Journal of Accountancy

Volume 18 | Issue 1 Article 9

7-1914

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Recommended Citation
Lawton, W. H. (1914) "Correspondence: Treatment of Sinking Funds," *Journal of Accountancy*: Vol. 18: Iss. 1, Article 9.
Available at: https://egrove.olemiss.edu/jofa/vol18/iss1/9

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Correspondence

Treatment of Sinking Funds

Editor, The Journal of Accountancy:

Sir: The treatment of sinking funds seems to be a subject that is worse than *Banquo's* ghost! Heretofore it has been more or less of an academic question, but in view of the fact that the interstate and state public service and utility commissions are undertaking to fix rates for public utility service, it becomes a question of serious importance.

Let me say at the outset that until within a very short time I took the same view as Mr. Ludlam in his article in the March, 1914, issue of THE JOURNAL, *viz.*: that it was quite sufficient for all practical purposes merely to set aside from general funds the amounts annually required for sinking fund purposes without going through the apparently superfluous process of setting up a corresponding reserve out of the surplus, or, what is practically the same thing, ear-marking it as a sub-account under surplus. Before Mr. Shipway's keen comment in the June issue of THE JOURNAL—"In the meantime, the advantage is had of a proper record of the facts"—came to my attention, I had had a little experience of my own which opened my eyes to the value of such proper record.

The accountant of a certain state commission in the course of a friendly conversation made the rather startling (to me) statement that where a utility had a sinking fund requirement in its mortgage, he did not consider it necessary for it to accrue any more of a depreciation fund than might be necessary to make up the difference between the total sinking fund and the total estimated depreciation for a given term of years. In support of this he submitted a final balance sheet based on the assumptions—

That the capital raised is $200,000, of which $100,000 is stock and $100,000 bonded debt;

That the bonds mature and the plant is theoretically exhausted at the same date.

BALANCE SHEET

Plant (original cost)	$200,000	Stock	$100,000
Sinking fund	100,000	Bonds	100,000
Depreciation fund	100,000	Reserve depreciation	200,000
	$400,000		$400,000

"Now," said my friend, "the sinking fund is used to pay off the bonds. The reserve for depreciation is deducted from the plant account. And we have left $100,000 in the depreciation fund, which, if the company goes out of business is paid over to the stockholders who get all their money back. If they want to continue business, they renew the bonds, transfer the sinking fund to the depreciation fund, replace the plant and begin all over again. In other words they are in exactly the same position as when they started."

You will note what he has done, constructively speaking. During the life of the plant he has charged only one-half the actual depreciation to earnings and credited it to the reserve account, and has made up the balance in the latter account from the sinking fund instalments charged against income or surplus. He does this either directly, by the entry

Surplus (or income)	Reserve for depreciation,

or indirectly by two entries,

(*a*) Surplus (or income)	Sinking fund reserve,
(*b*) Sinking fund reserve	Reserve for depreciation.

All the rest of the surplus has, under the terms of the assumed facts, been distributed in dividends.

Of course, it goes without saying that no accounting officer would be justified in transferring the sinking fund reserve to the depreciation reserve in this manner. It is merely juggling with names of accounts. The correct way to state the final balance sheet would be as follows:

Plant	$200,000	Stock	$100,000
Sinking fund	100,000	Bonds	100,000
Depreciation fund	100,000	Depreciation res.	100,000
		Sinking fund res.	100,000
	$400,000		$400,000

Now when the bonds are paid off, the resulting balance sheet is,

Plant	$200,000	Stock	$100,000
Depreciation fund	100,000	Depreciation reserve	100,000
		Surplus	100,000
	$300,000		$300,000

If the utility now goes out of business, the depreciation fund is used to pay off the stock in full, but the surplus is wiped out by the difference between the total amount invested in the plant and the actual amount of depreciation accrued.

What has become of the difference? Manifestly it has been paid back to the stockholders, in the form of dividends but actually out of capital. This is shown clearly by the fact that if the utility wishes to continue business, it must put up that $100,000 shortage in the depreciation fund, whether by issuing new stock or borrowing on bonds. My friend insists that since the stockholders get back their original stock investment (and he might have added the same amount in dividends really paid out of capital) nobody suffers. He ignores the fact that the stock at the end might be in hands entirely different from those of the original investors, and the later owners would undoubtedly have paid more than par for a stock showing such handsome dividends.

Ordinarily we might view the matter with more or less cynical amusement, saying that if utility managers choose to fool themselves in this way, even with the sanction of commissions, it is a matter of interest to the stockholders only as to whether they get back their investment as a whole or piecemeal. But accountants who have experience with public utilities will see at once the importance of clear statements and records since on them will hang the question of adequate rates to be charged to consumers. This is too involved and complicated a question to go into here. I am submitting this little experience merely to emphasize the point raised by Mr. Shipway—that the sinking fund reserve should be set up to show the proper record of the facts. It is manifest that if my friend's balance sheet were correctly re-stated as above nobody could be deceived into thinking that an adequate depreciation fund had been charged and accrued.

As to Mr. Shipway's questioning the soundness of a corporation borrowing money to pay a sinking fund instalment, it seems to me all Mr. Ludlam meant was that it would be proper to do so in a temporary emergency, as, for example, at a time when an abnormal amount of current assets was locked up in accounts receivable due to money stringency.

W. H. Lawton.

Wayne, Pennsylvania, June 15, 1914.

The Oregon State Society of Certified Public Accountants

At the annual meeting of the Oregon State Society of Certified Public Accountants the following officers were elected: President, Alexander C. Rae; vice-president, H. A. Moser; secretary and treasurer, Albert Lester Andrus; delegate to annual meeting, Alexander C. Rae; alternate delegate, W. R. Mackenzie; directors for the ensuing year, William Whitfield and George P. Clark.

The Dominion Association of Chartered Accountants

The annual meeting of the Dominion Association of Chartered Accountants will be held in Halifax, Nova Scotia, September 1st to 4th, 1914.

The Missouri Society of Certified Public Accountants

At the annual meeting of the Missouri Society of Certified Public Accountants held in St. Louis on June 12th the following officers were elected: President, B. D. Kribben; first vice-president, Frederic A. Smith; second vice-president, J. M. McShane; secretary, Richard Wilson; treasurer, J. D. M. Crockett; auditor, Edward J. Dillon; delegates, B. D. Kribben, L. N. Simson, and Stanley Young; alternates, E. G. H. Kessler, Richard Wilson and J. D. M. Crockett; directors, E. G. H. Kessler, Francis A. Wright, Jr., and Frederic A. Smith.