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Accounting Questions: Finance Companies Accounting, Hotel Chains Accounting

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Accounting Questions

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FINANCE COMPANIES ACCOUNTING

Question: We are attempting to standardize among our clients methods of ascertaining the amount of deferred income on instalment loans secured by automobiles and other chattels. We present below two methods in use, each having advantages which are outlined. Could you secure for us an opinion from some members experienced in automobile finance accounting regarding these two methods and any others that are considered better? The favor will be much appreciated.

Method 1. All loans are classified according to their terms as 8, 10, 12, 14, 16, or 18 months. For each class, a table is prepared showing the percentage of the total income on a loan which is earned each month of its life, based on the amount of money outstanding during each month of its life.

At the close of the fiscal year a summary is made of outstanding loans showing total fee, total life and balance of time to maturity. By use of this information and the tables above mentioned, the unearned fee on each loan at the end of the fiscal year is computed. Fractions of months are covered by interpolation. A total taken of all itemized unearned fees produces the amount of unearned fees to place on the balance-sheet.

The advantage of this method is a computation of unearned fees as accurate, we believe, as can be had. The disadvantage is the vast amount of time required to make the computations.

Method 2. Some of our clients record at the end of each fiscal year unearned fees amounting to 5% of the outstanding loans at that date. This percentage is arbitrary and, according to the companies using it, is supported by past experience.

Its advantage is that it is easy to compute. The disadvantage is that its accuracy can be proven only by detailed computations covering all or a percentage of open accounts. We are informed that a large percentage of the automobile finance companies use this method.

We have accumulated statistics as to the relation of unearned fees to loans outstanding for several companies using method 1 over the past five years.

The percentages range from 5.36% to 7.43%. The average is 6.59%. This would indicate that the 5% ratio used in method 2 by other companies is too low.

Answer: Your question, of course, has particularly in mind the balance-sheet. However, as a finance company executive, I feel that equal stress should be laid on the profit-and-loss account. In other words, instead of having the problem resolve itself into a question of how much should be deferred on the balance-sheet, I think it should be: How much of the income should be taken into earnings each month or year?

Your letter makes reference to two methods and I would, without hesitation, dismiss method 2 as not only being wrong, but positively dangerous. Method 2 could very easily result in a serious anticipation of income, particularly as there are fairly wide fluctuations in the volume and outstandings of a finance company. Further, a finance company must do a large volume of business on a narrow margin of profit. It can therefore be appreciated how serious would be the effect on the net profit by magnifying the error in the gross profit.

Method 1 indicates that some thought has been given to the subject and perhaps if I should elaborate on it in a paragraph or two, it might be of interest to you.

This method classifies the outstanding accounts according to the terms, or on what we generally speak of in the finance business as a maturity analysis. It is necessary, first of all, to prepare very carefully such a maturity analysis. Then when the total unearned income, as at a definite date, has been accurately computed and set up on the books, the starting point has just been reached.

Your letter intimates that the advantage of this method is a computation of unearned income as accurate as can be had, and adds that the disadvantage is the vast amount of time required to make the computation. I might state that it is a very arduous task to make the initial computation, but it only has to be made once and is well worth the effort and trouble. Having made it, it becomes the starting point and from that time on a record should be kept, which, for the sake of convenience, may be called "amortization record of unearned income." The unearned income thus determined, as at a definite date, should then be spread on this amortization record showing the amounts accruing to earnings each month, until the total is exhausted.

The next step is to determine the method by which the income each succeeding month should be spread to this amortization record, to produce automatically the basis for a monthly journal entry, charging unearned income and crediting earned income. All that is required is to classify the gross finance charges or income, according to the terms of the paper, that is an analysis drawn off showing the total income on eight-months' paper, total income on ten-months' paper, twelve-months', fourteen-months', sixteen-months', eighteen-months', etc. It will be readily seen that this is a simple operation. Even in a large finance company it would only be a matter of an hour or so, particularly if statistical machines are used. It is a by-product of the statistical analysis and involves no appreciable amount of labor. A pre-determined set of ratios must now be established to show what fraction of the gross income is earned the first month, how much the second month, the third month, etc., and a similar set of ratios for paper in the various categories from about six-months' paper up to eighteen-months' paper. It is obvious that it is a simple matter to apply these ratios to the classification of the gross income in order to arrive at the spread of the monthly total to be placed on the amortization record.

I hope it will be quite clear from this that the entire operation is almost startling in its simplicity. I might add that after it has been in operation for a year, it would not be a bad idea to make a test in order to confirm the predetermined set of ratios mentioned, but any further test is really unnecessary.

To sum up, the method might be described in this way: A very careful physical inventory is first made of the unearned income as the basis for a perpetual inventory control of it. This guarantees that not only the amount deferred would be correct, but the amount taken into the earnings each month would always be correct.

Answer: The first method mentioned by your correspondent, in my opinion, is preferable, although I know of several companies that use the second method with satisfactory results. Whether the percentage of deferred income to the loans outstanding is 5% or more will be determined from statistics prepared from the company's own figures. Because of the rise and fall in the volume of business at different times of the year, the percentage, of course, will vary.

The accuracy of the rate used in the second method may be proved by periodically computing an inventory of unearned service charges. If 5% (as is suggested in your correspondent's letter) of the outstanding notes is found to be too low the rate should be adjusted to conform more closely to the company's experience.

Your correspondent's explanation of the first method leads me to believe that his objection to this procedure, namely, that too much time is required, may be largely removed by eliminating some of the detail which apparently is now done, as he states that "the unearned fee on each loan at the end of the fiscal year is computed." To calculate the unearned service charge on each individual loan is not necessary, nor is it necessary to consider fractions of a month further than to regard all business from the first to the fifteenth as purchases to be spread as from the first of the month, and business acquired from the sixteenth to the end of the month to be spread as from the first of the month succeeding the month of purchase. With this division of the month's purchases as a basis the daily business should be spread according to maturity of the notes, consideration being given, for the sake of saving time, to summarizing the daily business into classes, such as eight-months' paper, twelve-months' paper, eighteen-months' paper, etc. From the monthly total of these daily summaries are calculated the percentages of the amount outstanding each month throughout the period, and the service charges (after making some allowance for the cost of acquisition) are prorated over the period on the basis of these percentages. The cost of obtaining and accounting for the business is incurred largely in the month in which the business is procured and for that reason some proportion of the service charge (say 10% or 15% thereof) may be deducted and taken into the current month before prorating the balance.

If the company has been in business long enough to establish accurate statistics I am of the opinion that service charges may be fairly spread on the basis of percentages ascertained to be the average over the preceding two or three years, the accuracy of which may be determined from time to time by an inventory of a fair proportion of outstanding notes.

HOTEL CHAINS ACCOUNTING

Question: It is desired to centralize the accounting for a group of hotels of varying size in one office. The desired objective is efficient and economical handling of the accounts with complete control and audit.

Before making our recommendations we would like to know what methods are used by chain groups of hotels, and what accounting arrangements have been found most satisfactory by other groups of hotels where management and accounting are centralized because of financing.

We are, of course, familiar with the standard works on hotel accounting, uniform systems, etc.—in fact, the present method where the books are kept at each hotel has been very satisfactory. However, our clients feel that expenses may be reduced and better control exercised by handling the accounting through one office, except, of course, guests' accounts, cash and revenue accounts which must be handled at the hotel.

Answer: I have consulted with the chief accountant for one of the large chain hotel organizations, and his experience and my own ideas coincide on this matter. I believe that it is unwise to attempt the complete centralization of accounting at one place for a group of hotels covering a wide territory. It is quite feasible to maintain the corporate accounts, such as capital stock, buildings, depreciation reserve, bonded indebtedness and fixed charges, in one place for all the hotels, but the operating accounts, it seems to me, should always be kept locally.

Centralization of hotels has been considered many times and, specifically, by some of the chains with which I am familiar, but in no case has it seemed advisable to keep the operating accounts at a central point. Your inquirer recognizes the necessity of keeping guests', cash and revenue accounts at each hotel. It seems to me as necessary to keep accounts payable and expense accounts there as well. If this is done all the material is available for the preparation of operating statements. The operating statements should be forwarded to the central office where, if they are on a standard form, they may be consolidated and compared and statistical percentages may be developed from them.

I do not know of any large chain of hotels which operates otherwise and I do know of four important chains whose operating accounts are all kept at the individual hotels.