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Accounting Questions: Certificate of Participation in Accounts of Investment Trust, Book Accounts, Accounting for a Finance (Small Loans) Company

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Accounting Questions

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CERTIFICATE OF PARTICIPATION IN ACCOUNTS OF INVESTMENT TRUST

Question: An investment trust sells certificates of participation to its participants. These certificates represent a pro-rata share of the net assets of the trust. The value of the net assets is determined by computing the market value of the securities in the trust at the date when the new participation is to be issued, plus any cash on hand, etc. No entry is made on the books to adjust the values of the securities to that date. The net value of the assets is divided by the number of participating units then outstanding to find the value per unit, and the new certificate holder pays that price for his units.

Now, a certificate holder some years ago paid, say, $10 a unit for a participation. The trust indenture provides that a certificate holder may turn in his certificate, and if acceptable to the board of directors, he will receive cash in redemption of his certificate, but he will receive only whatever his certificate may be worth when it is redeemed. Because of the decrease in values of the securities in the trust fund, a certificate holder gets only $6 a unit for his certificate.

To what sort of an account should the $4 difference be credited on the books of the trust, and how should that account be handled in the annual report of the investment trust? The trust indenture makes no provision covering this condition. The securities in the trust fund are carried on the investment-trust books at cost. Profit or loss is taken up on the books only when the securities are sold. The participating certificates outstanding are carried on the books at sale price.

Answer No. 1: It is our opinion that this transaction should be handled somewhat the same as if the investment trust were a corporation. In other words, the $10 originally received should be charged against the outstanding certificates of participation and the $4 difference should be credited to a surplus account separate from current profit and loss. If it were a corporation, proper credit would, of course, be to capital surplus, and some account of this nature should probably be opened by the investment trust.

It seems to us that some part of or perhaps all of the $4 difference may be an offset to charges against earned surplus, unless the reduction in certificate value to $6 represents a loss which is not eventually realized. In other words, if the company has actually sustained losses reducing the certificate value to $6, then so far as the certificate in question is concerned, the investment trust as such does not sustain the $4 loss, but this loss falls on the stockholder who sells his certificate for $6. If it were conceivable that all certificate holders could turn in their certificates at the price of $6 and the $4 difference were the measure of the accumulated losses, the investment trust would be left with its original paid-in capital. However, the foregoing remarks would also apply to a corporation, because capital surplus, arising through acquisition of its own stock, may in effect be an offset to deductions taken against earned surplus.

Our opinion, as stated above, is based on the rather limited data in your letter, and is subject to possible change which might result from a more detailed knowledge of the facts involved.

Answer No. 2: The question refers to the disposition of the difference of $4 between the price at which a participation unit was issued and the price at which it was redeemed. Inasmuch as $4 represents a proportionate part of the depreciation which had occurred in the value of securities owned by the trust between the dates of issuance and redemption of the certificates in question, it is quite apparent that the $4 should be credited to a reserve account which would represent the amount of depreciation on securities which had been recognized and absorbed by former owners of participating certificates.

In the preparation of statements, therefore, this reserve would be utilized to care for a certain portion of depreciation in the value of securities. Any depreciation in excess of the amount in reserve would, of course, represent a reduction in the value of the outstanding unit certificates.

BOOK ACCOUNTS

Question: Some time ago one of our customers was in difficulties and we took an assignment of accounts receivable to protect our interests. This company had a subsidiary to which it was supplying substantial sums for working capital, in fact the subsidiary company had a nominal capital of $1,000 and the advances by the parent company amounted to more than $700,000. Our assignment was drawn in a very general way, referring to "book accounts."

The parent company went into receivership, but the subsidiary was not involved in these proceedings and continued to operate. After making the assignment of the accounts, the parent company continued to make substantial advances to the subsidiary company. There were transfers of supplies and cash from one to the other, but the net effect was to build up a still heavier debt by the subsidiary. We are now endeavoring to bring under this assignment the amount owed to the parent company by the subsidiary.

Our attorneys are anxious to know what the accounting profession understands by "book accounts."

Answer No. 1: Without professing to understand the legal aspects of the situation, it seems to us that unless the assignment specifically covered the accounts of certain customers, the term "book accounts" could quite properly be construed to cover all open accounts, including the one representing advances by the parent company to its subsidiary company. The term "book accounts," as we understand it, would not necessarily be confined to ordinary trade accounts but would include all receivables.

Answer No. 2: In the first place, we do not believe that the term "book accounts" has been generally enough used to have acquired any clear definition. Our first impression would be that it related to accounts receivable, but the term is so general that it might very well apply to any account on the books.

Answer No. 3: So far as we are aware there is no technical or specialized significance assigned to the term "book accounts," except that by a loose usage "book accounts" is sometimes used as interchangeable with "book debts."

It seems to us that the question turns on the intent of the parties. From the details available it would seem that the intent was to assign the book debts of the parent company and, in the absence of a specific exclusion, the amount due from the subsidiary, we consider, might well be taken as coming within the description.

ACCOUNTING FOR A FINANCE (SMALL LOANS) COMPANY

Question: We have been asked to install a bookkeeping system for a finance (small loans) company, properly to reflect the earnings each month.

The finance company operates as follows—A person asks for a loan of $100. The finance company takes a note for $100 but gives the borrower only $90. The 10 per cent. of the loan which is deducted by the company represents 7 per cent. of interest deducted in advance and a 3 per cent. fee for making the loan. Repayment is made in 10 equal monthly instalments.

At the present time the 10 per cent. is taken up as income on the monthly financial statements, and every six months the deferred income is computed and adjusted on the books to the proper figure.

Answer No. 1: Generally speaking, the methods followed by finance companies (excluding variations) might be said to consist of the practically easier one of taking up the interest and fee income into earnings as received (i.e., at taking of note in this case), with periodic corrective adjustments for unearned income, and the theoretically proper one of deferring the entire amount at such time of receipt, with monthly entries taking the earned portions into income.

As a matter of practical convenience, we see no objection to the stated practice of the company in taking up the entire 10 per cent. of interest and fee as received, with adjustment for the proper deferred portion every six months, provided that any statement of monthly earnings in the interim be shown as subject to such semi-annual adjustment. This answer is predicated on the assumption that—if there is no considerable divergence monthly between the aggregate amounts of loan collections and new loans made—the income thus tentatively taken up would, in any event, approximate the proper accrual; and correspondingly, the deferred income credit carried forward from the beginning of the six-month period would measure, for practical purposes, the amount of unearned income. In the initial period of operations, of course, such an assumption would not be tenable, but once the company's working capital is all invested and thereafter merely in process of a more or less constant monthly turnover, the procedure above outlined should be satisfactory for practical purposes. In the event of any appreciable increase or decrease in the amount of loans outstanding over any such six-months period, some interim adjustment of the deferred income credit, made upon the basis of estimates, would suffice to place the monthly earnings on a fairly accurate basis.

As an alternative suggestion, the interest, as received, might be credited directly to deferred income, with a monthly transfer to earnings of the necessary amount to state the month's earnings on the basis of 1 per cent. of the month's average of total loans outstanding. The ascertainment of the latter should not be a matter of any difficulty.

Answer No. 2: From the standpoint of monthly earning statements, it is not in accordance with sound accounting practice to take into income in the month in which a loan is made the prepaid interest and fee which is collected by the finance company. Such deferred income, in order to reflect the correct earnings, should in our opinion be amortized over the period of the note. In the example mentioned by your correspondent, the entry at the time of making the loan should be as follows:

Notes receivable......................	Dr. $100.00	
To Cash...........................		Cr. $90.00
Deferred income..................		10.00

Inasmuch as the loan is repayable in ten monthly instalments, it follows that the amount to be credited to income for the last month of the note's duration will be interest on $10, whereas at the end of the first month it will be the interest on $100 and at the end of the 6th month interest on $50. In working out this calculation it will be found that the effective rate of interest on the loan is slightly over 15 per cent. and that the interest for the last period is therefore approximately 15 cents.

We can see no reason why the amount of interest which is taken into income each month should be computed for each loan. In our opinion, it would be sufficiently accurate if one-half of the first month's combined interest for all loans within a month be taken into income in the month in which the loans are made without regard to the particular day of the month on which a loan is made. As the loans are all repaid in equal instalments over the same number of months and at the same rates for interest and fee, a monthly computation only is necessary to determine the distribution by months of the interest and fees collected in advance on the total loans made each month. The result of this computation and distribution by months may be accumulated in columnar form by months with similar computations for prior months, thus obtaining the total amount to be taken into income each month.

While this method is not exactly accurate, it would appear to be reasonably so for all general purposes.