By **Francine Lee**

The Nuts and Bolts of Fiduciary Accountings

A fundamental duty owed to the beneficiaries

Acting as a fiduciary isn't easy. A fiduciary owes many duties to the beneficiaries, and a breach of a duty can result in liability. This includes the duty to account. Sometimes an accounting is required by the governing instrument or by state statute, ordered by a court or prepared in connection with litigation. Other times, an accounting might be needed because a beneficiary requests it. A fiduciary may decide to produce an accounting to assist with the administration of the trust or estate, manage risk or be released from liability if the beneficiaries won't sign a receipt, release and refunding agreement (or a version thereof) after the fiduciary's term ends. Whatever the reason, having an accounting is one of the best ways a fiduciary can protect itself from liability. An accounting also protects the beneficiary because it requires the fiduciary to disclose all of the activity in the trust or estate that the beneficiary can review and, if the beneficiary disagrees, can challenge.

Benefits

Some of the benefits of having an annual or periodic accounting prepared, even if not required, are:

1. Aids in the administration of the trust.
2. May help protect a fiduciary from future liability (absent fraud) for the period covered in the accounting.
3. Starts the statute of limitations.
4. Can be more cost-effective to do annually as it could take more time to reconcile a longer term accounting.
5. Enables the fiduciary to correct mistakes closer to real time rather than years later.
6. Can make tax compliance easier and less expensive, as many of the numbers needed for the tax return can be pulled from the accounting.
7. Produces information that's current and readily available.
8. Increases the likelihood that beneficiaries will sign a release when the matriarch or patriarch is alive for family trusts.
9. Satisfies the duty to keep books and records.
10. Protects against lost "history" of the account due to employee turnover, bank acquisitions or consolidations or a natural disaster.

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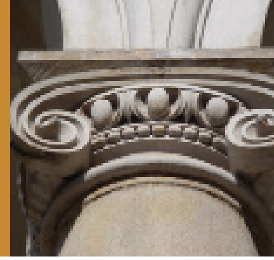
What to Include

A fiduciary accounting (sometimes called a "court accounting") is a comprehensive report of the activity within a trust, estate, guardianship or conservatorship during a specific period. It shows all the receipts and disbursements managed by the executor, trustee, guardian or conservator (the fiduciary), properly allocating all transactions between principal and income. These accountings are regulated by their governing instruments and state law. Many states have adopted the Uniform Principal and Income Act,[1] sometimes with modifications. For this reason, always check the governing trust instrument and state law when preparing an accounting because sometimes the rules are different.

An accounting differs from traditional financial statements. Financial statements don't allocate between principal and income, and they often don't contain the detailed descriptions of financial transactions required in an accounting. Accountings are



also different from tax returns as the latter doesn't differentiate between principal and income, and the tax law concepts don't apply.

The purpose of an accounting is to present enough information to put the interested parties on notice as to all significant transactions affecting the administration during the accounting period. How the information is presented in an accounting can vary depending on the type of entity. An accounting for a trust, an estate or a special needs trust may all look different. Some states have required formats. Even if a state doesn't have a required format, a local jurisdiction might have its own format, so it's always important to check the local county filing requirements. If there's no specific format required, the National Standard Format is generally accepted by most courts.

Accountings are typically required to have:

- A statement of receipts and disbursements of principal and income.
- A statement of the assets and liabilities.
- The fiduciary's compensation.
- The agents hired by the fiduciary, their relationship to the fiduciary, if any, and their compensation.

Some fiduciaries take the position that their statements already contain all of the required information. Therefore, as long as a formal accounting isn't required to be filed in court, the statements are a substitute for an accounting.

Settling Accountings

Accountings can be settled informally by having the beneficiaries sign a receipt, release and refunding agreement. In some states, such as California, if certain language is included when an accounting is delivered to a beneficiary, the beneficiary will have a set number of days to object to the accounting or it's deemed accepted.

California Code, Probate Code—PROB Section 16460 provides:

> You have 180 days from your receipt of this account or report to make an objection to any item set forth in this account or report. Any objection you make must be in writing; it must be delivered to the trustee within the period stated above; and it must state your objection. Your failure to deliver a written objection to the trustee within the period stated above will permanently prevent you from later asserting this objection against the trustee. If you do make an objection to the trustee, the three-year period provided in section 16460 of the probate code for commencement of litigation will apply to claims based on your objection and will begin to run on the date that you receive this account or report.

Properly allocating all receipts and disbursements between principal and income is required to accurately calculate fiduciary accounting income.

Sometimes an accounting will be required to be settled formally (for example, filed in court). An accounting will be required to be filed in court when: it's required pursuant to the governing instrument or state statute; it's ordered by a court in connection with litigation; or the fiduciary seeks to be relieved of liability and is unable to get all of the beneficiaries to sign a receipt, release and refunding agreement.

Fiduciary Accounting Income

Properly allocating all receipts and disbursements between principal and income is required to accurately calculate fiduciary accounting income (FAI). Some of the rules are complex and can vary depending on the governing instrument and state law.

Calculating FAI is important because:

- FAI is needed for a fiduciary to know how much income there is to distribute to an income beneficiary.
- A tax preparer needs to know the amount of FAI and to disclose it for complex trusts on Internal Revenue Service Form 1041.

- FAI is necessary for determining distributable net income and for tax planning for a beneficiary.

Many of the rules for determining income for tax purposes don't apply to calculating FAI, which sometimes causes significant confusion. To determine taxable income, look to the U.S. Tax Code. To determine FAI, look first to the governing instrument and then to the state's principal and income act that governs administration of the trust or estate. Some of the differences include:

- Accountings are prepared on a cash basis. A trust or estate only has a receipt or disbursement when an item is received or paid.

It's the fiduciary's responsibility carefully to review an accounting and confirm that the information presented is accurate.

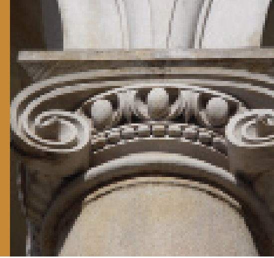
- When allocating inventory on the sales of securities, an accounting uses the weighted-average method, whereas tax reports may use "first-in, first-out," average basis (for stock in mutual funds or dividend reinvestment) or a specific identification.
- Accountings use the date of death for the estate valuation date; tax uses the date of death or the alternative valuation date.
- Activities within flow-through entities are ignored for FAI purposes. A receipt only occurs when a distribution is received. A trust could own an interest in a partnership, limited liability company or S corporation with a large investment portfolio or a successful business, but until the entity makes a distribution to the trust, the trust doesn't have FAI. There are complex rules for determining if a distribution of money from an entity to a trust is treated as income or principal.
- There are specific rules regarding whether payments from individual retirement accounts, annuities or deferred compensation arrangements are income or principal. These rules vary in different jurisdictions.

These are just a few of the challenges encountered in calculating FAI and examples of some of the differences between tax income and FAI.

Tips for Reviewing an Accounting

It's the fiduciary's responsibility carefully to review an accounting and confirm that the information presented is accurate. Some of the principles to keep in mind when reviewing a fiduciary accounting include:

1. Review the governing instrument to look for special instructions and understand the distribution requirements.
2. Understand the purpose of the accounting. Knowing whether it's being prepared because of the beneficiary's death, the death or resignation of the fiduciary or for a required periodic filing will determine whether distribution schedules are required, additional schedules are needed or final reserves should be retained. If an accounting is prepared due to the death or the termination of an income interest, special rules apply and the fiduciary may have more discretion in allocating certain expenses.
3. Make sure the accounting is prepared in the required format or National Standard Format or another format accepted by the court. Even if an accounting doesn't need to be filed in court, it's always better to use an acceptable format in case the accounting needs to be filed in court in the future.
4. The accounting should accurately reflect all the information contained in the source data, such as the checking, savings, brokerage and trust account statements and the IRS Form 706. Reconstruction may be required to reconcile missing documentation.
5. Each transaction must be documented on the appropriate schedule and should be itemized with a detailed description. Dividends and interest should be described by source and date. Each disbursement should be listed separately by date and payee, not grouped together in a broad category.
6. Review all schedules to ensure that entries are correctly categorized as principal or income.



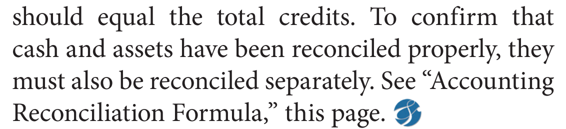
Accounting Reconciliation Formula

The total charges should equal the total credits

Cash reconciliation	
Cash on hand (beginning assets on hand)	Cash disbursements (disbursements or distributions)
Cash receipts (additions or receipts)	Purchases or reinvestments
Sales proceeds (gain or loss)	Cash on hand (end assets on hand)
Total	**Total**
Asset reconciliation	
Assets on hand (beginning assets on hand)	Assets sold (gain or loss)
Asset purchases	Return of principal
Asset reinvestments	Assets on hand (end assets on hand)
Total	**Total**

— Francine Lee

7. The accounting should identify and confirm all assets held in the trust or estate. For a first accounting, the opening balance will consist of the list of assets funding the account. For subsequent accountings, the opening balance should exactly match the ending asset values listed on the prior accounting. Document assets that have been removed, transferred or disbursed. Disclose all assets that belong to the trust or estate. The income received on investments should be compared with the principal and income investment schedules to verify that all dividends, interest and other income have been properly collected and documented.
8. Carefully check for capital changes. All stock dividends, spin-offs and exchanges should be reviewed to confirm that the inventory values are correctly applied, along with details of the assets spun off or exchanged.
9. The accounting must balance! The total charges



should equal the total credits. To confirm that cash and assets have been reconciled properly, they must also be reconciled separately. See "Accounting Reconciliation Formula," this page.

— The views expressed by the author are not necessarily those of Ernst & Young LLP or other members of the global EY organization.

Endnote

1. The Uniform Principal and Income Act (UPIA) was originally adopted in 1931 at the National Conference of Commissioners on Uniform State Laws. The UPIA has been amended several times over the years. Generally, the UPIA provides rules to determine who's entitled to property, income and principal in a trust or estate and how receipts and disbursements should be allocated between principal and income.

SPOTLIGHT

Smile

Study for Warhol's Marilyn by Sturtevant sold for $283,342 at Bonhams Post-War & Contemporary Art auction on March 24, 2021 in London. Unlike many other artists whose copies were met with backlash, Sturtevant's Marilyns were painted not only with Warhol's blessing but also on canvasses, paints and screens identical to those that Warhol began producing after the actress's untimely death in 1962.