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Accounting Questions

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INSTALMENT SALES OF REAL ESTATE

Question: A real estate company sells lots on the instalment plan, with a cash payment of from 10% to 25% of the sale price. All lots on which 25% of the purchase price was received are included in the completed sales amount, together with several others on which less than 25% was received.

How should the amount or account of "unrealized gain on sales" be set up on the balance-sheet? Would it be good practice to add this amount to the surplus account?

Answer: We would advise that in our experience many of these instalment contracts fall through, and it is usual to carry the unrealized gain on sales as a reserve on the liability side of the balance-sheet, or, more rarely, it is deducted from the amounts receivable under contracts. It is not good practice to add the amount to surplus account. An income-tax inspector, who happened to be engaged on work on a real-estate company's books at the time the inquiry was received, stated that with few exceptions in his experience this item was invariably carried as a reserve.

Answer: It would seem that by setting up such an account the company had definitely chosen not to regard the excess of the sale price over the cost as income until collected in cash, and therefore the gain should not be treated as surplus in advance of realization. The company could properly treat the excess as having been earned at the time of making the sale if it chose to do so, even though it were to report its taxable income on a realization basis, but having taken the conservative view that the profits are not earned until collected it should be consistent and regard the "unrealized gain on sales" as a reserve.

ROADS AND BRIDGES IN GOVERNMENT ACCOUNTING

Question: I would be obliged if you would inform me what is considered the best accounting practice with respect to the ownership of roads and bridges and similar assets by cities and counties. Should these items be carried as assets or should they be charged off at the end of each accounting period?

Answer: Roads and bridges owned by cities or counties are not assets in the accounting sense. They are, of course, assets in an economic sense. Stated another way—a value of a road or a bridge expressed in dollars, whether that value be based on cost, cost less depreciation or an appraisal, means little or nothing as a factor in determining the financial condition of a city or county at a given date. The value of such properties can be measured only from the standpoint of capacity for service. For these reasons accounts for roads and bridges should not be carried in that group of accounts from which the statement of financial condition or balance-sheet is drawn.

An entirely separate group of accounts should be kept to show the cost of construction of each road and each bridge. The purpose of these accounts is to show the progress of expenditure during construction and the completed cost, as a basis of considering many questions such as the relative economy or extravagance of construction, the advisability of extensions, etc. These accounts are also essential in budget making. Since they have no relation to surplus their balances are never charged off; instead they are kept open until the construction is completed and are then simply ruled off.

The principles above stated apply to all government-owned property with the exception of self-supporting public utilities, such as water works, gas or electric plants or railways.

The question which has been raised relates to some of the most important principles of government accounting. It is therefore very difficult to submit an adequate answer in a brief statement. It is well for you to know that some accountants are diametrically opposed to the opinions which I have expressed.

Answer: Roads, bridges and similar assets should be paid for out of the special funds which are provided for the construction of these particular improvements. They should be charged, after the construction has been paid for, to appropriate accounts, and credits should be made to "property account surplus."

AUDIT OF GENERAL INSURANCE AGENCY

Question: What special problems are encountered in auditing the accounts of a general insurance agency? By this I mean an agency writing all kinds of insurance and distributing this among a number of companies. I would like to know the principal things to be investigated in making such an audit.

Answer: Certain special items encountered in the audit of a general insurance agency are as follows:

1. The conditions of brokers' balances in the brokerage ledger: These items should be current in nature, otherwise investigation should be made to determine whether or not the agency is advancing the premiums for the brokers. If such advances are being made, the auditor should make provision for possible losses due to non-payment by the broker.

2. The condition of agents' balances: A sufficient number of agents' accounts should be compared with the monthly accounts rendered by the agents to determine the accuracy of these accounts. Differences of long standing and of relatively large amounts should be studied.

Most agencies bond their agents, as they are liable for any misappropriations by their agents. The bonding company requires documentary evidence to show that the money has actually been paid by policy holders to the agents.

Hence, the auditor should scan all agents' balances for their age and should determine the extent to which the agency is protected in those cases where the balances are old. A reserve should be provided for probable losses based upon the analysis of these accounts.

If the agency has established branch offices, it is important that these accounts be audited to determine the condition of the funds invested in branches.

In order to stimulate their agents, many agencies grant contingent contracts which provide an additional commission on the net profit arising from the business written by them during their contract year. While no actual liability accrues to the agent until the termination of the contract year, nevertheless the auditor should make provision for the additional commission if a study of available statistics indicates the probability of such a liability.

3. Reserve for agents' commission: Since the agency records some business on its books before the agents' commission is deducted by the agent in his accounts current, the agency must set up a liability for the agents' commission. Some agencies estimate this reserve by calculating the average percentage of commissions paid on business written during the period under review and deduct the amount taken by their agents in their accounts. Other agencies have comptometer operators determine the premiums on which the commission has not been paid. Proper percentages are applied to these sums to compute the reserve for agents' commissions. In either event, the auditor should check the calculation in order to satisfy himself that the reserve is sufficient.

4. Company balances: These balances represent the portion of premiums payable to the insurance companies after deduction for all commissions and expenses chargeable to them. These balances should be confirmed by direct communication with the companies. Inasmuch as the companies carefully audit these accounts for amounts of premium, commission deductions, etc., this confirmation provides a very satisfactory check for the auditor of an insurance agency.

5. Agency contracts and company contracts: Practically every transaction in the insurance business can be traced to a carefully written contract. The auditor should examine in detail the contracts with several companies and several important agents to see that the contracts are followed in the accounts. Insurance companies often grant contingent contracts to their large agencies just as the agencies grant such contracts to their agents. Effect should be given to these contracts by the auditor.

Answer: The scope of the audit will, of course, depend on the purpose, and whether it is for the company, for an outsider, or for the agent himself. It is perhaps needless to point out that care must be taken to separate the accounts of the different companies if there be more than one, and the accounts of different kinds of insurance. The auditor should see the contracts with each company showing the rate of commission allowed, distinguishing, in the case of life, first premiums from renewals. He should also see if any sub-contracts exist, whereby commission is to be allowed to others for placing business on account of the agency.

All statements received from the companies and copies of statements rendered to companies should be carefully scrutinized and compared with the books. Life insurance companies furnish the policies and charge the agent with the premiums, crediting him, of course, with returned policies not taken. The same practice usually applies to renewal receipts and also to receipts for loan interest, when loans exist on the policy. In checking the life account, the policies not yet taken and receipts in the hands of the agent should be examined to see that all policies or receipts delivered are accounted for in cash.

In the case of fire, accident, burglary, indemnity, etc., policies are usually written by the agent and he reports to the companies. In these cases the policy blanks, numbered consecutively, are furnished by the company. The remaining blanks unused should be compared with the record of blanks used to see that everything is in order. The numbers that should be on hand, as well as the general status of the account, may be confirmed by correspondence with the company.

Premiums returned upon cancellation involve return of commission by the agent to the company.

In the case of life business, there is usually an equity in the commuted value of renewals and sometimes an agent will obtain advances on the strength of this, but there is no fixed rule and the practice of companies varies. Renewal equity would belong to the estate in the case of an agent's death, and possibly could be transferred if the agent sold his business to another, but that, of course, would be subject to the consent of the company.

We have not touched upon features common to audits in general.

BAD DEBT LOSSES OF FINANCE COMPANIES

Question: We should like to obtain data relative to proper reserve for bad debt losses in the case of a salary and collateral loans finance company.

Loans are divided about equally between salary and collateral, the former being covered by two endorsers. The care with which loans are made is, of course, an important factor in determining bad debt losses but we believe that you could probably furnish us with some information as to the provision which should be made for such loans based on the total loans made each month, from the experience of similar companies which have been in successful operation for a number of years.

Answer: Obviously different finance companies will have different experiences regarding their losses in direct relation to the care of the credit departments in making loans. Another point that has a very distinct bearing on losses is the efficiency of the collection department. The operation, therefore, of these two departments is a very important factor in the percentage of losses that will be sustained. Accordingly, the experience within the company is the best criterion.

Attempting to answer the question in generalities, one might say that reserves of about 1/10 of 1% on three-name salary paper should normally be sufficient and possibly a slightly lower percentage on collateral loan paper. Assuming that this is a new company, it might be advisable that the estimated percentage be higher than the normal.

Answer: There is no standard relationship between bad debts and accounts receivable. Therefore, there can be no formula for setting up a "proper reserve for bad debt losses." Each company must determine its proper reserve based upon its own experience. Your correspondent must, of course, recognize that the experience of one company is not necessarily the experience of another company in the matter of bad debts.