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Accounting Questions: Depreciation of Hospital Buildings and Equipment, Donation Bonds on Municipal Balance-Sheet, Overhead Expense of Accountant's Office

American Institute of Accountants. Bureau of Information

Accounting Questions

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DEPRECIATION OF HOSPITAL BUILDINGS AND EQUIPMENT

Question: A sectarian hospital which dispenses service to both pay and free patients, makes an annual charge of $50,000 against operating income for physical wear and tear on its buildings and equipment. All ordinary repairs, likewise, are charged against income. The buildings and equipment, which cost $2,000,000 to acquire, were paid for through gifts received.

The hospital looks to the income from an endowment fund, the community fund allotment and sundry donors to make good its annual deficit from operations.

Is the depreciation charge a proper one? If the answer is affirmative, a discussion of the function and place of the credit side of the journal entry is requested.

Answer: The theory under which depreciation of capital assets is charged against operating income is that as those assets are worn out in operation their cost should be recouped from the proceeds of the sales of the product resulting from the operations. This is accomplished by adding a proportionate part of the cost of the capital (represented by the charge for depreciation) to the expenses incurred in production, which are represented by more or less direct outlays, such as labor, material, supplies, maintenance, service, etc. After adding another amount to represent the cost of selling and administration expenses and the profit, the aggregate is the sum at which the product must be sold to return to the manufacturer not only the expenses for which a cash outlay must be made, but also profit and a sum which, if set aside, would be available for the replacement of the capital assets as they became worn out.

Under the theory that the depreciation charge is intended to recoup the capital expenditure, depreciation seems to have no place in the accounts of your inquirer because the capital assets were acquired by gift. Indeed, if it is expected that other gifts will be available or will be sought with which to replace the equipment as it wears out, then depreciation should not be charged against operating income.

You state that the hospital looks to the income from certain funds from sundry donors to make good its annual deficit from operations. If the donors are only making good the excess of cash outlays over the income from operations, they are not making good the entire deficit from operations after charging depreciation as shown by the books. Therefore, there is no reasonable basis for expecting that the reserve for depreciation will ever be represented by cash available to replace equipment and the charge for depreciation is not only theoretically wrong, as stated above, but is also of no practical use.

However, if the deficit shown by the operating statement to which depreciation has been charged, is actually being made good by your donors, then your institution is in the very happy position of accumulating each year $50,000, which should be deposited in a special bank account or otherwise invested and be available for the replacement of equipment as it is worn out in service. If this is being done, we assume that the donors are fully informed as to the means by which the ever-increasing amount in the special fund or the investment has been accumulated. In these circumstances the charge for depreciation while not supported by the theory of accounting is practically correct.

The amounts on the credit side of a balance-sheet, liabilities, reserves, capital and surplus, represent the several sources from which the items on the asset side were derived. Thus, accounts payable were incurred to acquire materials and services with which the institute itself renders its service. The reserve for depreciation is the measure of the amount that has been added to the costs represented by direct outlays to recoup the cost of equipment. Surplus (of a private corporation) represents the amount further added to arrive at a reasonable selling price or value of the product sold or of the service rendered.

Furthermore these accounts on the credit side of the balance-sheet represent the channels through which the assets of the enterprise will ultimately be distributed. Accounts payable will be liquidated. Surplus (in the case of a private corporation) it is hoped will be distributed to the stockholders. The reserve for depreciation represents the amount that it is expected will ultimately be expended in replacing equipment, etc.

DONATION BONDS ON MUNICIPAL BALANCE-SHEET

Question: In audits of municipalities in southern California, the question has been raised as to the proper method of reflecting on the municipal balance-sheet the issue of general city bonds of $100,000, the proceeds of which are to be used as a donation to the university of California, southern branch, for the purpose of procuring land for the erection of the buildings at Westwood. These bonds, of course, stand as a general obligation on the municipality in question and, together with accrued interest, should be reflected in the municipal balance-sheet until full redemption has been made.

The point at issue is the setting up of the tenable interest of the municipality in the university site, as such donation of $100,000 was predicated upon the reversion of either the $100,000 or a divisional interest in the university site, if such site is ever alienated from its present use. It has been contended that the $100,000 should be charged off against the accumulated excess revenue over expenses resulting from prior years' operations of the general city funds, thus disappearing from the balance-sheet except for the unmatured and unredeemed bonds outstanding, together with interest on them.

It is my opinion that the $100,000 should be charged to an account for real estate purchased—university site, and deducted in setting up a balance-sheet from the total surplus account of the municipality. There is no fund balance-sheet in this case. I believe that it is preferable to have the $100,000 so donated appear both in the accounts and in the balance-sheet for the following reasons:

First: That the expenditure of funds provided through the $100,000 bond issue is properly accounted for on the balance-sheet without further explanation.

Second: That the reversional interest may not be lost sight of even after the bonds have been redeemed in full.

I would appreciate your opinion as to the proper method of accounting for this donation of $100,000, the expenditure being primarily in the nature of a purchase of goodwill, the bond issue being authorized primarily to assist in providing university facilities adjacent to the municipality in question for its citizens.

Answer: It would be our opinion that the reversionary interest in the university site would have so contingent a value and little prospect of realization that it should not be carried as an asset. Your inquirer refers to the use of the proceeds of the $100,000 city bond issue as a "donation," which would seem to confirm the thought expressed above.

The procedure suggested in the third paragraph of your inquirer's letter would serve the purpose of keeping a record of the donation, though at the same time giving it in effect the treatment referred to in the second sentence of the preceding paragraph, i.e., to charge the $100,000 donation against the surplus in the city general fund.

OVERHEAD EXPENSE OF ACCOUNTANT'S OFFICE

Question: What is the average overhead expense of an accounting office of the small firm or individual practitioner type, stated in its percentage relationship to gross annual fees. By overhead expenses I mean all expenses other than direct salaries of staff employed on engagements and partners' or principal salaries.

My classification of expenses against which I would like to have the comparison includes the following:

Staff traveling expenses, stenographers' and typists' salaries, office rent, stationery, postage, telephone, staff and office supplies, water, light and towels, repairs to equipment and depreciation on equipment.

Answer: I would advise you that the following figures represent a yearly average based on the years 1930–1929–1928–1927 and are taken from the income-tax returns:

2,042 man days of staff—yearly average	$48,721.00
Time of principal charged to clients	8,050.00
Gross fees	$56,771.00
Clerical help other than staff	$ 3,100.00
Rent of office	2,780.00

Telephone	$266.85
Stationery and printing	433.59
Tax and law service	100.00
Books and periodicals	56.50
Dues—professional societies	125.00
Dues—clubs	600.00
Entertainment	502.66
Carfare and traveling	1,559.46
Legal fees	86.52
City and state taxes	33.25
	$ 9,643.83

Expenses other than staff salaries amount to approximately 17 per cent. of gross fees.