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Accounting Questions: Depreciation Charges from Capital Surplus; Office Procedure in an Accountant's Office

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Accounting Questions

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DEPRECIATION CHARGES FROM CAPITAL SURPLUS

Question: Would appreciate it if you can procure an opinion relative to depreciation charges in the following circumstances:

(1) A corporation acquired depreciable assets in 1928.
(2) The assets were set up on the books at an appraised value in excess of the cost to the constituent companies.
(3) The internal revenue bureau recognizes the original cost as a basis for depreciation allowances.
(4) The depreciation based on book values is double that allowed by the internal revenue bureau.
(5) A serious distortion of income ensues if the book depreciation is charged against operations.
(6) Such income is drastically reduced thereby.
(7) Capital surplus and earned surplus previously accumulated were substantially wiped out by operating deficits to 1933, leaving a small amount of capital surplus on the books.
(8) For the past two years the difference between depreciation on book value and costs has been charged yearly against such capital surplus.
(9) At present the balance remaining will be sufficient to provide for differences for the next two years.

Is this sound practice? And what would be the desirable procedure to follow after the capital surplus is exhausted? It may be stated that on the basis of rates allowed by the revenue bureau, a reasonable net profit is shown but there is a large accumulation of unpaid dividends on the corporation's cumulative preferred stock.

Answer: From the statement that the assets were set up on the books at an appraised value in excess of the cost to constituent companies, it would appear that such appraised value constituted—for all practical purposes, at least—cost to the present owner. Later it is stated that the company has a capital surplus, but the origin of that capital surplus is not indicated. Presumably, however, the capital surplus did not represent appreciation of the property in question, although it might have represented paid-in surplus, consisting of an excess of the value at which the property was taken up on the books over the par or stated value of the securities issued therefor.

There might possibly be some justification for charging against capital surplus arising from appreciation of property values such part of the depreciation as is applicable to the appreciation; but that would be true only in certain circumstances, and in any event it appears that in this case the capital surplus was not thus created. We can hardly conceive of a situation where paid-in surplus, representing the excess of the values of capital assets over the par or stated value of securities, could be utilized to relieve current operations of any part of the depreciation charge.

Considering the facts presented to us, the only practicable solution that occurs to us is that the company ought to relieve itself of this burdensome depreciation charge by writing down its property, by appropriate corporate action, to a reasonable valuation based upon present conditions, if necessary reducing its capital stock for that purpose. In this general house cleaning process it should exhaust its earned surplus, if any, first, then any capital surplus remaining on the books, and then utilize such additional capital surplus as it may be necessary to create for the purpose by reduction of capital stock. If that is done the corporation should depreciate the written-down value of the property by current charges against operations. Also, any earned surplus accumulated after the date of this housecleaning should be indicated in subsequent balance-sheets as from that date.

OFFICE PROCEDURE IN AN ACCOUNTANT'S OFFICE

Question: We are making some changes in our office procedure, and we would value receiving from your office suggestions for the accumulation of time and expense charges against clients during the progress of the work, so as to have a satisfactory cost ledger or convenient record for billing our clients when necessary.

While we are capable of developing that which is necessary to fit our needs, it occurs to us that there may be a particularly suitable method in rather common use by the accounting firms with which you have contact or there may be a treatise with suggested forms on the subject with which we are not familiar.

Our time reports by staff members are satisfactory and furnish in weekly summary together with all the daily details, the time used in each particular case and the expenses incidental thereto by staff members. What we desire is to obtain the most convenient intermediary record between the time report and the client's bill.

Answer No. 1: The intermediary record used between time and expense reports and the bill to clients is a control account called "unbilled costs," controlling both hours and amount, with details in loose-leaf form. To the detail sheets for each engagement, identified by client number and kind of work, are posted the time report date, initials of the accountant, time report number, and to three columns, respectively, the time, cost amount and expense disbursements.

Copies of bills rendered are made on letter size blank sheets to fit a binder initialed by a partner and numbered. At the close of each month the bills and related cost sheets are presented to and inspected by a partner before final disposition, when the remaining open cost sheets are also scanned. Bills and costs are listed on a sheet headed "summary of billing and costs closed." This lists each item by bill number, case number, name, time in hours, cost amount, expense outlay and amount of bill. The total is the basis for a journal entry—or direct posting—charging "cost of cases billed" with time and dollar cost and crediting "unbilled costs" with the same items and also charging "accounts receivable" and crediting "cases billed" with the total of bills. The cost sheets for costs closed are removed from the binder, stamped with month closed and filed by client number in a binder for closed costs.

Expense disbursements are charged through the cashbook to "unbilled costs" identified by client number. The total of the column is posted to the control and the detail amounts to the cost sheets.

Some matters not specifically asked for but related to the foregoing may be mentioned.

A so-called "client record" is kept, to which time and costs are entered on one side and billed amounts, with condensed identification of the matter, on the other. The total of debits agrees with accumulated total charges to "cost of cases billed." The total of credits agrees with "cases billed." The accounts are kept in control and started new each year. This is useful for ready reference to prior bills and costs, totals charged to individual clients and for calculation of prior shares to certain partners on specific matters. No book entry for overhead is made to the costs; for calculation of total cost, overhead is based on a normal cost of $1. per productive (or case) hour.

The copies of bills are stamped with the date paid. This is supplemented by a consecutive listing of the bills in a book after they have been initialled by a partner, to which the cashbook entries of payments are posted as to date only. This book supplies the internal check or control on revenue.

Cost per hour for salaries of accountants are determined by dividing the annual salary rate by 1,750, representing the expected or hoped for number of productive hours. This produces a credit balance in the salaries-paid account when the rate is applied to costs on cases, time of holidays and available time; and that credit represents a reserve against the cost of the expense time enumerated.

A time quota of hours is set for each month, which varies with the number of days in the month and the season. Variations from the quota are entered and calculated on the time reports and become shown in dollar value in "gained time" and "lost time" accounts. A time control is kept in a separate record which is made up of the aggregate time in all time reports. This control is supplemented by time accounts kept for each accountant, showing total on time report and distribution between productive time, holidays, available time, gained time and lost time.

Answer No. 2: We post from time sheets the time spent on each piece of work by each man. A cost rate per hour based on a conservatively estimated number of hours per annum plus proper overhead is determined for each man and the time is extended at this rate. This gives a cost for each piece of work. It does not, of course, give any indication of what should be charged for the work.

For engagements on which a fixed fee is received the fee is compared with the cost so ascertained, but where per-diem rates are charged these are determined without any special reference to the cost rate and the time is extended accordingly.

This is all done through ledger accounts in what is essentially a cost ledger.