as conclusive evidence the company's records, particularly since the records agree with the bank's own books. We mention ten years as an arbitrary period of reasonable duration, although, again, there is no doubt that the courts would give full credence to the records in any case where the claim is made after the period of limitation for collection, since the court would be aware that the company could dispense with the submission of any evidence by setting up the defense of limitation.

We believe that the company may with safety destroy dividend cheques after ten years from their date and may with equal safety even destroy cheques bearing a date beyond the statutory period of limitation. As to what that period may be, we are not prepared to advise, as it is a legal question dependent upon the situs of the company.

*MUNICIPALLY OWNED WATERWORKS*

*Question:* The city of \_\_\_\_\_ operates water works, the original cost of which was financed solely by bonds, and the water is presumed to be furnished to consumers at cost, which comprehends

Operating and maintenance  
Interest on bonded debt  
Depreciation

With this information in mind, will you kindly furnish answers to the following questions:

- (1) Is depreciation a proper charge against earnings of a municipally owned water plant?
- (2) If your answer is "yes" to question number 1, next preceding, should a charge also be made against earnings for bond retirement or bond redemption accruals?

*Answer:* There can be no question, in my opinion, that depreciation is a proper charge to cost in the case of a municipally owned water plant no matter from what source the capital came by which the plant was built. It is essential that the plant which represents the investment of this capital should be kept intact and that the funds required for this result should be derived from the charges for water service. When these charges are not sufficient to provide funds to replace the plant, replacements must eventually be financed out of bond issues or by an appropriation from the general fund. The cost of keeping the plant intact is a part of the cost of the service rendered which should be paid by the consumers and each consumer should pay his proportionate share of this cost as nearly as it can be determined. This result does not occur when resort is made to a general fund or to a bond issue in order to replace the plant.

In respect to the second question, namely, whether the cost of the redemption of bonds should be charged against earnings, it seems to me that two opposite views may be taken and supported.

When the capital for original construction and subsequent additions is derived from a bond issue and no provision is made out of earnings for bond retirement, the bonds must be refunded at maturity. The objections to this are:

1. The absence of a definite provision for redemption in the indenture may require a higher rate of interest.
2. There is a danger of meeting at maturity an unfavorable money or credit condition which might make refunding expensive.

Generally speaking, I favor the more conservative practice of providing out of earnings a sinking fund for the redemption of debt at maturity, even though depreciation is included in cost.

## *Accounting Questions*

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*Answer:* In order to determine whether or not depreciation is a proper charge against earnings of a municipally owned water plant, consideration should be given to the existence of any legal requirements or definitions in respect of earnings or cost which may be included in the original authorization of the municipality for the building of the waterworks and the creation and retirement of the bonded debt. Your inquirer states that the water is presumed to be furnished to consumers at cost, and that cost comprehends operating and maintenance expenses, interest on bonded debt and depreciation. It is not clear, however, whether or not these cost elements are so defined by municipal authority. If the municipal authorities have provided that water shall be furnished to consumers at cost, and have defined the elements of cost, then it would not be in order to write something else into the legal definition. If, however, it has been provided that water shall be furnished to consumers at cost, without having defined the meaning of cost, it would seem clear that the elements of cost should be those which in ordinary business practice are considered as cost, namely, those enumerated by your inquirer as stated above. In the latter event it would not be proper to add the cost of bond retirement, in addition to depreciation, as a charge against earnings, because bond-retirement expenditures are not ordinarily treated as a part of cost or as chargeable against earnings.

In theory it may be stated that the accounting for a municipally-owned water plant should be the same as if the plant were owned by private interests. If a municipality chooses to undertake the business of operating a utility, the fact should be recognized that the capital with which to carry on business must be provided by the taxpayers or by borrowing, and that a sound business policy should provide for the replacement of property at the date of its exhaustion. Ordinarily depreciation is a proper and necessary charge against earnings, whereas bond retirement or redemption accruals are not properly chargeable against earnings.

In the accounting for a municipally-owned water plant constructed from the proceeds of a bond issue it must be recognized that either the present generation of consumers will be required to pay a sufficient sum to provide for replacement of the property at date of exhaustion together with the cost of retirement of bonds or it will be necessary to replace the property from the proceeds of future loans. Although burdensome upon the present generation of consumers, it is perhaps good business policy to require them to retire the original bond issue and provide for replacement of the property, and thus create a sound credit basis which in future will operate decidedly to the advantage of the municipality.

In the absence of any legal restrictions to the contrary, I would therefore recommend that depreciation should be treated as a charge against earnings, that the depreciation reserve so created should be invested so as to provide a fund for replacement of the property, and that the consumers during the outstanding life of the bonds should provide for the retirement of the bonds.

In any event, the depreciation reserve, if created, should not be charged (as is suggested by your inquirer) with an annual appropriation for retirement of bonds; nor should it be charged with improvements and extensions of the plant or with ordinary repairs, the sole purpose of the depreciation reserve being to provide for replacements of property.

It is perhaps the general practice in municipal accounting not to provide for depreciation, probably partly on the theory that a municipality which is in a sound financial condition can always borrow for new construction work and for replacements, and partly on the theory that it is not fair to the present generation to burden it with the cost of improvements which will benefit future generations. It is, however, becoming more and more the practice in modern municipal accounting to adopt the more conservative course which we have recommended.

*Answer:* The correct answer to the problem presented can only be accurately given in the light of the language of the trust deed or other documents underlying the bonds. These are not before me and, therefore, my reply is based upon the information at hand and is given with all due reserve.

On the basis of this information my answer to the first question is that depreciation is a proper charge against the earnings of such a municipally-owned water plant, and to the second question my reply is that a further charge should not be made against the earnings for a bond sinking fund or for serial bond redemptions. In this case it appears that the municipality did not invest its own money in the waterworks but borrowed the funds, probably pledging its credit in addition to giving a first mortgage on the waterworks property. From the statement presented to me, it seems to be a fair inference that the bonds are for a long term, so that a reasonable allowance for depreciation will approximate in amount the annual requirements for sinking fund or bond-retirement purposes. In effect, therefore, it would be relatively immaterial if the sinking fund or other bond retirement expenditures were charged in lieu of depreciation, as is done in some cases. The main point, however, seems to be that the consumers should not be required, in paying for the water they consume to pay both the indebtedness upon the present plant and to supply the municipality with funds sufficient to erect a new plant.