Journal of Accountancy

Volume 23 | Issue 6 Article 3

6-1917

Mis-Stated Current Assets

A. S. Fedde

Mis-Stated Current Assets

By A. S. Fedde, C. P. A.

It is fairly well understood that values as appearing on a balance-sheet are to a considerable extent the result of estimate and opinion, but the general idea is that this condition is primarily attached to the figures stated of fixed assets and the figures related thereto in the estimated provisions for depreciation—also the estimates which enter into the apportioning of betterment work between additions and renewals. That such estimates should be accurate is of course important, and especially as they have a bearing on the statement of profits.

Current assets, however, are too often looked upon as being absolutely statements of fact, as though all the items were the equivalent of so much cash. The truth is that there is quite as much room for the expression of opinion in the statement of current as of fixed assets; not only that, but many items under the former heading are often grossly mis-stated, at times quite innocently, but sometimes with full knowledge. The innocently incorrect statement may be quite as damaging as one which is deliberately mis-stated.

Financial statements are of interest to several classes of people, but the groups of assets and liabilities known as "current" are of especial interest to the creditor class. To banks it is of vital moment that the items which they scrutinize to judge of the probability of their realization in time to meet maturing liabilities should be correctly stated; but, without an intimate knowledge of the composition of the various items, it is unsafe to place reliance upon them as available for meeting obligations. This extends even to the item of "cash."

This will appear from a consideration of the make-up of the items as sometimes found by accountants in the course of their auditing work.

First, take the item shown as cash in banks and on hand. In some instances cheques drawn and mailed prior to the date of the statement, resulting in an actual overdraft of the bank balance, are written back to the extent of the uncleared cheques, and stated as cash on one side and accounts payable on the other. This is wrong, as the authorizations for the bank to pay certain sums have gone out and the balance of cash available has been reduced thereby. Furthermore, the payment of bills requiring the cash to be drawn so closely as to necessitate borrowing from expected receipts indicates pretty clearly a condition where claims by creditors are pressing. A peculiar instance was seen not long ago, where actual disbursements over a period of a year, amounting to thousands of dollars, were omitted from entry in the books of account, but carried as part of the cash balance, on the ground that the payments were advances to a partner for the purpose of helping a relative who was in business difficulties, and the partner did not wish the sums charged to him, as he expected to replace the cash when his relative had paid him. So far from being cash, this was not even a good account receivable, but a withdrawal of capital.

Miscellaneous items of intrinsic value are at times stated as cash—for example, bar gold which is to be used in manufacturing. The proper location of this is under inventory, as there is no intention of using it in any other way than as raw material.

A common practice is to include in cash, items advanced to salesmen, branch selling offices, traveling repairmen, etc. In a large company these advances will be considerable, and, in my opinion, would preferably be included as working assets. They are available for the conduct of a certain part of the business, but certainly not available for meeting the liabilities shown on the books. Such funds should be classified together with unexpired insurance, prepaid interest and other deferred charges to operating.

Accounts and notes receivable, when not accompanied by explanatory memoranda, are presumed to be debts due to the concern, arising in the ordinary course of business. Items which are often erroneously combined with the figures of balances due from customers are the personal accounts of partners or officers—the latter more frequently in close corporations, where the officers are majority holders of stock.

The matter of opinion enters to an appreciable extent into the values stated for receivable items, through the estimate of the provision necessary for non-realization of accounts. Where the business is large and has been carried on for a number of years, the percentage of bad debts to sales in previous statements of income may furnish an index to the adequacy of the reserve, if business conditions are normal, and if bad debts have been written off when ascertained to be uncollectible.

Advances to affiliated companies should never be combined with accounts receivable of trade customers. Even when shown as a separate item among the current assets, it should be ascertained whether they are balances actually collected from time to time or the advances are more of a permanent nature. In the latter case the item does not belong under current assets at all.

Inventories could be made the subject of a book; only some peculiar phases will be mentioned here. The matter of opinion is of course present in providing for deteriorated or obsolete stock, and one of the most important duties of the auditor is to see that inventories, for which no reserve has been provided, are constituted only of current and usable stock.

Where a cost system is employed, the absorption of expense is reflected in the inventory values, and it should be seen, if amounts in excess of actual expenses have been absorbed, that the portion thereof remaining in the inventory is deducted or provided for by a reserve. The same holds true where the system provides for the inclusion of selling expenses and perhaps interest. The inclusion of such items places fictitious costs on the inventories in the balance-sheet, through the overstatement of finished goods as well as goods in process. Even though inventories as shown may be fully realizable, they are incorrectly stated, due to part of the profit being anticipated.

Some inquiry on the part of a prospective creditor would be prudent, as to the length of time necessary to realize on the inventory in the ordinary course of business. In some lines it is over a year before raw materials are realized in cash, owing to the time necessary to season the raw materials, combined with time of manufacturing and seasoning the finished product, and long terms of credit thereupon being given to customers. Obviously, a banker extending ninety day credit cannot count on such an asset for the meeting of his note.

Apart from the old-time merchant who included his furniture, fixtures, horses, wagons and machinery as "inventory," there are businesses which have a class of merchandise which in some instances is used as part of their equipment and in other instances is partly for sale. If some legislators have their way, brewers' containers will be eliminated from the list, but there are many other instances where containers of some substance, or goods not intended to be sold, are inventoried when on hand and are charged to customers' accounts when shipped, though in neither case are the items expected to be realized in cash. Such items when charged to customers should be credited to a special account to be deducted in a balance-sheet from the accounts receivable, and the cost thereof should be added to the inventory of the same class of goods. Such inventory should be shown under fixed assets as part of the equipment for doing business, and not under current assets.

Accounts and notes payable, including accruals of periodical expenses, are properly subject to the same careful consideration as the current assets, in order that one may arrive at a clear perspective of the net balance of the latter. Ascertaining as far as possible that all liabilities are included is naturally of first importance, but it is also important to ascertain if liabilities are overdue. There have been instances where loans from the bank have been obtained just prior to closing and, though accounts to a great extent were overdue, a large balance of the cash was permitted to remain in the bank over the closing date. Noting such a condition in the cash, the natural inference would be that accounts payable were not yet due and that the concern was paying its obligations promptly.

Contingent liabilities may require the use of assets for their liquidation, dependent upon future conditions. A contingent liability, as to which I find no inquiry on the blanks furnished by banks, is that of liability upon contracts. This contingent liability will in the ordinary course become an actual liability, whereas it is the unusual situation that turns a discounted note into an actual liability. Contracts for future purchase of materials may be of such volume as to make any prospective lender pause and consider—and they may have been made under such conditions that at the balance-sheet date a loss is already in sight.

Some bank forms for balance-sheet contain as the last item following capital stock and surplus the item on a single line "reserves," and no provision appears for deducting any reserves from the assets, or for stating them as true liabilities. In this form the item is evidently considered as contingent or surplus reserves. Surplus reserves are only such as are set aside out of surplus, in order to designate the specific purpose for which such portions of surplus are to be used, whereas reserves set up to provide for valuing as nearly as possible an asset, or for writing off a portion of an asset cost, should be entered as a deduction in the statement of the assets to which they apply. Some prefer to state them on the liability side of the balance-sheet; but the main point, after all, is not to state such reserves as part of the capital employed. They are quite the reverse, being a reduction of the capital employed in the business, and, if applicable as a provision for bad debts, obsolete inventories or accruing liabilities, their consideration is important as bearing upon the values of the current assets and the relation of current assets to current liabilities.