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J. P. Grantham

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During the past few years there has been a marked increase in the tendency of jobbing concerns to finance their customers to a considerable degree either through cash advances or the extension of credit for a sufficient amount of merchandise to constitute the normal stock of goods required by the volume of the retailer's business. The reasons for the growth of this custom and the debatable question of economic justification do not fall within the scope of this article, which is concerned merely with the necessity of segregating in the balance-sheet those receivables which, in the ordinary course of business, may be liquidated so as to meet current liabilities and those which are in the nature of more or less permanent advances, as that distinction is of the utmost importance in the financial position of a jobbing concern.

It frequently happens that the extension of an abnormal amount of credit (and sometimes, but less frequently, advances of cash) takes the form of an open account receivable which is later converted into notes, in whole or in part. Such notes are, as a general rule, secured by chattel mortgages on the stock and fixtures and perhaps, too, the personal property of the debtor, assignments of insurance policies, leases, stocks and bonds and the like. If the debtor be a closely owned corporation, it is not uncommon for its capital stock, duly endorsed in blank, to be held as collateral to the notes. In such instances the jobber becomes, to all intents and purposes, the temporary owner of the retailer's business, although not a holder of record.

Notes receivable and the securities held as collateral against them, together with any other securities owned, should be examined at the same time and kept under the control of the auditor until all securities have been checked. The existence of notes out for collection or in process of foreclosure should be confirmed by correspondence with the holders, and the proceeds of those collected since the date of the audit should be traced into the cash records.

Unless the auditor has been instructed to make a surprise examination of the notes and securities the verification will be expedited by having the client's staff prepare lists of the notes on schedules, outlined in advance by the auditor, which call for the following information: name of maker, date of original transaction which gave rise to the note, date of note, maturity, original amount, balance at audit date, interest rate, date to which interest has been paid, amount of accrued or prepaid interest, description of collateral, comments concerning collectibility and estimated reserve required.

From these schedules a summary can be prepared which will show the amount of the secured and unsecured notes of the various classes, such as time loans, demand loans and serial or instalment notes, and the age of each class. It is of the utmost importance that the classification of notes receivable by age be based on the dates of the original transactions which gave rise to the notes rather than on the dates of the notes themselves. Failure to follow this procedure frequently results in an altogether erroneous impression of the receivables, as a substantial portion of the debts may have remained in the form of open accounts for a considerable period prior to the conversion into notes. Moreover, some of the original notes may have been renewed from time to time in whole or in part.

It may be well to point out that the maturity of secured notes, except those due serially, is frequently fixed by jobbers at a date in advance of the time payment or reduction is expected and renewal notes are not accepted, unless the statute of limitations threatens to operate against the original note. This places the jobber in position to institute foreclosure proceedings at any time; moreover, under the laws of some states the holder of an original note is in better position in the event of litigation than the holder of a renewal note.

Notes which have arisen through the practice of financing customers, whether by cash advances or extension of abnormal credit, should generally be regarded as non-current assets and shown separately under some appropriate caption on the balance-sheet. However, there can be no strong objection to including among current assets that portion of such notes which is reasonably certain of collection during the ensuing year. The amount to be so treated must be predicated to a large extent on estimates made by the management, but the aggregate amount of those estimates can be confirmed in a broad way by a comparison with the actual collections on such notes during the year under review, as revealed by an analysis of the notes-receivable controlling account, tempered, of course, by the consideration of current credit conditions in the particular territory.

Whenever practicable the company's staff should prepare for the auditor's use trial balances of the customers' ledgers showing, in columnar form, the age of those accounts which are past due, classified somewhat as follows: 30 to 60 days past due; 60 to 90 days past due; 90 to 180 days past due; over 180 days past due. However, it is not uncommon to find the open balances so numerous as to render it impracticable to attempt to list and age each of the accounts. In such instances, it will usually suffice to confine the trial balances of each ledger to adding machine tapes and to determine the age of the total outstanding accounts in the following manner:

List and age all the larger accounts; i.e., those having balances in excess of a specified amount. While these are apt to be relatively few in number, they will probably aggregate a substantial portion of the total amount outstanding.

List and age a representative number of accounts, selected entirely at random, having fairly large balances, the same number having medium sized balances and the same number having small balances.

The remainder of the amount outstanding can then be aged by the application of the percentages revealed by the analysis of the accounts selected entirely at random.

This method will usually be found to yield substantially accurate results, provided, of course, that all open balances which have arisen through the practice of financing customers have first been eliminated from the aggregate amount outstanding.

In some instances it is desirable, if not essential, for the auditor to verify in detail the trial balances of all customers' ledgers as well as the age of the accounts, but this work may often be confined, with perfect propriety, to a representative number of the ledgers. The auditor must use judgment in determining which of the two methods to follow and his decision should depend in part upon the nature of the business and other considerations, but primarily upon the efficacy of the company's system of internal check.

In either event, he must be fully informed as to the company's credit terms and must watch particularly for accounts representing advances of a more or less permanent nature, consignment accounts, special terms (such as future dating and "pay-on-reorder") and for any notations which may appear on the ledger sheets indicating that the customer has been placed on a C. O. D. basis or that the account has been turned over to attorneys for collection. The composition of the balances should also be observed, as it sometimes happens that, while a customer may be making regular payments on his current account, items which are in dispute have been carried forward.

The authenticity of charges and credits to customers' accounts should be tested by reference to copies of invoices and shipping records, the cash receipts book or remittance advices and, more particularly, evidence of approval, by a responsible officer, of credits representing allowances for one reason or another.

Consignment accounts clearly have no place in accounts receivable as the merchandise represented remains the property of the consignor and is held at its risk until sold and should, therefore, be reflected in its inventory at cost and not in its receivables at selling price. It may be added that true consignment accounts are relatively rare and that merchandise sold on a "pay-on-reorder" basis (which is merely an extension of normal credit terms with, as a rule, the right to return) is frequently mistaken for consigned merchandise.

If a sufficient length of time has elapsed since the date of the balance-sheet to allow a substantial amount of collections to be made, the amounts collected should be indicated on the schedules. The auditor will then know approximately the amount of uncollected accounts still remaining on the books and, when discussing the past due accounts with the credit manager, can eliminate those which have been collected.

The determination of adequate reserves for doubtful receivables, discounts, returns and allowances is of utmost importance in the audit of a wholesale jobbing concern. These reserves, while usually shown in the balance-sheet in one amount, are generally carried on the books in different accounts and the verification of them must proceed along different lines.

Each note or series of notes should be discussed individually in order to determine the reserve required for probable losses. In the case of secured notes, consideration must be given to the value of the collateral underlying the notes, if that can be ascertained with any degree of accuracy, bearing in mind the cost of realizing that collateral. If the collateral consists of a mortgage on the stock of merchandise sold the customer, it must be remembered that the basis of valuation of that merchandise should be cost to the jobber, not selling price, less an allowance to provide for slow-moving, obsolete and shop-worn items. In the case of fixtures which must be repossessed, the resale value to the jobber, less the cost of repossession, must govern.

After the accounts receivable have been properly verified and aged, the auditor should decide upon a method to use in order to determine the amount of receivables upon which losses may be sustained and the approximate amount of such losses. If the number of accounts is not unduly large each past-due account may be discussed with the credit manager and the estimated loss determined. If, on the other hand, the accounts are very numerous, the auditor must adopt a method of procedure which will give him sufficient information to enable him to determine an adequate reserve without too great an expenditure of time. One such method which may be followed to advantage requires the preparation of (1) a list of the balances due by the principal trade debtors and (2) a list of the past-due balances over a specified amount. As mentioned above, it will usually be found, in the case of a jobbing concern, that the balances due by a comparatively small number of customers will comprise a substantial portion of the outstanding receivables and a detailed discussion of these balances, which comprise the first list, will bring to light any doubtful items included in it.

Considerable care must be used in determining the amount of the balances to be entered on the second list. If the limit is set too low, many accounts will be listed and considerable time spent discussing trifling balances, thus defeating the purpose of this method of procedure. If it is set too high the list will not be representative of the accounts in general. The auditor must, therefore, fix an amount which will eliminate from discussion numerous small balances but will be small enough to allow a representative portion of the balances to be listed for discussion. After the accounts included in the second list have been discussed and it is found that, say, 60% in amount of the total receivables (other than those included in the first list) have been listed, it is reasonable to assume that the specific reserve for doubtful items determined by this discussion represents 60% of the total specific reserve required against all but those accounts included in the first list. The amounts due from the principal debtors, together with the specific reserves required against those amounts, should be eliminated from any computations on percentage bases, lest the results be distorted.

In addition to the specific reserve for doubtful items there must also be a general reserve to take care of losses which, due to unforeseen circumstances, will ultimately be sustained on accounts that are apparently good at the time of discussion. The amount of this general reserve may be determined with reasonable accuracy, if current credit conditions are normal, in the light of the company's known bad-debt experience.

Determination of the average percentage of bad debts to net sales requires an analysis of bad debts charged off during, say, the past four years, classified as between the years in which the balances originated, and, also, the classification as between years of origin of the specific reserves estimated to be required for receivables remaining on the books at the date of audit. For example, if the reserve is to be determined at December 31, 1931, the losses from receivables which originated in the years 1928, 1929 and 1930, whether actually sustained and written off prior to December 31, 1931, or still carried on the books at that date and specifically protected by reserves, can be approximated with reasonable accuracy; that is to say, if the business placed on the books prior to December 31, 1930, has not been paid for or definitely ascertained to be uncollectible and written off as such by December 31, 1931, it ought not to be difficult to estimate fairly accurately the loss which will ultimately be sustained on that business. However, the aggregate losses which will ultimately be sustained on the business placed on the books in the year 1931 would, at December 31st of that year, still be largely a matter of conjecture, and for that reason the figures relating to the business originating in 1931 are eliminated from the following table, which is used to compute the average bad-debt experience for the three years preceding the one under review:

	Year 1928	Year 1929	Year 1930	Total for the three years
1. Net sales	$	$	$	
2. Bad debts charged off from January 1, 1928, to December 31, 1931, which resulted from transactions originating in the respective years	$	$	$	
3. Portion of reserve for doubtful receivables remaining on the books at December 31, 1931,				

which is attributable to transactions originating in the respective years.	_____	_____	_____	_____
4. Together (2 plus 3).	$_____	$_____	$_____	_____
5. Percentage of net sales (4 divided by 1).	%	%	%	%

Having obtained the foregoing information, the aggregate reserve required for bad debts can be expressed in the following table:

(1) Total specific reserves required for doubtful receivables remaining on the books at December 31, 1931, as determined by discussion of the open balances. . .		$
(2) Add—general reserve for sales made during the year ending December 31, 1931, determined by the application to net sales of the average percentage of bad-debts losses for the preceding years as revealed by the foregoing table.		_____
Together.		
Deduct—		
(3) Amount of specific reserves for doubtful receivables that originated in the year 1931, which is included in item (1) above.	$	
(4) Amount of bad debts charged off during the year 1931, which arose from transactions originating in that year.	_____	_____
Balance, being the reserve required at December 31, 1931.		$_____

In case the reasons for deducting items (3) and (4) are not clear, it may be well to repeat that the aggregate losses which will ultimately be sustained from business placed on the books in 1931 will be difficult to determine at December 31st of that year. Consequently, both the known and estimated portion of those losses have been replaced, in determining the total reserve required at December 31, 1931, by item (2) in the table, which provides for all losses to be sustained on that year's business at the average rate of the losses for the three preceding years, which are known with much more accuracy. It is obvious, of course, that if abnormal credit conditions prevail in the current year or any of the three preceding years, the procedure outlined will have to be modified by consideration of those abnormal conditions.

In addition to the reserve for doubtful receivables, reserves should be provided for discounts, returns and allowances. These can best be determined in the light of the company's past experience with respect to each, but the computations should be based on gross sales, as the outstanding accounts against which the reserves are required are stated at gross selling prices. The provision for losses on expected returns should, of course, be limited to the gross profit taken up when the merchandise was sold if the merchandise to be returned is in salable condition.

It can not be emphasized too strongly that the current position of a jobbing concern is of primary importance and that the receivables and related reserves have a vital bearing on that position. Since the determination of the approximate realizable value of the receivables and their availability to meet current obligations is, of necessity, very largely a matter of judgment, supplemented by a knowledge of the company's past experience and of current credit conditions, it is incumbent on the auditor to bring to bear on the problem all the skill, diligence and ingenuity of which he is capable.