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Treatment of Commitments of Purchasers, Etc., on Certified Balance-Sheets

By Homer N. Sweet

The impossible task has been assigned to me of presenting in twenty minutes a comprehensive exposition of a topic which contains the letters, "etc." In the circumstances, I shall have to seek refuge behind a narrow definition of commitments, which will excuse me from speaking on contingent liabilities that arise from guaranties of quality of product, guaranties of dividend and interest obligations of allied companies, endorsements of notes and acceptances, provisions for cumulative dividends on preferred stocks and possible liability to additional assessments for federal taxes. I would restrict my discussion to commitments that involve more than ordinary risk of loss because of the possibility of an adverse movement of prices. Among commitments of this class are purchase contracts, sale contracts, agreements to protect the buyer against a decline in market price and various transactions that are hedged by futures or options. As my time is limited I shall confine myself principally to a consideration of purchase contracts.

Before proceeding, however, to analyze the relation of purchase contracts to the balance-sheet we may do well to ask ourselves two questions:

First: Why should commitments be expressed on the balance-sheet? Perhaps we should not take too much for granted as to the answer which ought to be given to this question. The balance-sheet, as a condensed exhibit of financial position, should set forth all relevant facts. On the other hand, it should not be encumbered with irrelevant data. What is relevant or irrelevant is, of course, a question of judgment. If it is probable that a given corporation will have to expend in the near future a larger sum of money for purchases of materials than the mater-

* An address delivered before the New England regional meeting of the American Institute of Accountants, Boston, Massachusetts, December 8, 1920.

ials will be worth in the market at the date of delivery, then there is a prospect of loss, and if the amount is considerable, the probability of loss is relevant to a thorough interpretation of financial position. It ought not to be omitted from the balance-sheet.

The other question is: To what extent should an auditor be governed by transactions or developments occurring subsequent to the date of the balance-sheet and prior to the date of certification? In judging the financial position of a corporation as of a given date, should he look only upon the past and shut out entirely from view the prospects for the future? It is my opinion, as to a contingent liability, that if any development occurring after the date of the balance-sheet and prior to the date of certification materially modifies or possibly removes the contingency, that development ought to be considered in the preparation of the balance-sheet. On the other hand, if there should be an appreciable change in market prices subsequent to the date of the balance-sheet and prior to its preparation, it is in order for the auditor to take the most recent fluctuations into consideration in estimating any contingent loss. In brief, an audit should not be restricted altogether to transactions which have been concluded or have reached a precisely determinable status at the date of the balance-sheet.

A purchase contract in the ordinary sense does not become an actual liability until one of the parties to the contract makes a delivery of goods. For that reason it is not customary for accountants to include outstanding purchase contracts among the assets and liabilities on the balance-sheet. In a year like 1920, however, when we have witnessed a marked decline in the prices of many commodities—wool, silk, cotton, leather and others—it is to be expected that many corporations will have, at the date of closing their books, outstanding purchase contracts that were entered into when prices were on a much higher level. Many of these purchase contracts are binding and, according to the present outlook, will oblige the purchasers to take title to goods that will have a market value substantially less than cost. While vendors may grant extensions of credit by allowing deferred payments or agreeing to accept notes, thus permitting the buyers to husband their cash resources for a time, the probability of contingent loss is none the less imminent.

Purchase contracts give rise to three different classes of commitments, namely:

(1) Commitments which are normal in amount and are for materials that would have a market value, according to reasonable expectations, at least equal to cost on date of delivery.

(2) Commintments, abnormal in amount for the particular concern, the liquidation of which would produce an unprecedented strain on the concern's resources.

(3) Commitments, whether normal or abnormal in amount, which are for materials that would have a market value, according to reasonable expectations, measurably less than cost at date of delivery.

Purchase commitments of the first class need not be discussed because they do not involve prospective loss.

Let us illustrate the second class of purchase commitments by assuming that a corporation has entered into a contract for a large amount of material or for construction and that the contract is unfulfilled at the close of the fiscal year. If the corporation has not arranged for the financing of the exceptionally large expenditures and could not be relieved from abiding by the obligations of the contract, without serious consequences, there is a contingent demand upon working capital which should not be overlooked by the auditor. In any consideration of this sort the public accountant, of course, has to weigh carefully the interests of his clients. It is hazardous to generalize from the variety of cases met in actual practice, and, therefore, any general suggestion which might be made is subject to such qualifications as the special circumstances may demand. In an extreme case, the conclusion might be reached that a footnote ought to be appended to the balance-sheet, under the head of "commitments," reading somewhat as follows:

> "The company's contracts for purchase of material and for construction outstanding on .(date of balance-sheet). aggregated $.........., payable during ..(period of time)."

While examples of the class of commitments just considered are not common, there will be numerous illustrations of the third class of purchase commitments on balance-sheets of corporations

at December 31, 1920. What are the essential facts to be ascertained and reported with respect to contracts for purchase of materials that have a market value at the date of the balance-sheet (or at a date prior to date of certification) substantially less than cost? The most important data, in my opinion, are:

(1) Gross amount of commitments.
(2) Market value of materials at date of balance-sheet or at a more recent date prior to certification.
(3) Net probable loss (difference between 1 and 2).
(4) Period during which corporation will be allowed to liquidate the liabilities.
(5) Provisions for financing the contingent liability by sales, credits, loans or security issues.
(6) Protection, if any, against loss through sale contracts.

There are two possible methods of representing a contingent liability on the balance-sheet: one, a reserve account, which would be created by a debit to surplus, and the other a footnote under the head of "contingent liabilities." In my judgment, the form to be adopted is not vital, provided the essential facts are clearly set forth. Personally, I am inclined to prefer the use of the footnote, on the ground that there is uncertainty as to the occurrence of the liability and the amount of loss. A footnote relating to purchase commitments of the third class might be worded as follows:

> "The company's contracts for purchase of materials to be delivered during ....(period of time).... outstanding at ..(date of balance-sheet)... aggregated $................ or $............. more than the market value of the materials at ....(even date or more recent date)........"
>
> or
>
> "On the basis of market values at ..(date of balance-sheet or more recent date). the purchase contracts unfulfilled at ....(date of balance-sheet)..... , aggregating $............ would show a contingent loss of approximately $................."

It has been suggested that the total amount of commitments be disclosed for the reason that the significance to be attached to the amount of contingent loss depends considerably on the gross amount of commitments. Should the amount of commitments

be large, provision for financing would be an important consideration and the footnote should be amplified accordingly. In some trades vendors have agreed to accept notes with six to twelve months' maturities for the difference between cost and market value of the materials purchased.

How is the market value of commitments to be determined? In speaking before another assembly last week on the subject of purchasing, I was asked whether purchase commitments should be controlled by a budget. That question and the answer thereto imply that records are usually available in the purchasing department to show the amount of outstanding commitments in terms of dollars. A well organized corporation will be able to supply that information at short notice. It should be the duty of an auditor, in the initial stages of his examination to call for a schedule that shall set forth in reasonable detail the outstanding commitments and the market values of the various items as estimated by the purchasing agent. If the purchasing agent asserts that he is unable to supply the data, then the auditor is confronted with the same sort of difficulty as that which he encounters not infrequently in the verification of ledger accounts which are not supported by adequate details. He must form an opinion from such data as he can collect as to the likelihood of any contingent loss arising from commitments.

I am nearing the end of my time limit, and will conclude with a brief consideration of sale contracts as related to purchase contracts. I have in mind a fairly common practice in some businesses. A sales order may be taken for a quantity of goods at a definite price and purchase orders may be placed later for sufficient quantities of raw materials to cover the requirements of the sales order. We may assume that the sale price and the purchase prices are consistent in the sense that there is sufficient margin between them to allow the manufacturer a profit. If the purchase and sale contracts are both unfulfilled at the close of the fiscal year and there has been a sharp decline in commodity prices, it may be essential to mention both contracts in any reference to contingent liability. The contracts should not be assumed to be offsetting because the sales contract may not be enforceable. Under the conditions of the trade, it may not be possible for a seller to force his customer to take the goods, and we all know that there have been great numbers of cancellations in recent months. Again,

if the customer should become financially embarrassed and forced into receivership, the receiver would have the option of repudiating the contract, a right which he would certainly exercise if the stipulated price was unfavorable to the bankrupt concern. For these two reasons the protection in a sales contract may be more apparent than real.

When there is an inter-relation of purchase and sale contracts, I suggest that the footnote in explanation of the contingent liability should be worded substantially as follows:

> "The company's contracts for purchase of materials to be delivered during ....(period of time)... outstanding at ..(date of balance-sheet).. aggregated $................ or $............. more than the market value of the materials at ..(even date or more recent date)". , but $......... is covered by sale contracts, leaving $................ as the net amount of possible loss."

If there is an inventory of goods which also apply against the sale contracts, the footnote might be expressed in the following manner:

> "The unfulfilled purchase contracts aggregate $...... ....at (date of balance-sheet) , and after applying thereto the unfulfilled sale contracts in excess of the inventory at ....(date of balance-sheet)...., would show, on the basis of market values at (date of balance-sheet or more recent date)......., a contingent loss of approximately $....."