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Finance Company Systems

D. Paul Musselman

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By D. Paul Musselman

The process of trial and error which tends to establish standards in accounting systems has made little advance in respect to the transactions which are peculiar to the finance company. Forms have been borrowed and adapted from other kinds of business, but have proved awkward and inefficient when tested by the special stresses of the new type of enterprise. Certain wasteful operations, negligible in other lines, are multiplied until they become a substantial expense to the finance company. The most general faults lie in an inability to provide quickly useful information for management purposes—such as statements of future cash position—and in difficulty in making a rapid and thorough audit.

The following comments do not pretend to be complete, as any preconceived system will have to be tailored to fit the needs of the particular company to which it is applied; but they are intended to cover the essential features of those special records which are peculiar to finance companies, omitting, so far as continuity of description will permit, those features which are common to all types of business. The topics to be covered are:

I. Instalment-note ledger;
II. Instalment-note register;
III. Cash records;
IV. Distribution of unearned finance charges;
V. Financial statements and ratios.

Instalment-note Ledger

Companies dealing in several types of notes may find it advisable to departmentalize them into several groups, each with its separate control and separate subsidiary ledger. In either case the ledger should be designed for:

A. Facility in finding the accounts for posting;
B. Facility in effecting agreement with the control;
C. Infallibility in revealing delinquents;
D. Facility in obtaining data relating to future cash position.

The form which most nearly satisfies these requirements is a modification of the so-called Boston ledger, in which the individual accounts are set up horizontally instead of vertically, one account appearing below the other—the vertical columns (in pairs) representing periods of time, any period from a day to a month or more, depending upon how frequently reports are desired by the management. This form of ledger is used advantageously when only one or a limited number of postings is normally made within the period, as in the case of public utilities, building and loan associations, etc.

Let us first describe the general appearance of the ledger sheet, reserving argument for discussion of detailed operation. At the left side of the sheet are columns for serial number (referring to note register) and name and a column for the total face value of the notes, to be used for information purposes only. It is unnecessary to duplicate any further information which already exists elsewhere, except that subsequent changes in the status of the notes will be entered by appropriate symbol or abbreviation in the money columns for the proper periods. Such changes include location of the paper, whether re-discounted, pledged or deposited for collection, repossession of collateral, etc.

Let us now consider the form in respect to the four principal requirements listed above.

A. *Facility in finding the accounts for posting.* Actual posting is a simple operation in any system. It is the time-consuming operation of searching for the account that must be reduced to the minimum. Visibility is the first desideratum and orderly arrangement, usually alphabetical, the next. Our form has a maximum of visibility, and may be arranged alphabetically, geographically, by dealers, or as desired. Also, it is impossible to separate one individual account and mislay it. Where card systems are in use the temptation to remove the accounts is practically irresistible. The purpose sought by grouping delinquent accounts will be better served.

B. *Facility in effecting agreement with the control.* The necessity of facility in effecting agreement with the control hardly admits of argument. Systems which do not include the periodical trial balance in their procedure can not qualify for comparison, as they do not provide a minimum of control against error and manipulation.

The Boston ledger is really a trial balance in form, and its superiority for that purpose needs no more than an ocular demonstration. However, there is more than one way of using the ledger; and the usual method, carrying balances forward from period to period, is not the best for the purpose. For reasons that will appear later, it must be emphasized here that all columns to the right of the last closed period—*i.e.*, the columns for the current and future periods—will be in constant use. There will be no interim balances in the future columns. Instead of using a single column for taking the trial balance, all the figures to the right of the last closed period will be understood to comprise the agreement with the general ledger control. At the end of each current period the balances of individual accounts which do show balances (relatively few in number) will be carried forward to the next column, and the former column will then be regarded as closed—practically as ruled off—and no further entries may be made in it. The computation and entering of interim balances is thus eliminated. Only the delinquent balances (differing in amount from interim balances) are carried forward.

(The defense of the interim balance would seem to consist of three counts: (A) It is used to ascertain the state of the individual account. The answer to this is that no one wants to know the balance in the individual account ninety-nine per cent. of the time. It is usually required when there is a delinquency, but in that case the predetermined interim balance is not the true balance. Let the interim balances be computed in individual cases where necessary. Why enter thousands of computations that will never be used? (B) It may be claimed that the interim balance is necessary for the preparation of schedule of notes. The answer to this is that such schedules are only required in exceptional circumstances and should not be a part of the regular routine. The ledger itself is in the form of a schedule, and the balances at any given date may be readily computed if required. (C) It may be claimed that the interim balances are necessary for the trial balance: but I have already explained that I make mathematical agreement with the control in an easier way, namely, by assembling the accumulated footings of the current and future period columns.)

The advantages of this method of operating the ledger may be demonstrated objectively by considering the various types of entries which are most commonly made:

1. Instalment-note purchases;
2. Collections and charge-backs to dealers;
3. Dishonored cheques and protest fees;
4. Re-writes;
5. Repossessions;
6. Adjustment of bookkeeping errors.

Instalment-note purchases. The debit is entered not as one amount (except in the information column) but by its instalments, each instalment being entered in the debit column for the period in which it falls due. Interim balances between maturities are omitted.

Collections and "charge-backs" to dealers. Collections are made in two ways: either by the dealer, acting as agent for the finance company, the maker of the note having no notice of the purchase by the latter; or by the finance company (directly or through the banks). In the former case the dealer is charged in each period for the entire list of maturities, and, so far as the instalment-note ledger is concerned, the transaction is completed by entering a credit opposite the already posted debit (either singly or by groups). Where the collections are made by the finance company, the postings will be made to the individual accounts in the credit column of the period in which received. In the majority of cases the credit will offset the debit for the period, and no further work is necessary.

The two types of entry listed above—purchases and collections—comprise what might be described as the normal transactions affecting the instalment-note ledger. The remaining types include the principal transactions arising from deviations in the normal course of business. There are certain refinements which should be observed in the posting of this next group, such as the entering of a debit in a credit column in red. But these are not matters of primary importance and need not be regarded as complications endangering the smooth working of the system: they may be entirely disregarded, and still the trial balance will remain intact, and in that respect the operation may be regarded as bookkeeper-proof. The worst that can happen will be a slight derangement of certain ratios, probably so immaterial as to be negligible.

Dishonored cheques and protest fees. Bad cheques are sometimes carried as cash in order to avoid clerical work, but the practice is undesirable as it often leads to neglect and abuse. Furthermore, they present pertinent credit information and as such should appear in the ledger. The charge should be posted in red in the credit column against the original credit, unless the latter was posted in a prior period which has now been (in effect) ruled off. In that case it will be entered in black in the debit column. An appropriate symbol will indicate the nature of the charge. If there is a protest fee, it will always be entered in the debit column as a separate item.

"Re-writes." It frequently happens that the maker of the note is unable to pay his instalments on time, and rather than repossess the collateral or charge the note back to the dealer, the company will make a new arrangement, extending the time, or reducing the periodical payments, sometimes with an additional amount added to the note for interest and finance charges. In such cases we have the cancellation of certain debits and the substitution of others. The original entry should be made in the note register in appropriate red and black figures. If there is no change in the total amount, the changes in dates and in the instalments will be reflected in the ledger by red entries against the instalments to be changed and new black entries for the substituted instalments. If the changes are material, and there has been an additional charge for interest and services, it may be more desirable to cancel all the old debits in red and open a new account, with proper references.

Repossessions. Repossessions should be regarded in the first instance as a change in the legal status of the account, rather than as an accounting transaction requiring a journal entry and a transfer of the balance in the note account to another asset account. A memorandum of the occurrence should be entered in the account by appropriate symbol, but no further entry should be made ordinarily until disposition of the collateral. In many cases the maker of the note will redeem the collateral by paying up his instalments, and the status quo ante will be resumed. When the collateral is not redeemed the note account will of course be closed, and this should be done by a series of red-ink entries in the debit columns, offsetting the balance carried forward to the current period and the unmatured debits shown in current and future columns. (If this is not understood, and a simple credit entry is made in the current column, no harm will be done, but the bookkeeper will have the necessity of carrying forward a reducing credit balance from period to period until the original series of debits is exhausted.)

Adjustment of bookkeeping errors. Errors are bound to occur in the best regulated offices, and the posting should follow the principle that the adjustment should appear against the original posting rather than as an independent entry, always with the reservation that columns for past periods are closed and in effect ruled off and no subsequent postings may be made in them.

As previously stated regarding the last four types of entries, the refinements as to red and black ink are matters of secondary importance. There is only one rule to be inflexibly observed, namely, that no entry should ever be made in a column for a past period, any more than an entry would be made in an ordinary ledger above the red line. If there is any danger of this it would be well actually to rule the past columns off by a vertical ruling of unmistakable significance.

This completes the list of typical entries to be found on the ledger sheet, in addition to the balances carried forward from accounts which show balances at the close of each period. In addition to the figures, space is available for references to journals or other books of original entry. It may be assumed that charges and collections will be found in their normal location, by number or period, in note register and cashbook, and the entry of the reference is hardly necessary. Local experience will determine the extent to which supplementary data should be added to the ledger.

Mathematical agreement with the control will appear in this form:

(a) Delinquent balances at end of current period;
(b) Prepaid balances at end of current period;
(c) Amounts due in future periods, listed by periods;
(d) Total in agreement with control.

Besides accomplishing mathematical agreement with the control, it will be seen that this statement has other uses, as in the preparation of statements on future cash position and as a basis for determining the true percentage of collections, especially where notes are purchased without recourse.

Infallibility in revealing delinquents. Delinquents do not appear, so far as the ledger under consideration is concerned, where the dealer is the collector, or where the burden of collecting delinquent notes is shifted to him. In those cases the credit factor is transferred to the dealers' ledger.

It was noted in respect to the trial balance that no interim balances are computed or entered in the individual accounts, and that in any case the interim balance is not the actual balance if there are delinquent payments. In the normal account, as it appears on the ledger, the only entries within the period are the original charge and the corresponding collection (or charge to dealer); and the only balances to carry forward at the close of the period are those in which the amount due has not been paid (or, in exceptional cases, those in which maturities have been anticipated, creating credit balances). When the old period is closed and, in effect, ruled off, these balances are carried forward to the debit column of the new period (credit balances in red), and they constitute, automatically, a schedule of delinquents. To make the list more distinctive, so that he who runs fastest can not fail to read, it is suggested that violet ink, which is darker than writing fluid, be used for this operation, especially as all balances will be carried forward at the same time.

A schedule of these balances, together with their age, may be readily transcribed. This schedule will serve several purposes: it will support the balance-sheet, serve the collection department, inform the management, and act as one of the checks against possible manipulation (substitution of fraudulent notes for cash). This statement is therefore a necessary step in the system and forms a part of the periodical report which will be discussed later.

Facility in obtaining data relating to future cash position. One of the disadvantages in organizing a description under a rigid group of headings is the redundancy which results when the comment on one topic necessarily involves others for its completion. Thus I have already described the manner of obtaining a statement of maturities by periods as an incidental result of the manner in which the agreement between the subsidiary instalment-note ledger and the control is maintained. Having these figures it is only necessary to combine several of the totals covering a period within which the current liabilities of the company are maturing (especially the temporary loans) in order to get a close estimate of the cash income and expenditure for the period, with the resulting probable cash surplus or shortage.

Instalment-note Register

The chronological record of note transactions is sometimes entered in a cashbook or split up into several books, in ways that are difficult to audit and difficult for anyone, including the management, to understand without reference to files and supplementary data. Entries of notes purchased should be kept in a special journal or register, but they should be divorced from the cash record and any other extraneous matters which may actually occur in the same transaction. In order to keep the book in balance a temporary clearing or suspense account will be employed, and this account will be offset by contra entries balancing the supplementary cashbook or journal entries.

The note register will consist of a number of information columns, followed by six or eight money columns, depending upon the details of the business conducted by the company. The information columns should be complete, beginning with serial number, name of maker, dealer, nature of collateral, etc., but omitting the amounts and dates of instalments, as the latter will appear in the instalment-note ledger.

The principal money columns will include:

1. Dr. Instalment notes receivable,
2. Cr. Dealer's equity,
3. Cr. Unearned finance charges,
4. Cr. Insurance payable on collateral,
5. Cr. Dealer's surcharge,
6. Cr. Due in settlement.

Dr. *Instalment notes receivable.* This item is the full face value of the note and is the amount that will be distributed in the subsidiary ledger by maturities.

It is advisable to split this heading into several departmental accounts according to types of contracts with dealers, and especially as to recourse. The subsidiary ledger need not follow this division if there would be any difficulty in immediately identifying collections for posting. The several columns will, of course, be representative of separate general-ledger accounts, but the trial balance of the subsidiary ledger, if it does not follow the same division, will be in agreement with the composite balance of the group in the general ledger.

Cr. *Dealer's equity.* It sometimes happens that the finance company will not advance the full face value of the note taken by the dealer from the consumer. Thus the company's investment is less than the face value of the note. In this case, either the collections will first be applied to the reimbursement of the company's advance or investment in the note before the dealer may receive his equity, or the latter will be paid (or allowed) to him in proportion as maturities fall due. The resulting credit therefore represents an amount due the dealer at a rather remote time, when collected by the company. It is not, in fact, a current liability of the company, though often classified as such. The company's position is that of agent rather than debtor. The proper place of the item on the balance-sheet is as a deduction from the asset. Published statements of large companies furnish examples of both methods. I prefer to apply it as a deduction from the asset, thus showing clearly the company's actual investment in the notes, and avoiding a credit which is neither a current liability nor a reserve. The item is frequently described as a reserve, which is misleading to the uninitiated. Perhaps an excuse for the use of the term may be found in the fact that the account frequently becomes a buffer against the dealer's failure to make good on default in which notes, or losses on them, have been charged back to him.

While I have not set out to comment on the dealer's ledger, it may be appropriate to state that it should be arranged to maintain the identity of the various transactions in which he has an interest, if the contract provides that the company's investment shall be reimbursed before that of the dealer. Original charges currently receivable should never be merged with unmatured credits. In the periodical reports, the unliquidated charges should be shown separately from the credit balances.

The manner of paying the dealer's equity may be indicated on the individual account in the subsidiary note ledger, in order to guide the bookkeeper in the matter of remittances.

The note register should also be used as a tickler for collateral transactions, such as the payment of commissions, insurance, etc., thus avoiding omissions and duplications.

Cr. *Unearned finance charges.* This item and the following two items—insurance payable and dealer's surcharge—are sometimes spoken of, in combination, as the finance charges. So far as the consumer is concerned they may be so regarded; but in the note register they must be entered in separate columns. Unearned finance charges comprise the company's interest and service charges exclusively. It is a deferred credit account and is also frequently called a reserve. I, however, prefer the term "unearned" as the more descriptive.

Cr. *Insurance payable on collateral.* This item is the amount of insurance on the collateral charged to the consumer and handled by the company for its own protection. Though payable to the company as its interest may appear, it is in no sense the property of the company—a statement which I would have believed superfluous had I not seen the item treated as an asset and written off over the life of the policies. The amount is, in fact, a trust fund, though it may be classified as an account payable to the insurance broker. It is possible that there may be an element of profit in the item. If so, it will appear as a credit balance which will eventually find its way into surplus.

Cr. *Dealer's surcharge.* This item represents an occasional charge made by the dealer against the consumer, above the finance charges of the company. It is included for convenience in collecting. It is an account payable to the dealer, provided he has no unliquidated charges against him. This item is sometimes called a rebate, and it may resemble one, depending on the nature of the agreement with the dealer. In either case the accounting will be the same. The balance will be offset either by a cash payment through the cashbook or a credit through the journal. No balance should remain in the general ledger unless there has been a delay in settlement.

Cr. *Due in settlement.* This is the balancing figure or remainder which is due to the vendor of the note. The credit will ordinarily be offset by the issuance of a cheque for the same amount, which will be entered in the cashbook and charged to the same account. Occasionally other deductions, not related to a particular transaction, may be made from the settlement, but these items will appear in cashbook or journal and will not involve the note register. No balance should result in the general ledger for this account, unless there has been a delay in settlement.

Cash Records

Petty cash, or funds in the hands of agents or branches, should be handled by the imprest system, which is not peculiar to finance companies, and need not be discussed here. The records which depart in certain respects from the standards of other kinds of business are the cashbook and cashier's daily settlement.

Cashbook. Finance companies usually have a number of bank accounts. A large volume of cash is handled. Many collections are made by the banks; and there are frequent transfers of funds between banks. Because of these things it is important that the records be arranged to show every transaction clearly for auditing purposes. The large number of banks need not involve an unwieldy cashbook nor even separate accounts in the general ledger. It is, however, advisable to maintain a distinction between cash on hand and cash in bank, in order that deposits, withdrawals and transfers may be clearly recorded. With this requirement it becomes undesirable to maintain the old separation between cash receipts and disbursements—a traditional form which originated when the record was regarded as a detached section of the general ledger rather than as a journal. Instead, we need a columnar book, the first four money columns of which will be:

1. Dr. Cash on hand;
2. Cr. Cash on hand;
3. Dr. Cash in bank;
4. Cr. Cash in bank.

Deposits will be entered in columns 2 and 3; withdrawals in columns 1 and 4. Exchanges of cheques for cash are, of course, equivalent to withdrawals. Transfers of funds between banks should logically be treated as two transactions, a withdrawal followed by a deposit. But as no ledger balances are disturbed by a transfer, the record may be made in a memorandum column, thus satisfying the requirement of a complete chronological record. Bank and cheque numbers will, of course, appear for auditing purposes in information columns.

The remaining columns will depend on local conditions—whether a voucher system is in use, etc.—and do not involve any problems peculiar to finance companies. (If a voucher system is in use, it will be understood that where I use the general term "through the cashbook," the distribution may take place through the voucher register.)

If the volume of work is large, certain subsidiary cash records will be found advisable, such as a special sheet for collections and a record for dividend payments. A daily sheet for collections has the advantages that usually go with concentration and classification and may prove a convenience for posting to the subsidiary instalment-note ledger. The daily totals of the collection sheet should be transferred to the cashbook in order to simplify posting to the general ledger and preparation of financial reports.

Cashier's daily settlement. All cashiers are obliged to verify their cash on hand and in bank frequently, and it is adding nothing to the office routine to make this a formal part of the system. On the contrary, the form serves a double purpose in accounting for the balances in the several banks, thus relieving the cashbook and general ledger.

Conforming to the distinction between cash on hand and cash in bank, the form for the cashier's daily settlement will consist of two parts which "tie in" to each other through the items of deposits and withdrawals. Petty cash and other funds are, of course, excluded from the settlement. The sheets should be filed in a post binder and preserved. The essential parts of the form are:

- I. Cash on hand:
  - A. Opening balance [from previous settlement].
    - 1. For deposit.
    - 2. Other cash items.
  - B. Add cash receipts:
    - 3. Collections.
    - 4. Other.
  - C. Deduct:
    - 5. Deposits [Cf. II-B-10].
    - 6. Fund reimbursements.
    - 7. Cash expenditures.
  - D. Remainder: Closing balance.
    - 8. For deposit.
    - 9. Other cash items.
- II. Cash in bank: [Columns for total, and for each bank account].
  - A. Opening balances [from previous settlement].
  - B. Add:
    - 10. Deposits [Cf. I-C-5].
    - 11. Bank credits.
  - C. Deduct:
    - 12. Cheques.
    - 13. Bank charges.
  - D. Remainder: Closing balances.

Debits and credits originating in the banks are numerous and include collections, collection charges, interest, loans, discounts, returned cheques, protest fees, etc., which will be entered in the cashbook in columns 3 and 4.

The reconciliation of the bank statement should be given a formal place in the office routine and should not be relegated to the back of the cheque stub or bank statement. Cancelled cheques should be filed with the bank statements and not mingled with cheques returned with previous statements, as this hinders the audit. Outstanding cheques should be listed by number, and those remaining unpaid for more than one period should be listed by date and name as well. This is necessary as a check against manipulation. The list will form a part of the routine financial statement.

Distribution of Unearned Finance Charges

As described briefly in discussion of the note register, the unearned-finance-charges account is a deferred credit to income. (The word "charges" in the title must not obscure the fact that we are dealing with a credit balance.) The account comprises the company's own service charges and interest exclusively. If the original distribution of the finance charge against the consumer has been made in accordance with the design of the note register, all other factors, such as insurance and dealer's surcharge, have been eliminated.

It is generally agreed that the factor of interest should be spread over the life of the notes. There is no such certainty about the service charge. Here is one of the instances where the practice of accountancy necessarily departs from the exactitude of science and enters the wider latitudes of art or artifice. Thus it may be contended that the service charge has been fully earned when the note was purchased; or it may be urged with equal force that the profit is not realized until the transaction is completed. In such circumstances practical considerations must control, and I therefore choose to identify the service charge with the interest as one item, distributing it over the life of the note. This simplifies the accounting, defers taxes, and is on the conservative side as to the realization of profits and their availability for dividends.

The above ambiguity of incidence of profit in relation to periods of time must be remembered by the reader should he be inclined to split hairs over the method I am about to describe for controlling the closing of the deferred credit to income. The superiority of actuarial methods is in this case completely nullified by the overshadowing potential variation in the valuation of the earned element in the service charge, and the resulting variation in the amount to be distributed. Inasmuch as we are choosing the most conservative position, any complaint on the score of the crudity of arithmetic as compared with calculus becomes inconsequential. We are justified therefore in using a formula which remains in the lower regions of mathematics, and can be used in the average business office to provide the management with trustworthy periodical statements of profit and loss without delaying until the end of the year.

The most usual method of estimating the periodic profit is by the application of a flat percentage of the balance in the unearned-finance-charges account. This is objectionable on the ground that the basis does not fluctuate in proportion to the maturities. With a falling off in the volume of note purchases or a reduction of rates the resulting amount tends to become excessive, and vice versa. Eventually the balance of the deferred credit will become disproportionate to the outstanding notes.

The following procedure avoids this accumulation of error, and eliminates personal opinion and possible manipulation of profits. A columnar book is required, which may be called distribution of unearned finance charges. The first three columns will be a condensed transcript of the ledger account, debit, credit and balance. The remaining columns will be distribution columns representing periods of time. These columns will be controlled by the first three, or ledger transcript columns, which in turn are, of course, controlled by the general ledger. Only one line of the book will be used in each period.

From the data furnished by the note register we first obtain an average maturity period for all the notes (or the notes in a given department). This will usually be consistent from one period to another, and does not have to be repeated periodically unless there has been an extraordinary change in the terms of the notes purchased. Accuracy in this first step is not such a serious matter as might be supposed.

The net increase in the credit balance of the unearned-finance-charges account for the period, as shown by the general ledger, will be transcribed (as one amount) to the credit column in the distribution book. This amount will then be equally distributed (horizontally) among as many successive columns as there are periods in the determined average maturity period, beginning with the column for the current period. (Thus, for each successive period the amounts in the distribution columns will begin one column to the right, and the page will assume the appearance of a flight of steps.)

The next thing is to add the distribution column for the current period. The footing represents the desired amount which is to be transferred from the deferred-credit account to income for that period—Dr. Unearned finance charges; Cr. Earned finance charges. This entry will be made in the journal, and, in order to keep the distribution book in agreement with the general ledger, let us also enter it in the debit ledger column. If mathematical agreement is preserved between the distribution columns and the ledger columns, and the latter are in agreement with the general ledger, the operation of the system can not go astray. Any slight deviation from period to period will be automatically corrected, and will not accumulate as it will with the flat percentage method.

This procedure completes the operation so far as the bookkeepers are concerned. There are some other aspects of the formula, however, which may be of interest from the academic standpoint. I have, in the above instructions, consistently used the term "net credit" to unearned-finance-charges account for the period, because there may be adjusting debits and credits during the period resulting from "re-writes," repossessions, etc. It will be found that these adjustments are relatively small, and in view of the wide latitude allowed in the premises in respect to the matter of service charges, and the conservative position taken, a separate treatment of these items as affecting the distribution of unearned finance charges is both impractical and immaterial, unless the adjustments are of catastrophic dimensions. Re-writes usually involve an additional finance charge which might be applicable to periods later than the average; and by ignoring them, the periodical transfer to income is theoretically a few cents too much. Repossessions sometimes involve a charge (reversal) against deferred credit (reducing loss on sale); and by ignoring them the transfer to income is again a few cents too much (because the application of the reversal or cancellation of the original credit, if applied to the distribution, would appear as a row of red figures against the distribution for the period in which the original credit occurred, thus reducing the monthly transfer at a faster rate than is effected when the charge is applied against the current period's credits). The effect of ignoring these adjustments is thus not only unappreciable, but is automatically corrected as the maturities for the current period's note purchases fall due—no errors being accumulated.

The statement has been made that accuracy in the determination of the average maturity period was of secondary importance. The fact is, though it may not be apparent on the surface, that in a going business the length of average maturity used is practically immaterial. If the volume of business were constant, it would literally make no difference what average was assumed. For example, if the finance charges were $1,200 a month, and the average maturity 10 months (the volume of business being constant), the distribution of the monthly credit would be $120 a month; the vertical footing, representing the amount taken up as income, would include 10 amounts of $120 each, or $1,200. But if an error were made in the average maturity period, and the monthly credit to unearned finance charges were distributed over 20 months instead of 10, the amount for each maturity period would be $60 instead of $120. On the other hand, the number of items in the vertical columns would be 20 instead of 10, and the footing would amount to 20 times $60, or $1,200—thus giving the same result as if the average maturity period were correct. Any error of this sort is material only in so far as the volume of business fluctuates; and considering again our fundamentally conservative position in deferring the entire service charge as well as interest, the variation may be dismissed as immaterial.

I have described this procedure as if from the beginning of a business. To start this method in the case of a going business, the method is this: If, for example, the average maturity is 15 periods, we go back to the net credit of the period 14 periods previous, and apply 1/15th of that amount to the current maturity period; the net credit of the period 13 periods previous will be applied 1/15th to the current maturity period and 1/15th to the next future maturity period, and so on. If it is merely desired to set up the deferred credit at a given balance-sheet date, it is unnecessary to distribute these fifteenths—we merely add them up and obtain the desired balance of unearned finance charges as of the balance-sheet date, and make the adjusting entry accordingly.

Financial Statements and Ratios

Financial Statements. The arrangement of the records heretofore described permits the preparation of periodical reports with little work beyond the transcribing of column footings and ledger balances. Statements are, of course, prepared for various purposes. The forms suggested here are primarily for internal management purposes. As such, they should be cumulative, comparative, and presented in considerable detail. Statements for banks or for publication may be prepared from them by reasonable condensation. Ratios may be stated at appropriate positions in the statements. For convenience let us consider them in a single group.

The feature of the periodical report of a finance company should be a cash statement, the cash position being very often the most important of the management's concerns; cash being, as it were, the inventory or stock in trade of a finance company. The periodical report will therefore consist of three major divisions:

1. Cash statement;
2. Balance-sheet;
3. Income statement;

with sundry supporting schedules.

The cash statement will comprise two exhibits:

(a) Cash statement (for current period);
(b) Future cash position.

Cash statement (for current period). These figures will be taken from the cashbook footings of columns contra to cash on hand and cash in bank. The arrangement should be such as to show the change for the period, thus:

i. Receipts [by accounts];
ii. Disbursements [by accounts];
iii. Net change for the period;
iv. Add: Opening balance;
v. Result: Closing balance.

The closing balance should be supported by a schedule showing the distribution by banks and the cash on hand. The latter should be divided between regular receipts ready for deposit and other cash items, which should be scheduled. It is also suggested that reconciliations of bank statements be included with the report, and that outstanding cheques more than one period old should be listed in detail. This will encourage the prompt entry of items originating with the banks and will act as a check against possible manipulation involving outstanding cheques. The necessity for a schedule of cash items will act as a check on the abuse of I. O. U.'s, post-dated cheques, etc.

Future cash position. The future period may include one or more accounting periods, but it should be an established period which will give its management sufficient time to make such arrangements as may be necessary to take care of the company's own obligations. The probable income will be determined from the trial balance of the subsidiary instalment-note ledger, where the maturities for the instalment notes will be stated, and from the maturing wholesale notes or trust receipts, open accounts purchased, etc. Estimated cash demands for the period, including regular expenses, notes payable, dividends, etc., will be deducted from the estimated income, thus forecasting the need of banking assistance.

Balance-sheet. It is advisable to omit the usual sub-totals for current assets and liabilities in view of the long maturity of most of the notes. The usual conditions of the current ratio do not obtain. Adequate substitutes are found in the statement of future cash position and the analysis of instalment notes by maturities.

The features of the finance company balance-sheet may be listed as follows:

(a) Instalment notes receivable;
(b) Schedule of delinquents;
(c) Reserve for losses;
(d) Dealers' equities;
(e) Repossessions.

Other items peculiar to finance companies, which require no further comment here, are wholesale notes or trust receipts, open accounts purchased and unearned finance charges.

Instalment notes receivable. The difficulty with the statement of instalment notes receivable is the several cross-classifications demanding precedence. If the note register and ledger are properly departmentalized, one demand is eliminated, as the several classes of paper can be separately listed. The principal conflict is between a classification by title or legal status and a classification by maturities. The former would show the notes on hand, pledged and discounted. The latter class is sometimes relegated to a footnote covering contingent liabilities, but this is undesirable in the case of a finance company because of the predominant position of notes in relation to other balance-sheet items. Whether the purchased notes are pledged or discounted is usually dependent on the preference of the individual bank, and the status is a matter of indifference to the company. Classification on this basis seems therefore to be a matter of relative unimportance, especially so far as the management is concerned. And the elimination of discounted notes is particularly bad, as it distorts both the general view of the volume of business on hand and the ratios that make use of the total outstanding notes as a basis.

Classification by maturities therefore seems to be the most desirable method of presenting the instalment notes. They may be shown in complete detail in a supporting schedule; but the most useful classification for the balance-sheet itself would seem to be:

i. Delinquent notes (supported by schedule)
ii. Notes maturing within a certain short future period (as used in the statement of future cash position)
iii. Notes maturing subsequently

This arrangement also offers opportunity for a computation of a current ratio on any basis of maturities desired.

Schedule of delinquents. This schedule supports the balance-sheet item, and is obtained from the subsidiary instalment-notes-receivable ledger by copying such balances as appear at the end of the period. The schedule also serves as a guide to the collection department and a check against manipulation. It is essential that the age of the delinquencies be clearly shown. If the notes are departmentalized, the significance of the several schedules will be more evident, particularly as to notes without recourse. It will be recalled that to a great extent the delinquencies are immediately charged back to the dealer.

Reserve for losses. A reserve for losses is a desirable procedure for finance companies. The item should be supported by a schedule of changes for the period, listing all charges in full detail. This is an important check on manipulation. (If a reserve is not maintained, the same kind of schedule should be prepared to support the loss item as shown in the income statement.)

This reserve should appear as a deduction from the asset.

Dealers' equities. The nature of this item was fully described under the head of note register. The discussion at that point covered the reasons for placing the item as another deduction from the asset rather than as a current liability or a reserve, neither of which it is. Another question connected with the account is the factor of delinquencies which are concealed in the balance. As previously described, certain unpaid notes and losses on sales are charged back to the dealers, but are not always collected, especially when the dealer has a substantial credit in equities. If the dealers' ledger has been properly written up, these original and unliquidated charges may be readily listed. The total of them should be shown on the balance-sheet, either as a deduction from the equities, or, if this proves awkward because the equities themselves are a deduction from the notes, it may be shown as a separate asset. Or the analysis may be shown in a schedule. It is advisable that the list of charges be shown as a part of the periodical report, or at least that the changes for the period be indicated in detail. While this schedule may not lead to any particular action on the part of the management, it serves as a check on possible manipulation of the asset as a substitute for cash. The account is a tempting burying place for improper charges, as it merges the charge against credits which are only remotely active. The routine analysis of the account is therefore desirable as a preventive, and the particular manner of presentation may be left to convenience.

Repossessions. The fact of repossession of collateral does not necessarily involve a journal entry, though the fact must be noted by appropriate symbol or reference in the individual note account. A list of notes in this category should be prepared at the end of each period, and submitted as a footnote to the item of delinquent notes. If the amount is considerable, it may be transferred to an independent title for report purposes, but no journal entry need be prepared, as it is better to carry the asset in the original account until the collateral is sold.

Income statement. This statement is made possible by the operation of the distribution of unearned finance charges. The statement presents no unusual features. Interest earned should be kept separate from interest expense. Unless there is a reserve for losses, the charge to this account should be supported by a detailed schedule. The principal classes of expense will be administrative, general, accounting, credits and collections and promotion.

Ratios. All statements are illuminated by useful ratios; but their usefulness is apt to diminish as their numbers increase. Ratios, like statements, may be used for various purposes. Those suggested below are the ones which seem to measure most sensitively the effects of management. The selection of terms should be guided by the appropriate contrast between figures which reflect the effect of management and those which circumscribe it.

The well-known current ratio is without significance as applied to a finance company, unless the maturities of the notes are known. The purpose of the ratio is better served by the analysis of future cash position.

"Percentage of collections" is a term frequently heard in credit houses, and it has a limited significance for the finance company. In applying collections to the maturities for the period, we have the logical basis for the ratio. "Outstandings" is the usual basis, in the absence of a better one, but by its use the ratio is deflected in accordance with variations in the volume of business. The ratio is of value if notes without recourse are separately recorded. The collection factor under other kinds of contracts is usually shifted to the dealer.

Dynamic ratios, or those concerned with the activities of the period, would include:

(a) Earned finance charges to combine capital, surplus and fixed liabilities.

(b) Operating expenses to earned finance charges.

(c) Losses to earned finance charges or to outstanding notes.

Static ratios, or those concerned with the balance-sheet, include:

(d) Outstanding notes and accounts purchased to combined capital, surplus and fixed liabilities.

Other ratios may be useful for special purposes. These are suggested merely as aids in making the periodical report more useful.