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Accounting Questions: Bad Debt Losses in Periods of Depression;

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Accounting Questions

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BAD DEBT LOSSES IN PERIODS OF DEPRESSION

Question: We have been requested to charge separately to surplus bad debt losses considered to be unusual losses during the present period of depression, and the clients submit that, at least in part, such unusual losses are due to inaccuracies in bad debt reserves for prior periods.

Similarly, requests have been made that we separately charge to surplus computed amounts considered to be declines in inventory values due to the market trend of the past year. The argument submitted in this instance is that the management had no control over these price declines and therefore the item is of an unusual nature and not a proper charge to operations. In particular, we have had this request in one instance wherein the computation of the decline is based on actual items included in the beginning and ending inventories at different values.

Answer No. 1:

(a) The treatment in the accounts of unusually large losses from bad debts due to the present business depression.

(b) The treatment of inventory write-downs necessitated by price declines.

The conditions described in your correspondent's letter are not peculiar to one or two companies, and we venture to say that practically all industrial companies were faced with the same problems in a greater or lesser degree at the close of the past year.

With regard to (a) it is, of course, obvious that losses from bad debts are greater in periods of depression than in periods of prosperity, and we believe it has been the experience of industrial companies generally that considerable increases have been necessary in provisions for bad debts in the past two years. While it would undoubtedly be conservative practice to establish reasonably substantial reserves in prosperous times to provide for possible future losses from bad debts, we do not think that failure to provide ample reserves in the past would warrant charging to surplus losses now incurred which conceivably might have been provided for previously. However, reserves for bad debts are largely estimates at best, and probably it will be found that the necessity for making unusually large provisions at this time is not due principally to inaccuracies in previous reserves but is a result of business conditions arising during the current year, which could not have been reasonably foreseen. It follows, therefore, that bad debt provisions should all be absorbed in the profit-and-loss account, and it has been our experience that this practice is being followed practically without exception. Such charges may, of course, properly be shown as a separate item in the profit-and-loss statement.

With regard to (b) it may be of interest to quote the following from the Institute's *Special Bulletin No. 7* issued in December, 1920:

"It was agreed that it would be in order to show operating profits on the basis of inventories at cost (less usual provisions for obsolete stock, etc.) and the adjustment from cost to market as a special charge either against profits or surplus, provided that the procedure adopted was clearly described. In point of fact, the loss from the decline of prices is an offset to the extraordinary profits from increasing prices realized over a series of years and not an operating loss of the year, but as the extraordinary profits in the past years have been included in the ordinary profits, any statement this year either must similarly absorb the corresponding decline or show clearly that this decline has not been absorbed in the operating results."

While the present conditions in some respects are comparable to those existing in 1920, it should be borne in mind that in 1920 price declines took place over a comparatively short period; whereas in the present instance the trend of market prices has been downward over a period of some two years. There would not appear to be much point to the arguments advanced by your correspondent's client that the price decline is of an unusual nature because the management had no control over prices. Price declines and advances occur from time to time and are usually beyond the control of management, and it would be quite impracticable to attempt to eliminate from operating statements the effect of changes in price levels either of purchases or sales or of fluctuations in volume. Furthermore, we are satisfied that the treatment of an inventory write-down under present conditions as a surplus charge would be looked upon with disfavor by bankers and investors generally, and in any analysis of operating results the write-down would be applied against the current profit.

We do not think the fact that some of the items upon which the price declines are computed appear in both the opening and closing inventory has any particular bearing on the question. It simply means that the prices of these items have declined during the year and the difference must be absorbed in the write-down. It does, however, raise the question of whether a further write-down is required for obsolete or slow-moving stock.

Answer No. 2: It is quite rare to find a commercial business of any size which can accurately ascertain at the end of each accounting period the exact amount of the losses which will be sustained in collection of the accounts receivable at a particular date. It is, therefore, generally admitted that the balance-sheet allowance for bad debts, with the resulting charge to the income account, is at best a careful estimate. There may be an occasional unusual case in which there would be justification for charging bad debts to surplus, but, as a rule, such charges should be made to the current income account.

If a concern has set up reasonable estimates of anticipated bad debt losses, and if, due to general business conditions such as exist at the present time, the amount of losses is abnormally high, then it would seem that such bad debt losses should be charged to the income account of the period in which the accounts are determined to be uncollectible.

One of the hazards of any business which carries an inventory is the variation in inventory values due to market fluctuations. Inasmuch as such market variations are an essential part of the conduct of such a business, there seems to be no justification whatever for ignoring such variations as proper charges to the income account. In any year in which there are abnormal declines, it might make a better presentation to show such abnormal amount as a separate deduction on the income account. There might conceivably be a case in which there has been a radical, and probably permanent, change in market values of some inventory item, and the inclusion of the full amount of such change might have no particular relation to the operations of the year in question. For example, if some new process for producing raw materials had been discovered, and as a result there had been a radical decline in the market price and it was fairly certain that such reduced price would continue, then such a decline might preferably be set out separately in the income account, but might be charged to surplus, provided adequate disclosure of such surplus charge were made.

We think it essential that in cases in which justification can be found for charging to surplus items of a class which ordinarily would be charged against the income account there should be adequate disclosure of the amounts so charged to surplus and the nature of such charges.

On the whole, the questions raised in your letter are of common occurrence under present business conditions, and usually are due to a desire to make the results of operations appear better than they actually are and to a failure to face the facts.

Answer No. 3: As a matter of basic principle, every so-called surplus adjustment is, in fact, a correction of the operating results of some year. There are cases in which losses arise which clearly apply to the operations of a prior year and may, therefore, be properly charged against surplus. In a restatement of the surplus account, analyzed as to earnings of prior years, such an adjustment would be directly applied against the operations of the particular year affected.

If it can be demonstrated logically that a reserve for bad debts, at the beginning of the year, was insufficient on the basis of facts ascertainable at the time, the relative increase in reserve for bad debts should be treated as a charge against surplus.

So far as provisions for market decline in inventory are concerned, such provisions should be made by charges against operations in the year in which the declines occur.

Here, again, if it can be clearly demonstrated that inventories at the beginning of the year have, for one reason or other, been overstated, an adjustment of such inventory at the beginning of the year may be made by a charge against surplus, but the provision for such decline as may have occurred during the current period should be charged against current operations.

As to inventory, it should also be noted that it is accepted practice to provide for substantial declines, which have occurred subsequent to the date of the balance-sheet (but prior to the issuance of statements), by an appropriation of surplus. This provision is made for the purpose of stating the balance-sheet conservatively on the basis of latest available information, but the losses represented by such an appropriation of surplus should be absorbed in the operations of the ensuing period and the appropriation should be reversed.