Journal of Accountancy

Volume 50 | Issue 3 Article 4

9-1930

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Leland Rex Robinson in his book *Investment Trust Organization and Management* describes the contractual investment trust in the following manner:

"Investment trusts of the 'contractual' type are those existing and operating purely by reason of a contract (usually in the form of a 'trust agreement' or 'indenture') involving three parties, (1) the creator of the trust, generally known as the 'depositor,' and usually a corporation organized for the purpose of setting up investment trusts of this character and selling to the public the participations therein; (2) the 'trustee,' that is, the trust company or bank which holds the securities and/or cash, authenticating and delivering the participating certificates to the 'depositor'; and (3) the owners of the participating certificates who, by the act of buying these certificates, become *ipso facto* parties to the indenture or agreement under which they are issued."

Dr. Robinson classifies the contractual trusts under two main groups: unit series trusts and fund trusts. The unit series trusts may be fixed or supervised. The fixed trust indenture defines and prescribes the composition of the unit or the underlying securities deposited with the trustee, usually consisting of a few shares in each of many specifically designated corporations. The depositor acquires the prescribed shares in the open market and, when a unit is completed, delivers them to the trustee, who issues trust shares (usually to the number of one thousand to each unit) representing proportionate participations in the ownership of the trust assets. The depositor corporation disposes of the shares to the public, the sales customarily being effected through other dealers.

The sales or offering price of the trust shares is based primarily upon the liquidation-value of the underlying securities on the day of sale. To the liquidation value basis, however, a few other charges are customarily added: (1) a small charge to cover the costs of printing certificates and other necessary expenses, (2) the amount of dividends or other earnings accumulated to the date of sale on the underlying assets, (3) a cash reserve amount for the purpose of equalizing future distributions, and (4) a selling or underwriting commission. The trust share gives the holder a proportionate ownership in accumulated earnings and cash reserves as well as an interest in the underlying securities and, as provided by the indenture, the right to his share of any distributions made by the trustee. The indenture may also entitle the owner of a stated number of trust shares (ordinarily one-half of a unit) to withdraw a corresponding portion of the underlying securities and accumulated earnings by presenting his trust shares to the trustee for conversion. In addition to this, the depositor corporation may maintain a market by repurchasing shares at agreed prices from holders of smaller lots than those described above.

In the fixed-unit trust no substitutions may be made in the underlying securities except those prescribed in the indenture for the purpose of protecting the principal and the earning power of the fund. Therefore, the depositor corporation acts only as creator of the trust and seller or underwriter of the authenticated trust shares and does not assume and is not permitted an extensive managerial control.

The supervised unit-series trust is created on the same general principles found in the fixed-unit type with the exception that the depositor corporation is given the right to supervise the trust assets. This right is ordinarily limited to the substitution of securities which fall within restrictions prescribed by the indenture. For this supervisory function the corporation is granted a managerial compensation usually based upon the profits earned by the trust with a minimum fee based upon a certain percentage of the total assets in the trust fund as of each ex-dividend date.

The fund trusts differ from the unit series in that the trust fund does not consist of a fixed number of shares in prescribed corporations. The fund is created by the deposit of cash and/or securities with the trustee. It is supervised by the depositor corporation which may use the cash for the purchase of securities or may sell the securities already in the fund and employ the cash so provided for the purchase of different securities. The assets of the trust are not ordinarily confined to the original funds deposited and accumulations thereon but may be increased by additional deposits of cash and/or securities and further participating shares issued against such deposits.

The shares issued by the fund trustees may be of one class, each share representing an ownership in the funds and the profits equal to that of all other shares. Or two classes may be prescribed, one of par value, giving the holder a liquidation ownership in the fund up to, but not exceeding, the par value; the other of no par value, representing proportionate liquidation ownership to the amount of the fund in excess of the total par-value ownership. The par-value share customarily is given a stated yield or dividend rate while that of the no-par-value share may be discretionary or contingent.

Many other variations of ownership structure may be found in studying the contractual trusts, but most of them are subject to classification under the general groups and provisions outlined above. As indicated by the title, the scope of this article is the accounting problems peculiar to the depositor corporations which organize these trusts and distribute the authenticated shares.

Among the depositor corporations creating and underwriting fixed unit-investment trusts, items of peculiar interest center chiefly in the income accounts. The primary source of income for this type of corporation is in commissions or "spread" income on the sale of the trust shares to the public through the medium of dealers.

Another source of profit or loss to the corporation is found in the variations of market price of underlying securities between the date of purchase and the date of sale of the trust shares. Increases or decreases in the market price of underlying securities will be reflected in the offering prices of the participating shares. As the underlying securities may be purchased on dates other than the sale of the shares, amounts of profit or loss are won or suffered by the selling organization because of the market fluctuations. Many of the depositor corporations, through their perspicacity in choosing the proper moment for the purchase of these securities, will bring this source of profit into almost as important a position as that received from underwriting commissions.

As has already been noted, the depositor corporation may undertake to maintain a market through the process of repurchasing the trust shares from the individual owners. The repurchased shares may be accumulated until a sufficient number is on hand to enable the corporation to convert them into the underlying securities. These securities may then be disposed of in the open market or they may be employed in establishing a new unit at a later date. The repurchased certificates may, on the other hand, be resold through the same channels utilized for their original distribution without disturbing the underlying assets. In any case profits or losses will arise from such transactions because of the fluctuations in the market value of the underlying securities and provision must be made for them in the accounting system.

An illustrative method for booking the income items in question is outlined below:

Stocks
  Stock brokers
To record the purchase of the underlying securities.

Trust shares
  Stocks
  Cash (for reserve for equalizing future distributions)
To record the deposit of trust assets and the receipt of trust shares from the trustee.

Accounts receivable—dealers
Dealers' commissions
  Sales of trust shares
To record sale of trust certificates.

Market fluctuations on sales
  Trust shares
To transfer cost of trust shares to a profit account.

Cost of sales
  Market fluctuations on sales
To credit market fluctuation account with the basic price, i.e. sales price less the spread between liquidation value of the trust shares at the date of sale and selling price.

The above entries record the income from commissions, dealers' commissions paid, and the profit or loss from market differences on the original sale of trust shares. The sales account less the cost of sales account reflects the "spread" income. The market fluctuation account accumulates the profits and the losses arising from differences in the price of underlying securities on the date of their purchase and the date of the sale of the trust shares.

Trust shares
  Cash
To record small lot purchases for purposes of maintaining a market on the trust shares. The bid price is an amount usually equal to or slightly higher than the liquidation value of the share.

Profit and loss on repurchases
  Trust shares
To transfer the cost of trust shares resold.

Market fluctuations on sales
  Profit and loss on repurchases
To transfer the liquidation price as of the repurchase date to a fluctuation account.

Cost of sales
  Market fluctuations on sales
To transfer the basic price on the date of resale of repurchased shares.

Accounts receivable—dealers
Dealers' commissions
  Sales of trust shares
To record the resale of the shares.

The various profits on shares repurchased and resold are accounted for according to the above summary entries. The "profit and loss on repurchases" account shows the profit realized or loss suffered by the depositor corporation because the repurchase price is greater or less than the liquidation price. This is a profit actually belonging to the period or the date at which the repurchase is made. Conservatism, however, usually persuades the corporation not to take up the profit on its records until actually realized by the resale or conversion of the certificates. Furthermore, repurchased shares are in this way carried on the books at cost rather than at a liquidation value on the date of repurchase, which is considered the most desirable by many of the companies. The other accounts are identical with those that analyze commissions and market profits on the original sale.

Profit and loss on repurchases
  Trust shares
To transfer cost of trust shares converted into underlying securities.

Market fluctuations on conversions
  Profit or loss on repurchases
To transfer the liquidating value of the trust shares on the date of repurchase. The "profit and loss on repurchases" account thus shows the profit or loss to the depositor corporation arising from the difference in the repurchase price and the liquidation price of that date.

Accounts receivable—stock brokers
  Market fluctuations on conversions
To record sale of stocks in the open market which were withdrawn from the trustee by presenting trust shares.

Should the converted securities be re-employed as underlying securities for a new unit, the entries would be the same as in a sale of trust shares based upon securities purchased in the open market, with the one difference that the cost of the securities will be taken from the "profit and loss on repurchases" account.

At the closing of the books for a statement period, there may be trust shares sold and not yet delivered or there may be commitments for the repurchase of outstanding shares which have not yet been received. These items must be properly accrued for the purpose of compiling an accurate statement. In the case of shares sold but not yet delivered, the accrual would consist of charging the cost of the underlying trust assets to the cost of sales. It sometimes happens that the underlying securities have not been purchased and in such a situation it becomes necessary to take an estimated cost based on the market price of those securities as of the closing date. The accrual for the repurchase of outstanding shares not yet received would be made by setting up the shares in an asset account at the repurchase price contracted for and crediting a properly labeled liability account.

The depositor corporations, engaged as they are in the business of underwriting and selling trust shares and of maintaining a market for those shares through repurchases, are in the usual course of events in possession of a number of those shares. The shares entitle the holder to a proportion of the distributions made by the trustee and suitable record must be made of such receipts. As a corollary to this, the corporation will usually receive all distributions not mailed directly by the trustee to the owners and the corporation is thus charged with accounting for these distributions. Such items not distributed must be carried, of course, as dividends payable.

Another source of income enjoyed by some depositors is interest on the reserve fund deposited with the trustee for the purpose of equalizing future dividend payments or for other purposes. Further interest income to the corporation on undistributed earnings accumulated in the trust is proscribed by some indentures. Another common provision is that the depositor retain the voting power attached to the ownership of the underlying securities held by the trustee. Such provisions make a system of close surveillance of the trust assets of particular importance and the records of the depositor should be organized with that purpose in view.

Stock split-ups, stock dividends and rights to subscribe on securities held in the trust are sometimes disposed of immediately and the proceeds paid out to the shareholders at the regular dividend-payable date. The depositor corporation, as a shareholder, receives its portion of such distributions. It is considered by some companies that these receipts should be credited to the asset value on the books because, they say, the cost of the trust shares represents the price of ownership of the underlying securities whose market value is diluted by the issue of stock dividends or "rights" to subscribe. Others contend that the proceeds are income, and some follow the federal income-tax regulations on the treatment of the profits from such transactions. It is not, however, the purpose of this article to enter into a discussion of this problem.

In addition to the types of income already listed, the depositor corporations of supervised trusts of either the unit series or the fund type are allowed a managerial fee for their services in substituting stocks and otherwise managing the fund. This income must, of course, be provided for by a proper income account.

As previously stated, the depositor corporations may at any given time have possession of some of the trust certificates which they underwrite and sell. This, of course, is the inventory of the stock-in-trade and as such presents the problem of valuation for statement purposes. Obviously the corporation may qualify as a dealer in such securities and therefore may value its inventory for federal income-tax purposes in accordance with article 105 of regulation 74 issued by the commissioner of internal revenue:

> "The dealer in securities who in his books of account regularly inventories unsold securities on hand either (a) at cost, (b) at cost or market, whichever is lower, or (c) at market value may make his return upon the basis upon which his accounts are kept."

Some of the corporations value their certificates for inventory purposes at cost, while others value them at cost or market, whichever is lower. The authors are not acquainted with any corporation that makes use of the straight market valuation, although that method of valuing security holdings of investment trusts is recommended by some writers. Cost of the shares withdrawn from the trustee on the original deposit and issue, but not yet sold to the public, would consist of a proportionate part of the cost of the underlying securities and the cash reserve deposited. The market value would be at the price offered to small lot shareholders for purposes of market maintenance. This market price is in accord with article 104 of the regulations which says:

> "Market means the current bid price prevailing at the date of inventory for the particular merchandise in the volume usually purchased by the taxpayer."

For shares repurchased from small lot holders, cost would consist of the actual amount expended therefor, while market would be identical with that described above.

The federal income-tax law presents another feature which is of importance to the accounting procedure of depositor corporations. Although organized as trusts, they may be classed as such for income-tax purposes or they may be considered to be associations and therefore taxable in the same manner as corporations. The criterion for such distinction lies in the degree of managerial control exercised over the assets by the trustees or beneficiaries. It is generally conceded that fixed-unit trusts, not being subject to extensive control by either trustee, depositor or beneficiary, may qualify as pure trusts for tax purposes, while the supervised unit trusts and the fund trusts are considered to be associations, because of the degree of management of the assets exercised by the depositor corporation.

The fixed unit trusts usually credit earnings for the period to the beneficiaries, and they must, therefore, under taxation provisions for trusts, take up their proportionate share of the income, whether or not distributed by the trustee. The depositor corporation, as a holder of certificates, usually accrues earnings as reported by the trustee, and divides it on his income records as to dividends, profits on substitutions, and to any other type of income which may occur. The asset side of this accrual is usually carried in a receivable account with the trustee and any income distributed or the accumulated earnings included in the sale of the shares in question are credited to this account.

The supervised unit and fund trusts are generally considered to be taxable as corporations, and the beneficiaries, therefore, take up the distributions as dividends. Consequently, the usual custom of the depositor corporations is to take the distributions into the income accounts as dividends when received from the trustee, and the income of the trust is not accrued as in the case of the fixed-unit depositor.

The fund trust depositor corporation will sometimes receive compensation for managerial services through the medium of a prescribed proportion of the total no-par-value shares issued in each fund. Under such agreements, the customary procedure is to book these shares so received at a nominal value or at no value in the case of the first issue and on later issues at the amounts paid in for each such share. The amounts so recorded are credited to income as management commissions. The method is illustrated by the following hypothetical example.

Funds and securities totaling five thousand dollars are deposited with the trustee. The trustee issues 500 class A shares and 550 class B shares. The class A shares have a par value of $10 and one A and one B share are sold to the public for that amount. The fifty B shares are given to the depositor corporation as management compensation. As nothing is paid into the fund for the B shares the depositor corporation takes them up at a nominal value or at no value on the books. As the fund increases, because of profits on sales, dividends and appreciation in the market value of unsold securities, the B shares will attain an equity in the assets of the trust and will also receive any distributions allowable by the indenture. Subsequently, the management may decide to increase the funds by depositing additional securities and/or cash and having another block of the same number of trust shares issued. In order that the shareholders of the first issue may not suffer a shrinkage in their equity, the new deposit must equal the total liquidating value of the underlying assets already in the fund as of the date of the second issue. Consequently the new amount deposited will equal $5,000, the par value of the first issue of class A shares plus the excess of the present fund over that amount, for example $5,500, making a total to be deposited of $10,500 or the present value of the original fund. Five hundred A shares and 550 B shares will be issued as before and the 500 A shares and 500 of the B shares will be sold to the public for $10,500. The other fifty B shares will again be retained by the depositor corporation. The booking value of the shares retained will be determined by dividing the $5,500 excess paid in by the 550 shares issued therefor or $10 per share. The class B trust shares account will be charged with its $500 equity in the trust fund, and management income will be credited.

Another variation of the principle of paying the management commission through the medium of trust shares is permitting to the depositor corporation a privileged subscription at less than the offering price on class B shares. In this situation, as in other arrangements, the proper booking procedure is to charge the share accounts with its equity in the trust fund at the time of the issue of the trust shares and to credit income with any excess over amount of cash paid therefor.

As in accounting for any other type of business, books of original entry and ledgers must be provided which will most efficiently record the transactions involved. The provisions in the indenture and other such circumstances will necessarily cause the problems encountered by different corporations to vary and no system of ledgers and journals can be prescribed to fit all cases. It usually will be found, however, that the following records will be necessary: general ledger, cash and security blotters, repurchase ledgers, security ledgers, general journal, sales registers, stock position, cost of unit record, accounts-receivable ledger, commission ledger and trust-account ledgers.