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Accounting Questions: Explanation on Balance-Sheet of Advances to Trustee

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Accounting Questions

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EXPLANATION ON BALANCE-SHEET OF ADVANCES TO TRUSTEE

Question: I have a client who owes a bank $200,000. On the books of this client there is an account, "John Doe, trustee, $54,000," representing payments to him. At my request, John Doe, trustee, has given me a copy of the agreement, which in effect, states that he, John Doe, for an undisclosed principal, agrees to purchase a certain number of the preferred shares of stock of this particular corporation, together with a house and a summer home belonging to the owner of this preferred stock, for the sum of $150,000, payment on which is to be made yearly. There is no mention of the corporation as being the principal in the contract, and the corporation is bound in no way to advance the money to meet these payments.

I furnish the statement that I know is to be given the bank, in which I list in the division, "Other assets," an item reading, "John Doe, trustee, $54,000." I state in my certificate that the enclosed balance-sheet, in my opinion, is a true and correct picture of the affairs of the corporation, etc., and that I have been given all of the information for which I have asked.

John Doe himself is not responsible. I make no mention in my comments or any footnote on the balance-sheet, that John Doe, trustee, has contracted to make additional payments.

I know from my knowledge of the people and their affairs that the undisclosed principal of the trusteeship is the corporation itself, and know that it is more than likely that the corporation will continue to advance, from its cash, the yearly payments to meet the contracts of

John Doe, trustee. They will be more than apt to use the funds that should have been applied on the payment of the note.

In other words, there is no legal liability of the corporation, yet am I honor bound to pass on to the bank the information, that, while I have every reason to believe it correct, legally may not be so?

Answer No. 1: In my opinion the auditor is not necessarily required to pass on to the bank, in such a case, facts or conclusions the reliability of which seems to him doubtful. On the other hand, it appears that the auditor has in his mind some thought that the bank may be misled if the statement is furnished as outlined in his letter of inquiry. If the bank should lose money as a result of the auditor's following this procedure, as to the adequacy of which there are now doubts existing in his mind, I think the auditor might find himself in an unenviable and perhaps in a very uncomfortable position. It seems to me that the remedy might be to disclose to the bank the facts which have given rise in the auditor's mind to the doubts now existing there.

This might be accomplished by stating in a footnote on the balance-sheet the assets which John Doe, trustee, is to purchase, the amount which he is to pay for them, the amount already paid on the purchase agreement, the dates of payments made, and the dates when payments are required to be made in the future. Also, if there is any agreement between the corporation and the trustee as to what the corporation is entitled to receive as a result of the advances made and when the corporation is entitled to receive it, it would seem to be proper to present this information as being necessary to enable any one to understand what is represented by the asset "John Doe, trustee, $54,000" in the balance-sheet.

If the bank had this information on the balance-sheet, then it would have before it the same basis for raising doubts in the mind of the bank's credit man as was available to the auditor. The credit man could then draw his own conclusions, make further inquiries if it seemed to him advisable to do so, and take such action as might seem appropriate.

Answer No. 2: Frequent reference is made in the wording of the question as to the non-liability of the audited corporation. It is believed that this is a matter of personal opinion rather than one of settled fact.

The problem gives rise to legal as well as accounting questions, and the accountant should seek the advice of the client's or his own attorney. Among the points to be considered are the following:

John Doe appears to be, not a trustee invested with fiduciary powers and limited to trustee liabilities, but an agent.

The common-law rules of agency hold an undisclosed principal liable when disclosed. The elements of a contract are present, for the

intention, consideration, etc., have become a question of fact by the payment of cash to John Doe. The corporation acknowledges an asset by the payment and the carrying of the payments as an asset.

The transaction is probably ultra vires, as apparently no record was made in the minutes of the formal appointing of an agent or the acquisition of preferred stock on other than pro rata basis. It is not at all a settled fact that the corporation, or rather its officers who have acted, could use this as a defense.

The auditor believes that it is a question of having personal knowledge and that he is not required to act officially.

Without bringing in this question of ethics, it would appear that payments made by a corporation and carried as an asset, agreeing, it is assumed, with amounts due under the agreement referred to above or at least approximating such payments, make this a question of routine audit which, if covered by an unqualified certificate, would clearly bring the auditor into an embarrassing situation unless there are certain facts in connection with the advances to John Doe, trustee, not mentioned in the inquiry.

Answer No. 3: To answer a question such as that presented, without having the advantage of the opportunity to study the relative or underlying agreement, is generally unsatisfactory. However, from the information presented we have no hesitation in stating the attitude the auditor should assume.

Having knowledge of the arrangement between the corporation and John Doe and of the agreement between the latter and the owner of the preferred capital stock, the auditor has a duty and an obligation to disclose the situation by appropriate statement in the balance-sheet or in his certificate. That the disclosure should be made in some detail is obvious when it is apparent that current funds are being used to acquire the company's own preferred capital stock and, in addition, a capital or fixed asset which probably is not serviceable in the company's operations, at a time when there exists a current obligation of $200,000 to a bank.

Further, having regard to the statement that "John Doe himself is not responsible," a question may emerge as to the collectibility of the $54,000 or of the assets acquired by him in consideration of the payments by him of that amount.

The particulars presented do not include any information as to the number of shares to be released to John Doe, or as to the transfer of title to the house and summer home as and when he makes instalment payments to the owner, or as to the amount of each unpaid annual instalment representing in the aggregate the balance of $96,000; nor is it clear as to when the corporation itself shall acquire the assets

from John Doe. These details should be included in the statement covering the presentation of the case.

Inasmuch as the payments by the corporation are substantially for the acquisition of its own capital stock, it is assumed that the surplus is sufficient for the purpose and that the corporation can legally make the acquisition. A notation against the surplus, indicating the extent to which it has been utilized or appropriated for the purpose of the acquisition of its own preferred stock, is necessary.