Journal of Accountancy

Volume 63 | Issue 5 Article 6

5-1937

Accounting Questions: "Giving Effect to" on Balance Sheet; Income from Endowments from Educational Institution

American Institute of Accountants. Bureau of Information

Accounting Questions

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"GIVING EFFECT TO" ON BALANCE-SHEET

Question: A client has preferred stock issue with dividend dates quarterly, including July 1st, with the privilege of retiring the stock on any dividend date. In order to avoid the laws governing the sale of securities, they propose to exchange the old stock for new, carrying a lower rate of dividend and at the same time propose to take advantage of their right to retire a substantial portion of the stock as of July 1st. The stock was formerly listed on the San Francisco Stock Exchange, but later taken off.

The company's fiscal year closes June 30th, and they regularly furnish to investment bankers a certified balance-sheet of such date. The attorneys want them to make the exchange as of July 1st, and the client would like to have the June 30th balance-sheet reflect the financial condition, after giving effect to the matters referred to above.

(a) Would it be proper to certify the regular balance-sheet of the company under date of June 30th, "after giving effect to" certain specified transactions of July 1st?

(b) Would it be in order to certify the balance-sheet as of commencement of business, July 1st (ignoring all trading operations as of July 1st), regardless of the fact that all prior year reports have been dated June 30th, and that presumably all subsequent reports will be similarly dated?

Answer No. 1: The distinction between the two plans suggested in the question does not seem to be pertinent. A balance-sheet "as at the beginning of business July 1st," would presumably be identical with a balance-sheet "as at the close of business June 30th," as theoretically no transactionscould happen between the close of business of one day and the opening of business the following day, save for a possible consideration of accruals.

If plan (a) is followed, the heading of the balance-sheet should very distinctly set forth each specific item that is "given effect to as at July 1st," so that there may be no doubt in the mind of any reader of the balance-sheet as to the items contained therein which differ from those as at June 30th.

Furthermore, the certificate accompanying the balance-sheet should again specify in detail each specific item that is given effect to in the balance-sheet beyond those recorded June 30th in the normal course of business.

Accountants prefer not to present financial statements which include the effect of transactions not yet accomplished as at the date of the balance-sheet. This hesitancy is increased whenever the unaccomplished transactions are of a character that may not be made completely effective for some time, so that there may never be a date upon which the actual financial position of the company agrees approximately with the one set forth in the balance-sheet giving effect to such transactions. However, in this case that condition does not seem to be present. If on July 1st all of the proposed transactions are actually made effective, then a balance-sheet as at the close of business July 1st would be identical with the one prepared, with the exception of the other transactions of July 1st occurring in the course of business and not considered in the balance-sheet.

We think, therefore, that the accountant might be justified in preparing a balance-sheet as at June 30th, giving effect to the recapitalization made effective July 1st, provided, as said above, that the items so introduced in the balance-sheet in advance of their actual accomplishment are clearly set forth in the balance-sheet heading, and in the accountants' certificate.

Answer No. 2: In our opinion the simplest and most direct manner of handling the situation outlined would be to submit a balance-sheet at the usual closing date, June 30th, supplemented by a clear notation at the top of the statement following the title and date, somewhat as follows:

> "Balance-sheet as of June 30, 1936
>
> "After giving effect to certain refinancing involving the exchange as from .... of .... shares of new .... stock for .... shares of .... presently outstanding, as specified in contract between the bankers and the company, dated........ ...."

This is the usual form of presenting accounts of this type and there could be no room for any misunderstanding. A balance-sheet dated July 1, 1936, would require a more detailed explanation in order to avoid confusion and misunderstanding and we do not approve of such a proposal.

INCOME FROM ENDOWMENTS OF EDUCATIONAL INSTITUTION

Question: An educational institution has endowments arising from various sources (bequests, gifts, etc.). Income from the related trust-fund investments is used under normal procedures, due consideration being given to the terms and conditions of the respective endowments. Reserves for depreciation and obsolescence are maintained.

Endowments, gifts, etc., are being made less frequently in late years because of the effect of heavy income and inheritance taxes on individuals and estates.

New buildings, and additions to existing buildings, are needed from time to time.

Is there any impropriety, or unreasonableness, or violence to good accounting practice, if the trustees of the institution set aside periodically from income realized from the investments of endowment funds, a special fund created for the purpose of accumulating capital with which to construct new buildings? Such special fund would be separate and distinct from any reserve for depreciation and obsolescence.

In so far as I have knowledge, there is no evidence that such practice has been used; but I can see no specific objections to doing it if there is ample income and endowment provisions are not invalidated.

Answer No. 1: It is our opinion that the income from endowments must be used in accordance with the terms of the gifts creating such endowments. In many cases the donors make no restrictions on the use of income and leave the disposition of such income to the judgment of the trustees. Where such conditions exist, we see no impropriety, or unreasonableness, or violence to good accounting practice if trustees should elect to set aside part of the income from such endowment funds to provide capital with which to construct new buildings.

Answer No. 2: I do not think this is an accounting question at all and can only be answered by an examination of the trust deed under which the endowment has been set up and possibly by a legal interpretation of the deed. The whole point seems to me to be a legal one. Obviously, in the absence of any provision to the contrary, it would be proper accounting practice to record the setting aside of any income for any purpose which the trustees were empowered to carry out. The accounts would merely reflect the application of the trustees' transactions under their powers and the accountant's only duty would be to satisfy himself that they were not exceeding their powers.

There are, I believe, some funds which specifically require the income to be spent currently. In cases like these I think a legal opinion would be necessary before the trustees could invest in capital assets.