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Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

WRITING OFF OF CAPITAL ASSETS

Question: A company has accumulated a substantial earned surplus in excess of the amount at which its fixed assets are carried on the books. It now proposes to write off such fixed assets to earned surplus, making a disclosure of such write-off in the year in which the fixed assets are so written off. Depreciation on such fixed assets is material in relation to the income account. The company proposes that in future it will write off additions to and all repairs and replacements of fixed assets, but it appears probable that such additions, repairs and replacements will be relatively small compared with the amount of depreciation which would have been written off annually had not the entire plant been charged off to earned surplus.

Would a public accountant be justified in certifying to the balance-sheet and income account of this company without reference to the fact that the plant has been written off, and particularly without reference to the fact that depreciation has not been deducted from the income account; also, if reference is made to the fact that depreciation is not deducted from the income account, should some amount be stated as the approximate amount of depreciation which would have been deducted from the income had the plant not been entirely written off?

There is the additional question as to whether the answer would be the same provided the company in question is a company just formed and the plant and equipment is stated at no value at the time of incorporation.

Answer No. 1: In reply, we wish to state that we have always discouraged a procedure such as mentioned in your letter, as we believe that a company owes it to its stockholders and the public to issue its accounts in a form which will not be misleading either as regards the financial position of the company or its subsequent earnings.

However, such action has been taken by a few corporations with whose accounts we are familiar and, while we have not refused to certify such accounts, we have always insisted upon full disclosure either in the accounts themselves or in the certificate. In one case which we have in mind, in which a

large part of the capital assets was written down to $1 by creating a reserve from surplus, the annual accounts have always shown the gross amount of such properties with the deduction of the reserve necessary to reduce to $1. The entries by which the reduction was made were clearly stated in the accounts, as has also been the charge by which subsequent additions have been written off, and the certificate has clearly stated that as capital assets are carried in the accounts at nominal values, and the additions for the year having been charged against surplus, no charge has been made against income for depreciation. We are strongly of the opinion that a public accountant should not certify such accounts unless there is a clear disclosure of the facts in the matter.

Regarding the question as to whether the procedure would be the same provided the company in question has just been formed and the plant is stated at no value at the time of incorporation, we are of the opinion that the situation is the same and an equally clear disclosure of what has been done in respect to the property accounts, subsequent additions and depreciation should be made in the accounts or the certificate.

Answer No. 2: We do not believe that a public accountant would be justified in certifying to the balance-sheet and income statement without reference to the fact that the plant has been written off and that depreciation has not been deducted from the income account.

It would be preferable in the circumstances to give the approximate amount of depreciation which would have been deducted from the income account had the plant not been entirely written off although we do not believe that this is absolutely necessary. The important factor is to place the reader on notice that the accounts have been prepared in an unusual manner so that he is not misled into believing that the profits are stated on the ordinary basis.

We believe that the answer would be the same if the company in question were one just formed and the plant and equipment were stated at no value at the time of incorporation.

Answer No. 3: Depreciation—as has been succinctly stated in a well-known court decision—is a matter of fact and not merely a bookkeeping device. Depreciation represents an actual operating expense; it is nothing else, so to say, than the piece-meal consumption of a plant. The mere fact that the plant property has been written off and thus a real asset suppressed in the accounts, does not alter these two facts—namely, that the asset value still exists and that it is being gradually consumed in the operations.

The suppression of the asset, and the overstatement of current earnings resulting from there being no charge made against operations for what is nevertheless an actual current operating expense, call for qualification in the accountant's certificate; the amount of the omitted depreciation, if at all determinable (and presumably it would be computed in any event, in such a case as this, for tax purposes) should be indicated.

The answer is the same for the case mentioned in the last paragraph of your letter.

Answer No. 4.

1. (a) Would a public accountant be justified in certifying to the balance-sheet and income account of this company without reference to the fact that the

plant has been written off, and particularly without reference to the fact that depreciation has not been deducted from the income account; and

(b) if reference is made to the fact that depreciation is not deducted from the income account, should some amount be stated as the approximate amount of depreciation which would have been deducted from the income account had the plant not been entirely written off?

2. Would the answer be the same provided the company in question is a company just formed and the plant and equipment is stated at no value at the time of incorporation?

Dealing with question (1), it is our opinion that the accountant should state in his certificate that the fixed assets had been entirely written off or were included at a nominal value, the balance-sheet and relative income account being subject to this explanation. In ordinary circumstances, however, we do not consider it necessary to mention the amount of depreciation which otherwise would probably have been charged against operations.

It should be added that repairs and ordinary replacements such as do not constitute betterments are normal charges against operations. The proposal to make such charges does not therefore affect the question under consideration but if additions are also charged to an appreciable extent, that fact should also be mentioned. Of course, we have in mind relatively large capital outlays and, regard being had to the magnitude of the operations, not those comparatively small capital additions which, as a matter of conservative practice, might be charged against income instead of being capitalized.

With regard to (2), we believe the requirements would be met in general by describing the fixed assets in the balance-sheet as being included at no value or at a nominal value. It might be necessary to refer in the certificate to this condition but, it seems to us, the necessity for this further reference depends on the particular circumstances of individual cases, for which no general rule can be formulated.

DEFERRED FINANCING COST IN ACCOUNTS OF PRIVATE SCHOOL

Question: A private school, not for profit, but supported by tuition fees, has a plant and equipment purchased from the proceeds of subscriptions received mostly through a public appeal.

A condensed balance-sheet shows:

Plant and equipment	$1,518,045.04
Cash and receivables	130,114.88
Unpaid subscriptions	203,778.43
Inventories	10,901.65
Deferred financing cost	189,544.94
Total	$2,052,384.94
Liabilities	345,134.88
Net assets	1,707,250.06
These net assets are represented by:	
Subscriptions	1,448,141.02
Profit from sale of old plant and equipment	137,483.19

Bequest under a certain will........................	$ 100,000.00
Surplus..	21,625.85
Total...	$1,707,250.06

The item in question is "deferred financing cost," $189,544.94. It seems that nothing is accomplished by carrying this on the books. However, to write it off would change the statement from a surplus of $21,000 to a deficit of $168,000.

I would like suggestions as to how this item should be carried.

Answer No. 1: The question is one as to the advisability of writing off the deferred financing cost on the statement of a private school not operated for profit.

The capital of the school, as shown in the statement, is carried in four different accounts, namely, subscriptions, profit from sale of old plant and equipment, bequest under a certain will and surplus. It does not appear that there is any value in continuing this segregation of capital beyond perhaps retaining the identity of earned surplus. Even in that case the reasons applying to commercial or profit-making businesses do not apply. I would, therefore, suggest merging all of the capital items, except possibly surplus, into one account and reducing their total by the amount of the deferred financing cost. This is logical because I presume deferred financing cost really represents the cost of obtaining subscriptions and is not properly chargeable against the earned surplus in this case.

It is an entirely different proposition from a business corporation having capital stock and paying dividends.

If it is desirable to maintain the identity of the several capital accounts, I would suggest writing off the deferred financing cost against subscriptions. That suggestion, of course, is dependent on the correctness of my theory as to the origin of the expense.

Answer No. 2: We are of the opinion that the financing cost might properly have been charged against the subscription account, and that it would be proper at this time to write off the deferred financing cost to such account. If this is done, we suggest that the balance-sheet should disclose the situation somewhat as follows:

Subscriptions.......................	$1,448,141.02	
Less financing cost.................	189,544.94	$1,258,596.08

or

Subscriptions (less financing cost—$189,544.94)	1,258,596.08