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Accounting Questions

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ACCOUNTING FOR PENSION PAYMENTS

Question: 1. If a company has a pension plan under which payments are made to employees during their lives, after they have reached a certain age or after they have been employed for a certain number of years, should the amount of these payments be charged to operations

- (a) during the period in which said employees actually rendered service to the company, or
- (b) during the period in which the said pension payments are made (during which time, it will be noted, employees rendered no service to the company)?

2. Would the answer to the foregoing question be different in cases in which the pension payment represents a contractual agreement that could be enforced if the company were liquidated, as compared with the answer in cases in which there is only a moral liability or informal understanding that such payments will be made, it being reasonable to assume in the latter case, that said payments will actually be made?

It may be assumed in considering these questions that the amount of said pension payments can be estimated with reasonable accuracy on an actuarial basis.

Answer No. 1: It is customary to deduct appropriations for a pension plan in the year in which the company has made such appropriation. If there is a contractual agreement with employees that could be enforced if the company were liquidated, it would seem that a provision

should be made during the period in which the employees actually render the service to the company. Otherwise it would appear to be adequate to charge to operations the amount of the appropriation, which should not be less than the payments actually made, except for a company in liquidation.

Answer No. 2: The question contains the following statement of facts:

(1) Payments may be made under two different arrangements—(a) the pension obligation represents a contractual liability legally enforceable against the company; or (b) the pension obligation represents only a moral or informal understanding and is not enforceable at law.

(2) In the latter case, it is reasonable to assume that payments will actually be made.

(3) In both cases the amount of the pension payments is susceptible of actuarial determination.

Under the first arrangement, viz., where the pension agreement represents a contractual liability on the part of the company, we are of the opinion that the pension expense should be a charge to operations of the period in which the employees render service on the theory that the period which receives the benefit from an employee's services should also bear the expense thereof. This situation may be compared with the case of civil service employees a part of whose salary is paid into a pension fund to be withdrawn at a later date when the employee has ceased to render service.

The accounting under the second arrangement, whereby the pension payment results only from a moral obligation and is not legally enforceable, cannot be categorically defined. Where a company has paid pensions under such an informal arrangement for years without interruption and has every intention of continuing, it is preferable to record such transactions on the accrual basis not merely with a view to recognizing the company's future payments to pensioners, but primarily with a view to allocating the expense to the period in which the services were rendered. The pension reserve can be described so as to indicate its quasi-liability character and can be shown in the balance-sheet as an allocation of surplus.

On the other hand, if the company does not choose to recognize the fact that it will undoubtedly continue to make such payments to old employees, the reason is probably that the company can, if it so desires, discontinue further payments; furthermore, such payments seem to be gratuities, not "pensions." The accountant may point to the company's experience in the past and intentions for the future and indicate how future income will be distorted due to pensions which, in effect, represent payments for services rendered in years past—not current services

or services to be rendered. We believe that income of the period in which the employee renders service should bear the expense of pensions, but cannot wholly condemn the practice of a company which treats such payments on the cash—in contrast to the accrual—basis.

Answer No. 3: In my opinion, if a pension plan has been set up on the basis of a contractual agreement with employees, then suitable provision should be made out of current income during the period in which the employee actually renders service to the company. If, on the other hand, the liability is only moral and the understanding is purely informal, I believe that the provision would be more appropriately set up annually by a charge to surplus during the period in which the employees actually render service to the company, the distinction in this case resting on the thought that the payment in the latter case constitutes a distribution of profits and is not an operating expense of the business.

This answer is predicated on the statement which is made that it is reasonable to assume that the payments will actually be made. If considerable uncertainty existed as to the eventual payments of the amounts to superannuated employees, I would prefer to defer the provision entirely and only recognize the situation as payments were actually made. In that case, I would charge them to the current income account.

RENT OF HOTEL

Question: What percentage of the gross dollar of income of an inland city hotel should go towards the payment of rent?

Answer No. 1: It is, of course, impossible to give an unqualified answer to such a question. The rent a hotel is able to pay depends entirely on circumstances.

The first point that must be recognized in fixing the rent of a hotel is that a hotel building embraces two separate and distinct enterprises—a hotel business and a real-estate business. The income from store rents is purely an income from real estate, and it depends entirely on location. In some hotels store rents are negligible; in others they are a more important source of income than the hotel business itself. Obviously, this makes it impossible to fix a general percentage of gross income for rent that would apply even to hotels of the same type.

The percentage of gross income that the hotel as a business can pay also depends on circumstances. In some cities the relation of supply to demand is such that it is impossible to obtain a reasonable average room occupancy. Then again, many hotels cannot possibly get an average room rent commensurate with their character because the buildings are of a much higher type than was warranted by the rates

that can be obtained in that particular city. Such buildings, of course, are more expensive to operate because the facilities are more elaborate, and still the possible rate is considerably lower than what could repay the hotel operator for such operation.

An important consideration, also, is the liquor laws of the state in which the hotel is located. A hotel with a large amount of food and beverage business can pay more rent, but a lower percentage of gross income, than a similar hotel with much less restaurant business. This is because the percentage of profit on food and beverages is limited.

It is usually not advisable to fix a percentage of total gross income as the rent. It is customary in hotels to have certain departments operated by concessionaires. If a hotel is operating its own valet, newsstand, cigar-stand, and coat-room departments when the percentage of the rent is fixed, it would be very easy for the lessee to reduce the amount of rent, without any change in his income from operations, simply by leasing these departments to concessionaires. He would thus include in his gross income the subrents instead of the gross sales of these departments. For this reason, it is best to base a percentage rental either on room sales or on room, food, and beverage sales. The income from minor departments is usually proportionate to the room sales, so that this arrangement leaves the management free to decide just how these minor departments should be operated—whether directly or through a concessionaire.

In quoting a definite percentage I must restrict it to what, for want of a better word, I will call here a "normal transient hotel." Such a hotel would, at the present time, have an average room occupancy for the year of approximately 65 per cent. and an average daily room rate of about 75 cents for each \$1,000 of original investment per room in the hotel building (not including land and furniture). The hotel building would be less than 20 years old and the room and restaurant sales would be about in this proportion: rooms, 50 per cent.; food, 35 per cent.; and beverages, 15 per cent.

Such a transient hotel should be able to pay, at the present time, a rent equivalent to one-third of the room sales, plus the gross income from store rents (only leased ground floor space with a direct entrance from the street is considered a store). However, if the hotel is to supply the stores with heat, light, and maintenance without extra charge, the lessee of the hotel should retain a reasonable part of the store rents to reimburse him for such expense. This rent includes taxes and fire insurance on the building and furniture, and is predicated on a case where the lessee has no investment in furniture and equipment.