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Receivership Accounting*

BY MORRIS J. ROOT

Financial embarrassments are numerous at the present time. They are a post-bellum result of wild speculation and war finance. Because of these conditions, the subject of receivership accounting has a timely and increasing interest for the accountant.

R. J. Bennett in his text-book *Corporation Accounting* defines a receiver as "an officer of the court appointed to take charge, custody, control and management of a plant, property or business, to hold and operate or sell out to the best advantage." The receiver, as court representative, takes the property away from the corporation, puts it out of the reach of creditors and places it in such a position as to be secure both from the mismanagement of officers and directors and the incursions of creditors.

Receiverships have often been attacked as a serious invasion by the courts of the rights of private management of private property; and a brief statement of the justification for the so-called invasion perhaps would not be out of place.

Most businesses are today engaged in manufacturing, mining or transportation. These businesses are organized and conducted with properties and implements which are highly specialized and consequently cannot be utilized and are unavailing for any other purpose. To illustrate, take the business of transportation. A railroad consists of narrow strips of land thousands of miles in length, terminals, locomotives, rails, spikes and cars. It is not in the category of a store building or of a farm or of general merchandise, which can easily change hands or be shifted from one type of business to another. "The property of a railroad can be used for no other purpose than the transportation of passengers and commodities." If it is desired to sell this property, it must be sold to another railroad company, for then only will it have more than mere salvage value. Furthermore, the property being a coördinated unit, "no part of it can be separated from the others and sold without destroying a large part of its value." Now, if receiverships were to be eliminated and the creditors of the company permitted to enforce their respective liens, what would be the consequence? The property of the railroad would be pieced,

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the equipment would be hauled off, the terminals taken from it, the organization would be virtually destroyed, the franchises perhaps lost and its entire earning power reduced to nothing. It is evident, therefore, that the property would be completely disintegrated in the contest of creditors. Each set of creditors would make off with a piece of the corpus, and the value of the property, after it had been thus rent, would have a distant relationship to its value as a going concern.

A receivership is an extraordinary remedy for an extraordinary condition. Like a surgical operation, it serves to save the life of a distressed corporation, but it leaves the patient in a weakened condition from which recovery is admittedly slow. It is, however, absolutely necessary in order to prevent the complete destruction of the business and to conserve the value of the company's property. Essentially, it is a measure intended to protect in every respect the rights of all parties concerned.

There are two kinds of receivers: receivers in equity and receivers in bankruptcy. Since the purposes of their appointment and their particular functions are different, it is desirable that a clear line of demarcation be drawn between these two officers of practically the same court.

In bankruptcy, whether voluntary or involuntary, the purpose of appointing a receiver is to preserve temporarily the property until a trustee is elected. The receiver's powers are limited and his tenure of office is brief. He takes possession of all the property of the bankrupt with the expectation of its ultimate disposal and with the understanding that the amounts realized shall be applied to the liquidation of the bankrupt's debts. If the owner makes a voluntary application, there is seldom a need for the appointment of a receiver. The creditors come together and proceed immediately to the election of a trustee. It is the duty of the trustee to take charge of the entire property, to turn it into cash as quickly and advantageously as possible and to apply the proceeds to the liquidation of the claims against it.

In involuntary proceedings, a petition is filed in the federal courts in the judicial district in which is the bankrupt's business. The bankrupt is served with a copy of the petition and given usually about three weeks in which to file his reply. The court will not appoint a receiver unless one of the following conditions exist.

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a. A suit by creditors having a lien, mortgage or judgment, there being imminent danger of the property being lost, wasted or misapplied.

b. A suit by stockholders, when there is fraud and mismanagement on the part of some of the stockholders.

c. In foreclosure proceedings, to prevent the disintegration of the property concerned.

d. In dissolution proceedings to protect the interests of all parties.

The receiver, having been duly appointed, is given charge of the property until the election of a trustee. This is usually done at the first meeting of creditors, held thirty days after the owner or the corporation has been adjudged bankrupt by the court.

The purpose of appointing a receiver in equity is to continue the business, frequently as a preliminary step to reorganization. The receiver in equity usually takes only a part of the property and uses it in whatever way seems best for the liquidation of the more pressing current claims of creditors. A condition of insolvency does not necessarily exist. The liquid assets may not be sufficient to meet the maturing obligations; the management may have permitted a tie-up in its current resources; the business may be financially embarrassed—but even these contingencies do not necessarily point to the insolvency of the firm. Its total assets, more or less in unrealizable form, really may exceed the total liabilities; yet, the business cannot pay its pressing obligations and it therefore becomes necessary to turn over the property to a representative of the owner and his creditors, appointed by a court of equity, for the purpose of satisfying the more urgent and insistent claims and for the purpose of preserving the property from needless dissipation.

The powers and liabilities of receivers may be considered together, because with every responsibility and power there comes a corresponding duty or obligation. The order of the court appointing a receiver and all other orders that emanate from the court will determine to a large extent the duties and responsibilities of the receiver. These orders are also the first matter of interest to the accountant. He should be fully acquainted with them. They are the instructions by which both the receiver and the accountant are guided, and the former particularly must see to it that he follows out the instructions in every detail.

Upon his appointment, the receiver takes title to the personal property. All real estate must be conveyed to him. He may institute suit to recover assets belonging to the firm. On the other hand, no suit can be brought against him without the permission of court. He has been called the executive hand of the court and, as such, unwarranted interference with his work may amount to contempt of court. The receiver may compromise claims, sell assets and promote reorganization. However, express authority from court is absolutely essential for the undertaking of any new business. Under his general authority, he takes all the books of the corporation, he manages and operates, and his acts will be enforced by court unless they are proven fraudulent.

To execute his duties, the receiver requires funds. Usually two sources are available for obtaining these necessary funds. First, there is access to the excess of operating income over operating expenses; second, receiver's certificates may be issued. These are evidences of debt, issued only upon specific authority from court. They are prior claims, taking precedence over all existing debts. The receiver may continue or refuse to continue existing contracts and leases. If he decides to continue them, all debts created as a result of such continuation become preferred claims and the receiver must use the income from his operations first for the liquidation of these claims. Receivers often manage so unskilfully that upon completion of their work there is very little left for the creditors. In such cases there is no redress, unless the receiver has acted fraudulently or is proven guilty of gross negligence. Should the receiver do anything of an important nature without authority of court, he is personally liable for any loss resulting from such act. He is, however, not to be held for any lack of ability or business talent—the courts have erred in their appointment.

Turning to the question under consideration, accounting for receiverships, we find many plans and schemes in actual practice. Every receiver displays his personality in the methods pursued; and his knowledge or ignorance of accounts will determine to a large extent the system in vogue. For instance, some use single entry; others, double entry. Some take all the assets and liabilities into account; others consider the assets and the liabilities only as the claims are proved and allowed. Some take the assets at book valuation; others, at appraised or receiver's valuation. Some

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use the subsidiary records of the company and continue the book-keeping as before. The general practice, however, seems to be to open a separate set of records for the receiver wherein all the official transactions are recorded. The rule of keeping a careful record of all the cash receipts and disbursements is followed invariably by all.

The accounting for receivers may be simple or complex, according to circumstances. There is no prescribed method or system for keeping the accounts of a receiver. The accountant enlists his personal judgment in outlining the system and manner of keeping the books. One thing is certain and unvarying. The records must fulfill their designated purpose. The receiver was entrusted with property; accordingly he must render a full accounting of his stewardship, and the records must thoroughly, concisely and clearly set forth all his activities.

The subject under consideration can be subdivided and discussed under five headings, following each other in natural sequence, and all involving specific but kindred principles of accounting. They are:

1. The entries made when opening the books of a receiver.
2. The recording of transactions during the receiver's administration.
3. The entries made at the settlement of the estate and when closing the books of the receiver.
4. The intermediary and final reports of the receiver.
5. The company's records during the receivership and the adjustment of the accounts at the beginning and the end of the receivership.

The subject will be discussed in the manner outlined.

With the order of the court before him, the accountant makes a prompt and expeditious audit of the asset accounts. The principles of a balance-sheet audit are applicable at this point. It is necessary to take a physical inventory of the merchandise on hand; outstanding cheques should be added to the bank balance; accruals calculated; depreciation charged off; all the necessary reserves created—in short, the entire procedure is similar to the work done at a normal conclusion of a fiscal period.

Having established the condition of the asset accounts and their respective reserves at the date of the receivership, the receiver's books can be opened. A charge is made upon the re-

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ceiver's ledger to the various asset accounts. A credit is made to the various reserves belonging to the accounts and a credit for the net balance is posted to an account called "Estate of John Doe, in receivership," or "The X. Y. Z. Corporation, in receivership." The opening entry would appear as follows:

Cash	\$200.00
Accounts receivable	5,000.00
Inventory	45,000.00
Machinery and fixtures	15,000.00
Reserve for bad debts	\$500.00
Reserve for depreciation, machinery and fixtures ...	3,000.00
Estate of John Doe, in receivership	61,700.00

To record book value of assets taken over by order of court.

The various accounts as entered must be properly classified. The principles of classification of accounts are as applicable to the ledger of a receiver as to the ledger of any prosperous concern. If any of the asset items taken over have liens against them, proper notation of these liens should be made on the accounts. But all liabilities are for the present completely disregarded. At this stage of the work, one is bound to meet the difficulty of determining the status of merchandise ordered and shipped prior to the financial embarrassment of the business, but received by the receiver after his appointment. The shipper, had he known of the receivership, could have stopped the goods in transit. However, the merchandise has arrived and the receiver may accept it. What should its status be? Is the shipper an unsecured creditor or is the debt an obligation against the receiver payable at one hundred per cent.? In point of equity the receiver should accept only goods which he intends to use during his administration. In that case, the invoice for the merchandise should be fully paid and charged as an operating cost of the receivership.

In considering the next division of the subject, the recording of transactions during the period of receivership, we are met with nothing new in principle. Care must be taken at all times to keep a complete record of all transactions. The receiver will often be ordered by court to pay some of the claims existing prior to his appointment. Preferred items, such as wages, rent and taxes, will also be paid upon order of court. Certain expenses are incurred

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by the receiver and they must be met. Assets will be sold and funds realized therefrom. In addition there will be the general income from the usual and continued operation of the business. In regard to all the above, two considerations must be taken into account. Briefly stated they are: (a) there must be a complete record of every act of the receiver; (b) an ample and clear distinction should be drawn between payments made on account of obligations existing prior to the receivership and disbursements made for the receiver's own transactions. This latter point causes a great deal of trouble. It is difficult to make fine distinctions. There is a great deal of overlapping of the two classes of payments; questions of priority are continually presenting themselves for solution; and the receiver must act cautiously and deliberately, obtaining the advice of counsel or consent of court upon all moot questions.

The receiver should close his books periodically, the closing period agreeing with the regular fiscal period of the business. Uniformity in the accounting and continuity of the records should always be the aim. This is desirable for comparative purposes, so that prospective purchasers of the business property or prospective financiers may be readily presented with uniform statistical records, showing clearly and definitely the results of operation for prior years and for the period of the receivership.

The receiver's closing entries will depend upon the nature of the termination of the receivership. After operating for a time, and having shaped things into order, the receiver may be ordered by court to sell the residue of the estate and liquidate the entire business. Or a reorganization may take place without any foreclosure proceedings. Again, very often, it may be advisable to go through foreclosure proceedings, to be followed by reorganization and recapitalization.

In any of the above cases, the receiver first closes his books and adjusts his ledger accounts in order to determine the final status of the estate. He opens a profit and loss account and shows the results of his operation, connecting these results with a financial statement. Having established the net book value of the assets on hand, he will proceed to liquidate, if it is so ordered by court. This involves the preparation of realization and liquidation accounts, showing the receipts of cash from the sale of assets, disbursements for all expenditures, payments of all claims in their

respective order, i. e., preferred claims, first. Any balance remaining as a result of the liquidation will go to the proprietors or stockholders of the business.

When a reorganization takes place without foreclosure, the receiver returns the property to the reorganized company, after deducting the necessary funds for the settlement of all outstanding receiver's obligations. The entries upon his books are the reverse of those made at the opening of the books. He charges the "Estate of John Doe, in receivership," and credits the asset accounts that he is returning.

If, as is often the case, foreclosure proceedings have been ordered by court, these proceedings to be followed by reorganization, the receiver's acts and entries upon the books will be regulated by the orders of the court. All property sold will be delivered by the receiver to the purchasers, and the receiver will charge himself with the funds received and credit the proper asset account. As part of the reorganization plan, the purchasers by agreement with the various creditors and lien holders will often assume all liabilities, pay off dissenting bondholders and provide the funds necessary for financing the reorganization. The receiver, though acquainted with all the terms of the settlement, is not much interested in the details of the reorganization plan. Upon his books are shown only the sales of assets, proceeds from such sales, disposition of funds and form of settlement of the outstanding obligations. He closes everything by a transfer of all the open accounts into the "Estate of John Doe, in receivership," account.

In considering the question of intermediary and final reports for a receiver, the accountant will be guided by the desires of counsel for the receiver. There is no standardized form for these reports, as each case brings out its own peculiarities. The receiver may make periodic reports or submit only a "first and final account," depending upon the nature of the case, the amount involved, the duration of the receivership and other factors. One thought must be predominant in the preparation of these reports. They must not be mere accumulations of figures, unintelligible and purposeless schedules and exhibits, but rather clear, concise, non-technical, convincing presentations and explanations of the receiver's undertaking, his operations and the results thereof.

The first report will show schedules of inventories and properties taken over, carefully divided and analyzed as to their forms

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(liquid or fixed), location and whether pledged or free. It will also show all the liens on the property. The receiver will also prepare schedules of all the creditors as shown by the books. These claims are to be classified under the respective headings of preferential claims—such as taxes, wages and rent—fully secured and partly secured creditors with details as to the nature and amount of security, all unsecured creditors and contingent liabilities.

After the first report and as the receiver is progressing in his work, he will submit, from time to time, intermediary reports. Quoting from H. C. Freeman's article on *Accounting for Receiverships* in the October, 1917, issue of *THE JOURNAL OF ACCOUNTANCY*:

The objects to be served in the preparation of these reports are: (a) to demonstrate the extent to which the liquidation of the property taken over has proceeded; (b) to indicate the changes which have occurred in the status of the property; (c) to show the results of the operation of the property by the receiver; (d) to enable the court to appraise the value of the services of the receiver. All these purposes to a substantial extent can be accomplished by the presentation of accounts in the form known as an account charge and discharge. The receiver charges himself with:

- (1) The assets at the date of the receivership (or at the date of the last report), exclusive of permanent or fixed assets;
- (2) Additions to such assets since discovered;
- (3) Increments upon realization of such assets;
- (4) Amounts realized from the sale of permanent or fixed assets;
- (5) Amounts realized from the sale of receiver's certificates;
- (6) Increases in the amounts of receiver's liabilities;
- (7) Gross income from the operation of the property.

The receiver credits himself with:

- (1) Preferred or other liabilities of the company paid;
- (2) Decreases in the assets stated as taken over at the date of the receivership;
- (3) Losses on realization of such assets;
- (4) Expenditures on permanent or fixed assets;
- (5) Receiver's certificates repaid;
- (6) Decreases in the amount of receiver's liabilities;
- (7) Interest charges paid;
- (8) Expenses of operation of the property;
- (9) Receivership expenses;
- (10) The assets at the close of the period covered by the report, exclusive of permanent or fixed assets.

The report should also contain comparative balance-sheets, showing conditions at the time of the previous report and conditions now. In addition, it may contain a profit and loss account and a summary of the cash transactions.

Before the court authorizes any payment or distribution of funds, an auditor is appointed by court to audit and examine the

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receiver's accounts and to pass upon all claims submitted. The auditor places an advertisement in the newspapers, giving public notice of his appointment and orders the filing of all claims. These claims are first reconciled with the books of the company and passed on to the auditor for final approval.

The final report of the receiver is a summary and complete accounting of his stewardship. It outlines what property is to be returned to the business, the amounts of the unpaid obligations, the results of the receiver's operations, etc. This report, chiefly a résumé of the receivership, helps the court to a large extent to determine the amount of remuneration due to the receiver for his services. The compensation is usually either a fixed percentage of receipts or disbursements of cash or a round sum, depending upon the volume of the work, the time spent and the responsibility involved.

The last topic for consideration is the method of handling the books of the financially embarrassed company during the period of the receivership. These books may be adjusted to meet the new conditions or abandoned until reorganization takes place. The most desirable plan is to keep them in harmony with the receiver's books as to all interrelated matters. When the property is turned over to the receiver, an account is opened with him on the general ledger as "A. B. receiver." This account is charged with every asset turned over and credited with every reserve for the particular asset.

During administration by the receiver, all liabilities prior to the receivership paid by the receiver are recorded by a credit to the receiver's account and a charge to the respective liability account. The books must continue to show all recurring liabilities such as interest, rentals and all other obligations not assumed by the receiver himself.

Upon the termination of the receivership, the plans of the reorganization having been formulated and completed, the company's books will be adjusted to show exactly what has occurred. The assets returned by the receiver are charged upon the books and credited to the receiver's account. The profits and losses that resulted from the receivership are reflected by a debit or credit to the receiver's account. All claims and liabilities allowed by the court auditor are entered upon the books as obligations of the business and, if incurred by the receiver, are charged to his

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account. The net balance of the receiver's account will show the net worth of the company. In most cases, the capital accounts will have undergone certain changes as a result of the reorganization. These must be entered in the books. The old capital, surplus or proprietorship accounts are closed and the new capitalization is recorded, in accordance with the figures and plans prepared and executed by the committee on reorganization.

In conclusion, it may not be amiss to digress a little from the specific subject under consideration and express the writer's amazement at the apathy prevailing in the ranks of the professional accountants to the consistent and systematic refusal of the courts to recognize the accounting profession in their appointments of receivers. It is indeed to be regretted that many of these appointments have gone to personal and political friends as plums, and they who are best fitted to handle this kind of work have been flatly disregarded and ignored. The advantages of appointing accountants as receivers of large enterprises have long been openly appreciated and recognized in England and in Scotland. Skilled in accounts, familiar with commercial law and usage and acquainted with business of almost every description, it would seem that the accountant is particularly fitted and adapted to the intelligent handling of the complicated tasks of receivers. Our courts have failed to adopt this point of view and many a receivership, because of incompetent administration, has netted only enough to pay the receiver's fees and expenses.

It is to be hoped that the near future will bring with it a better understanding of the status of the accountancy profession in this country and a reform in the selection and appointment of receivers.