FEDERAL RESERVE BOARD

WASHINGTON

X-3151

June 24, 1921.

SUBJECT: Methods of Accounting for the Expenditures for New Buildings,

Dear Sir:

The Federal Reserve Board has been considering a plan for accounting for the expenditures for new buildings, for writing off cost in excess of replacement value and for providing for depreciation, and has decided to request the managements of the respective Federal Reserve Banks to favor it with an expression of their views. For your information, I am enclosing copy of memorandum received from the Federal Reserve Bank of New York which you are requested to read and use as a basis, if you wish, for a similar memorandum expressing your own views.

Very truly yours,

(Enclosure) Governor.

TO CHAIRMEN OF FEDERAL RESERVE BANKS AT:
Boston, Cleveland, Chicago, Kansas City,
Dallas, Richmond and San Francisco.

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METHODS OF ACCOUNTING FOR THE EXPENDITURES FOR NEW BUILDINGS.

1. The book value at which the new building should be carried.

The expenditure for the new building will result in the acquisition of a "plant" of the most permanent kind. The transaction will consist of converting a certain portion of the liquid assets into fixed property and therefore will constitute a capital outlay. On account of its permanence, magnitude and special design, the property thus acquired will be practically unavailable as an asset. Therefore, the amount of liquid assets withdrawn by the transaction from available form, that is, the cost of the property, will not be a true measure of its value. The value of such a building to a Federal Reserve Bank depends solely upon the capacity and the facilities it affords for continuous, permanent and effective service. Therefore, it cannot be treated as an investment nor as an asset that materially affects financial condition.

In view of the principles just stated, it appears that the new building should be carried on the books at the estimated cost of replacement. That is the only true measure of its value that can be expressed in dollars and cents.

It is suggested that the estimated cost of replacement be arrived at by determining the mean of two amounts, namely: (1) the total actual cost of construction and (2) the estimated cost of construction based on the lowest prices that have existed during the last fifteen years. The figure thus arrived at would be a reasonable one at which to carry the book value of the new building as an asset, since during a long period of fluctuating prices it would be a reasonable measure of the eventual cost of replacement.

2. Method of writing off cost in excess of replacement value.

If the value of the building is established on the books in accordance with the method described above, any amount of cost in excess of this value will have to be written off. Several methods might be adopted for disposing of this item; that which seems most reasonable consists of distributing the amount of excess cost to be earnings of those years in which the cost was incurred. An additional reason for this procedure is found in the fact that the present high earnings and high costs are closely related.

The amount to be deducted from earnings and set up as a reserve would be arrived at as follows: An estimate would be obtained from the best authorities - architects, builders, etc. - of the percentage of cost of construction representing the amount of cost in excess of the replacement value, and this percentage would be applied to the total annual expenditures, to arrive at the amount to be deducted from earnings and set up as a reserve each year during construction.

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If this method is adopted, when the building is finally completed an amount equal to the reserve thus accumulated would be credited to the Building Account and debited to the reserve, thus writing the cost of construction down to the estimated replacement value and closing the temporary reserve established during the years of construction.

3. The provision that should be made for depreciation.

Having established a book value such as that recommended in the preceding paragraph, an annual charge for depreciation or replacement should be adopted based on the estimated life of the building. This charge should be applied to profit and loss, and credited to an account entitled "Reserve for Depreciation of Building." Such an annual charge would be consistent not only with good business but with good accounting practice. Moreover, it would be consistent with any reasonable interpretation of the provision of Section 7 of the Federal Reserve Act, which, in order to arrive at net earnings for distribution, permits as deductions from gross earnings all "necessary expenses" that have been "paid or provided for." The practice of writing off arbitrarily certain amounts or items of building expenditure could not be easily defended if criticized from the standpoint that such arbitrary deductions are not "necessary expenses,"....whereas it could be reasonably maintained that a uniform charge set aside annually and continued during the life of the property in order to provide for replacement constitutes a "necessary expense" and a proper deduction from earnings in any self-supporting undertaking.

The annual rate of depreciation that should be used must be an arbitrary one because the life of a building such as is being planned depends more upon the date at which it will become obsolete than on the date on which, through natural causes, it will have depreciated to a point at which rebuilding is necessary. From the standpoint of depreciation from natural causes, it would be reasonable to expect that such a building would last one hundred years whereas it might become obsolete in twenty-five years. Therefore, it is thought that fifty years would be a reasonable estimate of the life of the building, exclusive of fixed machinery and equipment. This would mean that an annual allowance for depreciation, amounting to 2 per cent. of the replacement value, less residual value, would be set aside in the reserve account and deducted from earnings.

The practice of writing off to profit and loss as soon as possible expenditures incurred prior to actual construction, could be easily criticized and would be difficult to defend. Such expenditures are commonly considered as a part of the cost of a building and at the time of replacement would, of course, have to be again incurred. From this standpoint they should be included in the total cost as a basis of determining the replacement value. If they are written off as soon as possible, it would be better, in view of the provisions of section 7 of the Federal Reserve Act, to charge them to super-surplus.

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The same principles as to the determination of a reasonable book value apply in the case of fixed machinery and equipment as in the case of the building itself. In the case of machinery and equipment, however, different rates of depreciation should be adopted. By fixed machinery and equipment is meant all large permanent units such as boilers, engines, dynamos, elevators, heating, ventilating, lighting systems, etc. An estimated replacement value, residual value and life should be arrived at, based upon the best engineering advice obtainable, and following this, percentages of the replacement value less residual value consistent with estimated life should be set aside each year in a reserve for depreciation of machinery and equipment, and a corresponding deduction should be made from earnings.

The book value of the vault should be carried as a part of the book value of the building.

STORAGE BUILDING.

Methods of accounting in accordance with the foregoing principles should be adopted also in the case of the expenditures for the Storage Building.

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