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# Correspondence: Finance Company Systems

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# Correspondence

## FINANCE COMPANY SYSTEMS

*Editor*, THE JOURNAL OF ACCOUNTANCY:

SIR: The article in the August JOURNAL by Mr. Musselman regarding finance company systems is one of the most interesting which has ever appeared in THE JOURNAL. It is undoubtedly the result of considerable work on his part, and I feel that he is entitled to an expression of the appreciation which the article inspires.

Although finance companies have much variety in the methods of keeping their accounts, I believe that the net result obtained by those with efficient accounting systems will be much the same as those which Mr. Musselman has outlined. The major divergence will be in the matter of distribution of unearned finance charges, and on that point I believe a very interesting discussion could be developed among accountants who are interested in this problem.

After elimination of insurance, dealers' equities and similar items, Mr. Musselman has distributed the net charge on one basis. This seems to be the common practice, although the basis of this distribution varies considerably. It is with this practice that I wish to take issue. The net charge as described by Mr. Musselman in actuality covers three items, namely, interest, operating expenses and profits. It is my contention that proper distribution of the first two items is so different that the calculation of the distribution should be computed separately. The interest expense of carrying a piece of discount paper varies directly with the uncollected balance of the investment in the paper. It is accordingly heavy in the early months and decreases regularly until it becomes quite light in the final months of the life of the contract. This is not true of the portion of the net charge which is designed to cover operating expenses. The expense of making the collection each month during the life of the contract is approximately the same whether it be one of the early instalments or one of the later ones. This portion of the charge should, therefore, be distributed pro rata over the months in which collection is to be made.

Another minor element is the allocation to the current month of a certain portion of the charge to cover the expense of purchasing the contract and placing it on the books. Provision still remains to be made for the allocation of the profits item of the service charge. If a concern with an established history sets aside provisions for interest costs and for operating expenses which are in line with the established history, it could probably justify the immediate transfer to operating profits of the excess service charge. In our case we have preferred to be somewhat more conservative, and have pro-rated the excess charge on the same basis as the provision for operating expense.

This procedure is not at all complicated, even though the above outline may seem to indicate otherwise. Some of the contracts purchased bear interest at six per cent. in addition to a minor service charge. Others are not interest-bearing, but contain a major charge. A separate register of maturities is maintained for each of these two classifications. The interest-bearing obligations will automatically take care of the interest cost of carrying them from month to month. The accumulated totals of the maturity register of non-interest-

bearing contracts will show the amount which will be outstanding in each month throughout the life of these contracts, and it is a very easy matter to calculate the interest cost of the funds necessary to carry these contracts. Minor discrepancies occasioned by prepayment of some contracts and by failure to pay others promptly at maturity will offset each other to so close a degree that no adjustments need be made.

Having calculated and deducted from the net service charge the provision for interest cost of carrying the contracts, and having spread it by months, we next allocate to the current month provision for cost of purchasing and setting up the contracts at the rate of $1.00 per contract. This is an arbitrary figure, but is our best estimate of the cost of the work involved.

After deducting from net service charge the provision for interest cost and the estimated cost of acquiring, the remainder of the net service charge is divided by the total number of items to be collected as set out by the maturity register. This gives the amount per item to be collected of the net service charge which is available for operating expenses and net profits. Since the collection of each item involves approximately the same amount of work whether it be a large or a small payment, and since the interest differential between large and small payments has been cleared above, we regard this as a fair distribution.

This provision per item is then multiplied by the number of items maturing in each month throughout the life of the contracts purchased during that month, and provision for operating expenses and distribution of residue profits is allocated to definite months in the future in that manner. The amount allocated to each future month is then joined with the amount provided for interest cost in each future month, and we have a spread of net service charges by months over the life of the contracts, which is merged into a columnar set-up as described by Mr. Musselman in his article.

The distribution on the basis of average maturities as outlined by Mr. Musselman is in line with our procedure in the matter of interest cost, but his method distributes the entire net service charge on a graduated basis, with the largest amounts in the first months and a gradually decreasing figure, whereas there is no decrease in operating expense per month until the last instalment of the contract has been collected.

We have operated on the above method for the past five years. Prior to that time I was connected with another finance organization, which used the method outlined by Mr. Musselman. Under that method the monthly profits fluctuated rather sharply with the volume of paper purchased, and the credit balance in the unearned service charges also fluctuated with regard to the dollar value of paper outstanding rather than with regard to the amount of work remaining to be done in the collection of the remaining instalments on that paper.

Our method has proved superior in both respects. Our deferred-income account fluctuates more on the basis of percentage against volume outstanding, but is more stable on the basis of per-item-provision for costs against number of items still remaining to be collected.

From the viewpoint of the monthly operating statement, we also present a more stable picture. The operating expense from month to month is comparatively uniform. Under this provision the transfer from deferred income to actual income is more uniform, with the result that the net profit differential

remains more constant and permits more intelligent comparisons of month-to-month operations.

I do not know whether you can make any use of this or not, but if it is in order to forward it to Mr. Musselman for his comments, I would be interested in receiving them.

Yours truly,

Detroit, Michigan. G. V. EGAN.

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*Editor*, THE JOURNAL OF ACCOUNTANCY:

SIR: I have read Mr. Egan's letter with great interest, and I should say that he has offered us a post-graduate course, while my offering was for the kindergarten. If I were engaged exclusively to handle the accounts of one company, or if I should obtain one of those rare engagements where time and money are no object, I would probably wish to elaborate my system in much the same direction as Mr. Egan has carried his. But I was more concerned in devising something that would be reasonably accurate, could be operated by a bookkeeper of average ability in a small company, and particularly something that could be kept under control with only intermittent supervision. Only an itinerant accountant can experience the thrill of gazing upon the work of a bookkeeper whose fancy is free to wander where it will, untrammeled by consideration of the higher accountancy.

By way of illustration, there was a case where, as a result of certain man-handling, the reserve acquired a debit balance, whereupon the system was plunged into reverse, and monthly charges to profit were the result.

Of course, outside of another finance company, there is no place where a bookkeeper would be likely to gain any of the special information needed for his work, and usually the executives are even less competent and, often, less interested. Therefore, as I say, an elementary course of instruction is needed if the accountant's work is to have lasting results.

Mr. Egan analyzes the finance charge into its various elements. These he properly applies on three appropriate bases. Admitting the superiority of this method, the question is whether the defects of the flat distribution outweigh the advantages for the small company under absentee accounting control. Mr. Egan thinks the latter method "distributes the entire net service charge on a graduated basis . . . gradually decreasing," but I think that here he has misapprehended the effect of the distribution. My distribution is flat for each period. It includes both interest and profits, representing reimbursement from purchasing and preliminary expense, as well as collecting and operating expense. As interest is the largest item, and as the others should, technically, be either taken up as profit immediately or distributed in equal amounts over the life of the "deal," the fault is on the conservative side, as the taking up of that part of the profit representing factors other than interest is deferred too long. However, it is arithmetically interesting to know that the profits actually taken up in each period will be substantially the same for a steady volume of business, whether distributed on a flat or graduated basis. The following diagrams illustrate the point. The horizontal columns represent the distribution of periodic deferred income, and the vertical columns represent the current and future maturity periods. The deferred income is fifteen units per period and is distributed over five periods by each plan,

graduated and flat, and the resulting profit to be taken up for the current period is the same in both cases. This, I think, shows that what difference there is in the resulting periodic profit of the two plans is only in proportion to the variation in volume of business.

| *Graduated* | | *Flat* |
|---|---|---|
| 1 | | 3 |
| 2–1 | | 3–3 |
| 3–2–1 | | 3–3–3 |
| 4–3–2–1 | | 3–3–3–3 |
| 5–4–3–2–1 | | 3–3–3–3–3 |
| 15 | Profit for current period, equal | 15 |

Mr. Egan also believes that the flat distribution fluctuates "rather sharply with the volume of paper purchased." Here again I think he is mistaken, and that the variations in periodical profits are stabilized rather than accentuated. Suppose the purchases in the fifth period increased 100%,—

| *Graduated* | | *Flat* |
|---|---|---|
| 1 | | 3 |
| 2–1 | | 3–3 |
| 3–2–1 | | 3–3–3 |
| 4–3–2–1 | | 3–3–3–3 |
| 10–8–6–4–2 | | 6–6–6–6–6 |
| 20 | Profit for period | 18 |

The fluctuation is thus less under the flat distribution.

Therefore, I feel that if I can not get the complete analysis that Mr. Egan enjoys, I have at least a reasonable and self-correcting approach to technical accuracy, the deviations from which lie on the conservative side. And by obliging the bookkeeper to keep his "distribution book" balance in agreement with the ledger account, I feel that I have the works under control, even though I can not maintain daily supervision over them.

So much for the defense. As to Mr. Egan's own system, I have already said that it is undoubtedly based on correct theories, even to the extent of estimating the costs of purchasing. I think the idea of charging a provision for interest on the basis of outstanding paper is unusual. I assume that this leads to an over or under absorbed balance representing the difference between standard and actual charges. I have always accrued the interest expense on the basis of notes payable or re-discounted and shown the two items of interest-and-finance-charges-earned and interest-expense-(accrued) separately on the statement, after which the ratio of interest expense may be applied ad lib.

As for notes bearing interest, I favor adding the interest to the face of the note upon entering it, which immediately permits grouping them with "non-interest"-bearing notes—the added interest being credited to reserve, the same as the finance charge. This eliminates a separate column or ledger account, and the remitting difference in periodic profit is immaterial.

Yours truly,

D. Paul Musselman.

Philadelphia, Pennsylvania.