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Correspondence: Treatment of Sinking Funds; Treatment of Mortgages and Values

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Correspondence

Treatment of Sinking Funds

Editor, The Journal of Accountancy:

Sir: I read with interest the article entitled *Treatment of Sinking Funds*, by Chas. S. Ludlam, which appeared in the March issue of The Journal.

On page 170 under paragraphs 8 and 9, the author states that the premium or discount on bonds purchased for the sinking fund is a profit or loss to the mortgagor. It would be extremely interesting to know whether the premium or discount should be carried in the sinking fund reserve or the surplus account. If the premiums or discounts are to be entered in the reserve account, it is apparent that a readjustment of the amount to be set aside for the retirement of the bonds at maturity would be necessary.

The author also states that current assets should be transferred to the sinking fund, without making a charge to income to accumulate a reserve. I fail to see the advantages of this method for the following reasons: First, the facts are not properly recorded unless a special reserve is created; second, the directors of the corporation may pay dividends if the amount is not set aside; third, there is no difference in the final result.

To illustrate the third point: A corporation issues bonds to the amount of $5,000,000, and the accounts show the condition of the company before the issue to be as follows:

Assets	
Plant and property	$5,000,000
Current assets (excess over current liabilities)	500,000
Liabilities	
Capital stock	$ 4,500,000
Surplus	1,000,000

After the bonds are sold, the cash proceeds would appear temporarily among current assets until additions to the property were made. Assume that the mortgage requires that a sinking fund be established to retire the bonds in twenty years. On the theory that the instalment will be paid from current assets without making a deduction from income, the accounts as a result of the method employed will reflect the following condition at the end of twenty years:

Assets	
(*a*) Plant and property	$10,000,000
(*b*) Sinking fund	5,000,000
(*c*) Current assets (excess over current liab.)	500,000
Total	$15,500,000

Liabilities

(*d*) **Capital stock**	$ 4,500,000
(*e*) Bonds	5,000,000
(*f*) Surplus	6,000,000
Total	$15,500,000

Items (*b*) and (*e*) would be eliminated after the bonds are paid, and there would be $5,000,000 more in the surplus account at the end of the period than at the beginning, represented on the asset side by additions to plant and property. If the charges had been made to income during the twenty years, we would have as a result a surplus of $1,000,000 and a reserve of $5,000,000; this latter amount could be transferred to surplus after the bonds are paid. In the meantime, the advantage is had of a proper record of the facts.

During the twenty-year period, the corporation is in effect making additions to plant and property from its surplus earnings. In order to pay dividends it must have additional surplus earnings sufficient to provide current assets from which to pay them. Is it sound finance for a corporation to borrow money in order to pay a sinking fund instalment, the current assets having been depleted because dividends were paid? It would not be necessary to create a second debt if the company had maintained a reserve or an adequate surplus. An indebtedness incurred to pay sinking fund instalments would still remain after the bonds had been paid.

George W. Shipway,
Certified Public Accountant.

New York, May 4, 1914.

Treatment of Mortgages and Values

The Editor, The Journal of Accountancy:

Sir: Many accountants allow stockholders of a corporation, members of a partnership or individuals to fool themselves or their creditors by not installing a system that will give the full facts within the same space allowed in a report for partial and misleading facts.

One great fault is where a piece of real property is sold on contract and no attention is given to the liability to deliver under certain conditions. At the time the contract is made the honors are even and, after the first payment is made, the cash received is a new form of an asset but the liability remains the same. In short, the net liability on a contract sale is the original amount of the contract less the unpaid balance. The property has not been deeded and no profit can be considered until the title passes. The cost or book value of the real property is listed under assets, the payment on the principal of the contract sale is an asset, and the net amount due on the contract is a debit charge against the liability to deliver. It is the case of a conditional sale and "when property is sold on contract it belongs to the seller until title passes."

The interest on deferred payments is income but no profit on the sale of the real property can be taken until the title passes.

Some argue that the liability would only be the amount of the contract less the estimated profit to be realized, but I claim there is no absolute proof that the terms of the contract will be fulfilled and, therefore, no profit can be considered until the actual transfer of title has taken place. If the known profit at the time of making the contract is credited to "anticipated profits on uncompleted sale contracts," and "contract sale agreements at cost value" is credited with an amount equal to the value carried on the books for the asset sold on contract, the deal will be stated in full.

Another loophole which is very often taken advantage of is where real property is purchased on the basis of a certain value, "subject to" a mortgage for a certain known amount.

The attorney states that the debt is against the property and not a liability of the new owner of the property, therefore the innocent person or wildcat schemer hides either intentionally or not under the veil produced by the statement made by the attorney.

The real property was purchased on the basis of a certain known value and a known debt must be paid before the title to the property is clear, therefore the value of the property should be considered the asset and the amount of the mortgage a liability. The equity being considered and no liability mentioned is in error, misleading and the cause of much harm to innocent persons.

For an example of my views I give a copy of a "modified balance sheet" for a large investment company, and claimed by its board of directors to be based upon a report made by a well-known firm of accountants. This report had previously been published in full. The "modified balance sheet" referred to is set forth as follows:

Assets

Real estate	000,000,000.00
Agreements of sale	000,000,000.00
Mortgages	00,000,000.00
Bills receivable	00,000,000.00
Accounts receivable	00,000,000.00
Stocks of other corporations	000,000.00
Furniture and equipment	00,000.00
Cash	000,000.00
Total	000,000,000.00

Liabilities

Gold notes	000,000,000.00
Home certificates	0,000,000.00
Accounts payable	00,000.00
Trust funds	00,000.00

Dividends (uncalled for)	00,000.00
Capital stock	000,000,000.00
Surplus	000,000,000.00
Total	000,000,000.00

It is a well-known fact that there is a large amount still unpaid on the real estate and the "agreements of sale" indicate that the title has not passed, and, therefore, I will now give an example of how I claim the balance sheet should read.

Assets

Cash	00,000,000.00
Accounts receivable	0,000,000.00
Notes receivable	0,000,000.00
Mortgages receivable	0,000,000.00
Stocks of other corporations	0,000,000.00
Real estate (at purchase value)	000,000,000.00
Furniture and equipment	00,000.00
Total	000,000,000.00

Liabilities and capital invested

Accounts payable		0,000,000.00
Dividends uncalled for		000,000.00
Trust funds		000,000.00
Contract sale agreements		0,000,000.00
Original amount	0,000,000.00	
Less unpaid balce.	00,000.00	
Mortgages payable		00,000.00
Gold notes		00,000,000.00
Home certificates		000,000.00
Total liabilities		00,000,000.00
Capital stock	0,000,000,000.00	
Surplus	0,000,000,000.00	00,000,000.00
Total		00,000,000.00

Too little attention is given by bankers, the purchasers of stock of a corporation, the purchaser of an interest in a partnership, etc., to the liabilities, and all assets items are sure to be given by the person presenting the statement, therefore a change as suggested by me above would protect all parties and state real facts. The liabilities have to be met and they are the facts that are most important since the stated assets will show the source from which the money for the payment can be realized. Liabilities not stated have caused more harm than can ever be calculated.

If the statement is presented to a banker for the basis of a loan, it is very easy to arrange it so that it will give the cost or book value and at the same time allow space to show the appraised or estimated value, and then the facts are clear to all parties concerned.

If real property is purchased by contract and no title passes until certain payments have been made, it is proper to record the deal as follows:

Real estate, title subject to contracts,
To real estate purchase agreements.
With explanations.

The payments on the contract will reduce the liability and the asset remains the same until the title has been transferred; it can then be written off and charged to real estate.

Yours very truly,

R. L. McCrea.

San Bernardino, California.

New York State Society of Certified Public Accountants

At the annual meeting of the New York State Society of Certified Public Accountants on May 11th, 1914, the following were elected officers for the ensuing year and directors for the terms specified:

President, Hamilton S. Corwin; first vice-president, J. Lee Nicholson; second vice-president, W. Sanders Davies; secretary, James F. Farrell; treasurer, David E. Boyce.

Directors for one year, Henry R. M. Cook, Charles Hecht, Charles E. W. Hellerson, Duncan MacInnes, Richard P. Tinsley, and William F. Weiss. Directors for two years, Howard B. Cook, Herbert C. Freeman, Frederick H. Hurdman, Ferdinand W. Lafrentz, John R. Sparrow and Edward L. Suffern.

Certified Public Accountants of Massachusetts, Inc.

At the annual meeting of the Certified Public Accountants of Massachusetts, Inc., the following officers were elected: President, J. E. Masters; vice-president, William Franklin Hall; secretary, George Lyall; treasurer, Gerald Wyman.

Maine Board of Accountancy

The next examination in Maine for certified public accountants will be held at Portland on June 23, 24, 25. Applicants must be either residents of Maine for one year, or certified public accountants of another state or under a foreign government which extends similar privileges to certified public accountants of Maine.