Correspondence: Installment Accounts Receivable; Accountants' Reports for Credit Purposes

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INSTALMENT ACCOUNTS RECEIVABLE

Editor, The Journal of Accountancy:

SIR: I have read with interest the article in the November JOURNAL on *Instalment Accounts Receivable* by Mr. Musselman but am afraid the problem is not solved quite as easily as would appear. He states it in the form of four questions but there is little, if any, difference between the first and fourth, and the third requires no additional accounting work.

The two main questions are:

(1) The analysis of accounts receivable by maturities.

(2) The sufficiency of the bad-debt reserve.

Admitting that the solution proposed is based on the simplest kind of a proposition for the sake of clarity, the question arises as to whether or not such a solution is applicable to the ordinary instalment business.

The suggestion is to maintain a columnar sales record spreading the total sales for each month over the months during which collections will be made, thus showing by the footings of the subsequent months' columns the maturity dates of the uncollected amounts.

Is this practical? My experience with instalment houses is not very extensive but I have found that the terms of payment differ for various reasons, including the down payment, the kind of article sold, the salvage value of the article and the convenience of the purchaser.

If the house were selling only one article or on only one form of contract perhaps the plan could be easily worked. Otherwise the cost of analysis would be excessive.

Mr. Musselman makes no suggestions as to the adjustment of these future maturities by repossessions and by bad debts actually written off. These would obviously have to be tabulated in a similar manner and deducted.

Now as to his bad-debt theory. He proposes first to charge bad debts and credit bad-debt reserve No. 2 with say 10% of future maturities as shown by the sales analysis. There is no objection to that if the sales analysis be adjusted first by repossessions and by bad debts actually written off. If not so adjusted the reserve will exceed 10% on the true balances and may distort the intended result.

His next proposal is to charge bad debts and credit bad-debt reserve No. 1 with the difference between the sales analysis collections to be made during the month just closed and the actual collections, in other words all delinquent items are to be treated as bad. It is true that any collections on delinquent items would reduce a subsequent charge off but at any balance-sheet date such items would be shown as of no value. Supposing, however, that some accounts are several months in arrears, are the future maturities to be considered good?

It all depends upon the actual value of the article if repossessed.

Accounts actually bad are to be charged off the books by charging bad-debt reserve No. 1 and crediting accounts receivable. Remembering that this reserve is credited only with delinquent items, should part not be charged against reserve No. 2? If not, reserve No. 1 may result in a debit balance if the entire amount charged off is not delinquent. Mr. Musselman also states that the accounts-receivable controlling account must agree with the maturity record. If the future maturities are not adjusted by repossessions and bad debts charged off and if reserves Nos. 1 and 2 are not adjusted to correspond this would not be the case.

Another point not discussed is the refinancing of the final payment, which is sometimes larger than the others, or the entire contract for that matter. In periods of depression this is quite an important item.

Many houses, instead of charging the customer with one sum, charge the account with the, say, 12 monthly payments in detail, showing the actual payment when made by stamping in the date paid only. If the accounts are not too numerous and if the monthly payments are practically equal, the maturities can be easily arrived at by listing the total balances in columns headed with the month of final maturity, delinquent amounts being deducted from the total balance and listed separately. When completed, the grand totals are distributed equally over the number of months from the balance-sheet date to the month of final maturity. This saves spreading each account over perhaps a dozen columns.

Yours truly,

EDWARD FRASER.

Kansas City, Missouri, November 15, 1927.

Editor, The Journal of Accountancy:

SIR: I am glad to reply to Mr. Fraser's letter of November 15th.

I can not agree that there are only two major questions involved. The matter of percentage of collections is of vital importance to an instalment house. It is the index to the financial health of the business and to the value of the principal assets—the accounts receivable. It is unsafe to base this ratio on sales or accounts receivable. If sales decline, for example, or even if the rate of increase of sales declines, the ratio, if based on sales, will be deflected upwards and may thus seriously mislead the management.

Another use for the maturity record, which, however, I did not go into in my article, is in eliminating unrealized gross profits for tax purposes. The methods laid down by the treasury department for instalment sales of personal property are based on analysis of individual sales and are, therefore, impracticable where sales are voluminous and of small individual amounts. A demonstrable reserve can be set up and the unmatured portion of the accounts receivable can be analyzed as to cost and anticipated profit, the latter being eliminated for tax purposes. In this way, the lowest legitimate tax can be arrived at, equaling the advantages of the instalment method, but without the prohibitive expense involved in allocating every collection to the sales of a definite period.

The matter of average collection period is less serious than it seems. A reasonable amount of study upon installing a maturity record will generally indicate a fair average. We do not expect to find absolutely the correct figure; in fact, there is no such figure. We are aiming at an average collection period, rather than an average legal contract period, and we believe it wise to allow an ample margin of time for collection. Mathematically, it will be found that there is a remarkably small difference in the figures, whether we take say 15, 18 or 20 months in a given business whose average contract period we shall say is 12 or 13 months. This fact will be more apparent if we consider a case where the sales are constant; in this case there will be no difference in the total maturities, whether the monthly sales are divided into 15/15ths, 18/18ths, or 20/20ths. In other words, the degree of error due to this cause varies with the variation in volume of sales. This is not, in actuality, so great as to cause any appreciable loss in the value of the data obtained from the maturity record for a normal going business. Furthermore, any variation from this cause is self-correcting in the long run.

However, if the accountant has time and wishes to classify his sales by terms, it can be done, and several lines may be used in the maturity record each month instead of one. If sales are departmentalized, this procedure can be followed more easily. The cost of such analysis would not be excessive, as Mr. Fraser fears, since our figures are based on the general ledger, not on the individual accounts. If the ledger is already departmentalized, the additional cost is no greater in proportion than the additional work required to maintain the additional sales accounts. We simply have to apportion two or more sales totals instead of one, each total having a different term for collection.

Down payments, if substantially more than the instalments, should be separated from the collections, as they will tend to distort the percentage of collections. This requires only one additional column in the cash-received record. If, however, the down payment is not materially different from the instalments, it is unnecessary to separate them from the collections. In many cases, in the sale of small articles, the down payment is even less than the instalments, especially where a customer already has an account and the new purchase is charged to the old account.

Repossessions, if numerous, require analysis as to months in which original sale was entered. The net loss should be spread over the remaining months over which the sales of that month have yet to run. This will appear as a red line, effecting a reduction in the remaining maturities, on the same principle as the sale of a portion of a fixed asset is spread on an exhaustion schedule of depreciation. If repossessions are so small in amount that they will not materially affect the percentages of collections, the net losses may be combined, for maturity-record purposes, with returns and allowances on sales, or if it is preferred to show sales per maturity record the same as per ledger the net loss (if proportionately very small) may be combined with the collections. In either case we have to enter a credit to accounts receivable, but it is better that this should be effected through a reduction in debits arising from sales than through an increase in credits arising through collections. Theoretically, the treatment of repossession by a reduction in maturities is correct, but practically the process described may be just as good in view of the practical results to be obtained.

I think the above also answers Mr. Fraser's next paragraph regarding the bad-debt theory.

In his next paragraph Mr. Fraser questions whether if some accounts are several months in arrears, the future maturities are to be considered good. I would say that this is taken care of in the averages. We are confronted here with a condition in which we have say 20,000 small accounts. We can not analyze them periodically in detail. Therefore, we set up an analysis based on the general ledger. No doubt many individual accounts will deviate from the average condition. But as the total of our average maturities is controlled by the general ledger, we claim that our resulting reserves and percentages are more dependable than if we tried to treat the 20,000 accounts on their individual merits, which would be impossible if our time for making an audit or preparing statements were limited.

Accounts actually written off are charged to reserve No. 1, and do not affect our percentages in the least, nor our charge for bad debts. This charge is thus stabilized and is not subject to managerial vagaries. I do not think many accounts are written off where there are unmatured balances. Actual practice tends to be quite the opposite. If however, a manager, in an excess of zeal, did charge off a majority of his accounts which had not fully matured, it is possible that he would wipe out the reserve No. 1. This would not upset the principle involved. It would indicate either an abnormally pessimistic collection department, or a colossal blunder in estimating the average collection period. I would use the No. 2 reserve exclusively as a reserve applicable to probable *future* losses. It has a special use in this relation as a comparison from month to month with the actual loss when ascertained, and is thus an additional index to the trend of collections as compared with past periods.

Question as to whether or not the maturity record will agree with the controlling account is answered in the affirmative by the preceding paragraphs relating to repossessions and bad debts.

As to the refinancing of a final payment which is larger than the others, I would say that this is a condition which I have never seen in instalment houses selling consumer's goods on any basis other than for promissory notes. Let me say again that our problem deals with the sale of goods of comparatively low price, and in large volume, not with sales of land or of expensive machinery. In the latter case, it generally pays to analyze the individual accounts, but in our case this is too expensive in proportion to the small amounts involved. That is a condition of the problem. If, however, such a house did sell on a contract calling for a large final payment, it would be necessary to set up this final payment separately from the balance of the account payable in equal instalments and apply it to the month when actually due. I think this will seldom happen in the cases to which this method can be profitably applied.

This method could be applied to any instalment plan, but where the sales are individually large, individual treatment is practical and also preferable. The maturity record could be kept for such a business, but it would not have the same necessity that it has where accounts are small but numerous. Mr. Fraser's last paragraph refers to the former type of business. Our problem, however, is with the business with numerous accounts.

I do not quite understand Mr. Fraser's last sentence. I have never proposed spreading the accounts individually over a number of columns, nor the individual sales. The whole point of the method is to deal with *one* final figure each month after the books are balanced (or with several if the sales are departmentalized). We do not touch the books during the month. We prefer the greatest simplicity where the work is most voluminous and we prepare our data from the final figures of the trial balance only. We believe that our results are more dependable than where based on opinion as to the worth of individual accounts, and that we can get valuable data not otherwise obtainable.

Yours truly,

D. PAUL MUSSELMAN.

Philadelphia, December 13, 1927.

ACCOUNTANTS' REPORTS FOR CREDIT PURPOSES

Editor, The Journal of Accountancy:

SIR: There appeared in the *Bulletin* of the American Institute of Accountants dated November 15th, on pages 4, 5 and 6, an article which is a description of form and content of accountants' reports for credit purposes as prepared by the Florida Institute of Accountants.

I have given this a preliminary reading and consider it good so far as it goes. I believe, however, that accountants' certificates should more clearly state the value of qualifications. The suggested form under item 2 of article III reads as follows:

> "We have prepared the accompanying balance-sheet of the —— Company after verifying the items shown therein in the manner, and to the extent, described in the accompanying report, of which this balance-sheet is a part, and, subject to the explanations therein, in our opinion, it sets forth fairly and fully the condition of the said company on the said date."

That certificate might cover all three phases of a balance-sheet certificate—without qualifications, with minor qualifications or with important qualifications.

A balance-sheet with important qualifications, but certified to in the way indicated, might be accepted at its full value unless the bankers gave due heed to the words in the certificate, "subject to the explanations therein." Furthermore, a balance-sheet which is strongly qualified in the terms of the report may require a revision of the figures in many particulars in order to ascertain the real condition as intended to be conveyed by the accountant.

I take the liberty of offering a suggestion of three certificates using substantially the form suggested by the Florida Institute, but with variations to indicate whether the balance-sheet should be accepted as stated or to what degree it requires modification.

> No. 1. We have prepared the accompanying balance-sheet of the —— Company after verifying the items shown therein in the manner and to the extent described in the accompanying report, of which this balance-sheet is a part, and, in our opinion, it sets forth fairly and fully the condition of the said company on the said date.
>
> No. 2. We have prepared the accompanying balance-sheet of the —— Company after verifying or examining the items shown therein in the manner and to the extent described in the accompanying report, of which this balance-sheet is a part. Subject to the explanations therein, which qualify the balance-sheet in minor matters only, in our opinion, it sets forth fairly and fully the condition of the said company on the said date.
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> No. 3. We have prepared the accompanying balance-sheet of the —— Company after verifying or examining the items shown therein in the manner and to the extent described in the accompanying report, of which this balance-sheet is a part. It is submitted subject to the explanations therein, which, in our opinion, qualify the balance-sheet in important particulars.

In the third style of certificate which indicates clearly that the balance-sheet is qualified, there might be included a reference to the qualifications if they are few in number, as, for example, omission to reserve for federal taxes, or insufficient provision for depreciation.

There are many balance-sheets submitted by accountants where the comments qualifying the items are vague: for example, a reference to accounts receivable may contain a statement as to the age of certain accounts and reference to the fact that no reserve for bad debts is carried, and conclude with the statement that in the opinion of the accountant a reserve is necessary, but fail to mention what amount, in his opinion, should be provided. I believe that so far as possible, where an item is qualified in the text of a report, the dollar value of the qualification should as nearly as possible be indicated. Then the banker or other persons interested may enumerate the value of the qualifications and apply them to the balance-sheet and so arrive at the balance-sheet as it would be prepared by the accountant if he had a free hand to revise the accounts.

As is well known, an accountant is very often restricted to submitting the balance-sheet as shown by the books, and may then make his own comments. This brings me back to the form of certificate, wherein I believe should be inserted something to indicate that the balance-sheet either is, or is not, in accord with the books.

Please do not think that I wish to be overly critical, as the memorandum submitted by the Florida Institute is exceptional, considering its brevity. I have, however, felt for some time that accountants' balance-sheets are accepted at their face value far more often than is justified by the accountants' own comments attached thereto. I doubt very much whether proper importance is attached by the banker or creditor to qualifications indicated by the words "subject to the explanations" or "subject to the terms of," and I believe it is necessary to state whether the comments constitute qualifications or not, and if they do, whether they are of minor or major importance.

Yours truly,

A. S. Fedde.

New York, November 23, 1927.