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Accounting Questions: Liabilities of a College on the Balance-Sheet; Depreciation on Plant Investment

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ACCOUNTING QUESTIONS

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LIABILITIES OF A COLLEGE ON THE BALANCE-SHEET

Question

There has been discussion among some accountants here regarding the showing on the balance-sheet of liabilities of a college.

Some accountants contend that the liabilities should be shown under the several funds the balance-sheet is composed of according to the suggested balance-sheet shown in *Financial Reports for Colleges and Universities*, compiled by the National Committee on Standard Reports for Institutions of Higher Education, and the *Accounting Manual for Colleges*, by Gail A. Mills.

Other accountants contend that all liabilities of the college should be shown under the "Current funds" caption with amounts due to the other funds in "Current funds" in order to balance asset and liability side of each fund.

The principal reason advanced for this method of handling was to have all the liabilities concentrated in one place so that one could see them at a glance. All this discussion was in connection with a small college, not a large university.

I would appreciate your informing me which practice is correct if possible.

A specific item was discussed which is presented in the following hypothetical example:

XYZ College had a number of notes payable to banks aggregating $150,000, of which $120,000 was for erection of building and purchase of fixed equipment and $30,000 for financing deficit from operations. The notes were taken up by an issue of income bonds. The bonds were secured by the income from a parcel of rental property carried in the endowment fund, the income from which was not restricted.

In our discussion some claimed the whole $150,000 should be shown under the heading, "Current funds," and after the total liabilities were arrived at show "Due from plant funds $120,000" as a deduction on the liability side, thereby balancing both "Current funds" and "Plant funds" sections. Others contended the liability for the $150,000 of income bonds should be segregated showing $30,000 under "Current funds" and $120,000 under "Plant funds" section of the statement.

Answer No. 1

Based on the assumption that both principal and interest of the income bonds issued by XYZ College were secured by rental income accruing from property carried in the endowment fund, it appears that the aggregate amount of the notes outstanding ($150,000) should be shown as a liability of that fund accompanied by a note describing the nature of the security. This method of presentation, we believe, indicates more clearly the relation between the liability on the bonds and the asset on which the income security accrues than the methods advanced in the question. Furthermore, it is our opinion that the interfund receivables of $30,000 and $120,000 due from the current fund and the plant fund, respectively, should be shown in the asset section of the endowment fund and not as offsets to the liability, inasmuch as the endowment fund's liability on the bonds is in no way contingent upon the ability of the current and plant funds to meet their obligations.

In regard to the general question of grouping third-party obligations of all funds as current-fund liabilities, we are of the opinion that by so doing the facts may not be properly presented especially in the case of mortgages, loans, tax liens, etc., which are not of the nature of general liabilities but of liens secured or partly secured by specific assets and would therefore be better classified as liabilities of those funds in which the relative assets appear.

Depreciation on Plant Investment

Question

For a period of several years a company has charged each annual depreciation provision in its entirety to profit and loss, instead of manufacturing costs. This method naturally resulted in less net income from an income-tax standpoint, which was the reason for not considering depreciation on plant investment as a manufacturing cost.

This company is now considering the proposition of charging depreciation on plant investment to manufacturing costs, but does not wish to forego the benefit from the income-tax angle of the present procedure, viz.: charging the entire annual depreciation provision to profit and loss.

Will you kindly tell me if there is any way of accomplishing the above-mentioned?

Answer No. 1

It is my opinion that the problem is not affected by mere change of classification, and if it is permissible to leave depreciation out of the calculations of cost for inventory purposes if such depreciation is shown as a charge to profit and loss, it is equally permissible to leave such depreciation out of calculations for cost of inventory if depreciation is shown as an item of manufacturing cost.

I have never understood that classification of overhead items had any bearing on the propriety of capitalizing such expenses in inventory.

As to the financial statements, it seems to me the problem is whether or not the elimination of depreciation from overhead has resulted in such a conservatism of inventory valuation as to distort the income between years, in that such conservative factor might reduce the earnings in years of expanding inventories and increase the showing of earnings in years of decreasing inventories. If the amount is not large and does not materially distort the showing of profit and loss, in my opinion, there is no serious breach of accepted accounting principles.

I do not see how a change in practice could add taxable income for the year except on the theory that inventories have been constantly undervalued for tax purposes and that depreciation should be added to inventory and included in income. This is not a question of classification.