

1-1933

## Audit Features of Finance Companies' Accounts

Willard E. Crim

Follow this and additional works at: <https://egrove.olemiss.edu/jofa>



Part of the [Accounting Commons](#)

---

### Recommended Citation

Crim, Willard E. (1933) "Audit Features of Finance Companies' Accounts," *Journal of Accountancy*. Vol. 55 : Iss. 1 , Article 4.

Available at: <https://egrove.olemiss.edu/jofa/vol55/iss1/4>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact [egrove@olemiss.edu](mailto:egrove@olemiss.edu).

## Audit Features of Finance Companies' Accounts

BY WILLARD E. CRIM

Fundamentally the functions of finance companies may be divided into two general classifications: (a) the extension of credit on short-term indebtedness through hypothecation by manufacturers and dealers of open accounts receivable and (b) the financing of instalment purchases. A third function, that of making loans to persons on property or against future income, is not peculiar to the commercial finance business and will not be included in these comments.

Inasmuch as the financing of instalment purchases constitutes the major portion of the total activities of such companies, while the activities of finance companies as a class in turn embrace a large portion of all such financing, they may be considered one of the instruments which make possible the immediate possession and use of property on a deferred-payment plan, in contradistinction to the older method of immediate ownership in exchange for cash or short-term credit. The principal difference in economic results of the two methods may be briefly indicated as follows:

The acquisition of property on a deferred-payment basis by a purchaser results in current reinvestment of capital by the vendor for materials and the employment of labor. On the other hand, acquisition for immediate ownership with concurrent payment in full by a purchaser necessitates a prior accumulation of the required funds by the purchaser during a time when the funds are probably wholly or at least partly non-productive in his hands. It is likewise true that the instalment plan of purchasing makes possible to the purchaser the discounting of the future and the present enjoyment by him of the anticipated fruits of labors. The instalment plan of purchasing has stimulated mass production and consumption and to that extent it is responsible for lowered production costs and resultant reduced selling prices. Comment is frequently heard to the effect that the instalment plan of purchasing is costly to the buyer on account of the service charges of the finance company, but this criticism generally ignores the fact that instalment buying has undoubtedly enabled the manufacturer to effect savings in production which in a large measure

have been passed along to the consumer. However, the purpose of this paper is to describe briefly certain features peculiar to the audit of a finance company rather than to venture an opinion as to the economic soundness of the commercial finance business or the benefits or disadvantages arising from its existence.

While it is true that the success of any properly organized business is dependent largely on the shrewdness and ability of its managing personnel, this condition is particularly true of a banking enterprise, and, since the operations of a finance company are a specialized phase of commercial banking, the first concern of a public accountant undertaking the audit of such a company should be to inquire into (a) the nature of the finance transactions and (b) the business procedures of the company, and so far as possible through discreet discussions enable himself to form an opinion as to the ability and integrity of the management. Such an opinion will be of assistance to him in deciding to what extent the information furnished by the management may be accepted without extensive verification and what degree of conservatism should be adopted by him in the preparation and presentation of the company's financial statements. An established record of favorable earnings under normal conditions is, of course, the best indication of capable management and a comprehensive survey of the financial history of the company should, therefore, be made at the outset. A record of unsatisfactory past performance will justify vigilance during the progress of the examination as to the underlying causes of the bad record.

Perhaps the most widely discussed accounting feature peculiar to the commercial finance business is the allocation of discounts and service charges received to the proper periods as earnings. Numerous methods of treating these items have been used or proposed, ranging from recording the entire finance charges as earnings when received to deferring the entire amount until the relative receivable has been collected in full. These two extremes have so little merit that they may be dismissed without further comment, for the principle has been generally accepted by bankers and accountants that any equitable method must provide for spreading the finance charges pro rata over the entire period of liquidation of the corresponding receivable. It may be stated parenthetically that most finance companies consider the two terms "discounts" and "service charges" synonymous from an accounting point of view and make no distinction between them

in recording transactions on the books. Theoretically, the discount is the interest return from money lent, while the service charge is compensation received by the discount company to defray incidental expenses incurred by it, credit investigation, collection and bookkeeping costs, insurance, etc. Since both the discount and service charge apply to the entire period of liquidation of the corresponding receivable, they may well be treated as a single item in the accounts of the finance company and will be so considered here. The term "finance charges" will be understood to include both elements.

Without undertaking a comprehensive exposition of all the ramifications of the question of apportioning finance charges, it may be stated that the method which appears to be the soundest and has in addition the merit of being entirely practical is to divide the income pro rata on the basis of the amount invested in the receivable in relation to the time element. This may be accomplished by spreading the total finance charge received over the term of realization of the corresponding receivable in the ratios of the unmatured balances of the receivable at the end of each month to the sum of such balances. A simple illustration of this method follows:

Finance charges amounting to \$1,800 received during May on purchase of notes totalling \$18,000 and maturing in equal instalments during the following six months—

	Unmatured balance of notes at end of						Total balances
	May	June	July	August	September	October	
	\$18,000	\$15,000	\$12,000	\$9,000	\$6,000	\$3,000	\$63,000
Per cent. of total . . . . .	28.57	23.81	19.05	14.29	9.52	4.76	100.00
Total finance charges re- ceived allocated in above percentages . . . . .	\$514.26	\$428.58	\$342.90	\$257.22	\$171.36	\$85.68	\$1,800

The accuracy of the results obtained from using this method is not seriously disturbed by delinquent collections, because it is customary to make an additional interest charge on delinquencies. Refunds of finance charges arising from prepayments should be pro-rated in the same manner, while in case of accounts closed through repossession of the underlying collateral, the entire remaining portion of the deferred finance charge should be credited against the expense of and loss from repossessions. From the auditor's point of view any accounting treatment of the finance charges which gives proper consideration to the time element and to the amount of capital invested periodically may be generally

considered as satisfactory. In the case of a company dealing in only one class of acceptances, which have nearly uniform periods of maturity, an average percentage of unearned finance charges to outstanding acceptances may be determined from past experience, and the deferred income may be computed periodically on this percentage rather than based on an actual division of individual purchases pro rata.

Many finance houses purchase various classes of acceptances, such as automobile paper, instalment lien obligations arising from the sale of other merchandise, property improvement notes and open accounts. As the discount rate, conditions of purchase and security obtained usually differ to a considerable extent on the various classes of obligations purchased and as the receivables must be properly segregated on the books and in the balance-sheet, it is customary to segregate also the purchases of the different classes of paper and the income received from them. The management may feel that it should likewise be furnished with the net operating results from the various departments of the business and that the general and administrative expenses should be apportioned between these departments. Any division of these expenses must be on an arbitrary basis, and careful consideration of the matter leads to the conclusion that the important guides in determining the relative desirability and lucrativeness of the several classes of business are to be found in the ratios of (a) service charges received to capital employed in the purchase of acceptances and (b) bad debt losses to acceptances purchased. While it is true that the solicitation, bookkeeping and other incidental expenses may be greater for one class of acceptances than another, the amount of variation compared to the capital employed will ordinarily be so small as to be relatively unimportant. Consequently the apportionment of these expenses to the different kinds of receivables purchased may be regarded in a majority of cases as an unnecessary and unjustified refinement of the accounts. Such a segregation, however, of bad debt losses and repossession expenses can readily be made. In some companies collection expenses may be found to be an item of considerable importance and the variation in them as between different classes of acceptances may make desirable a departmental allocation of these expenses also.

The item of greatest size and importance appearing on the balance-sheet of a finance company is the receivables. As al-

ready stated, the acceptances purchased by the company may be of various kinds, and the financing arrangements entered into with manufacturers and dealers may also differ widely. As a complete understanding of the arrangements under which the obligations have been acquired is prerequisite to a satisfactory verification and balance-sheet presentation, three examples of financing arrangements commonly encountered are outlined briefly in the following paragraphs.

(1) The finance company may purchase instalment notes given to manufacturers or dealers by their customers. Ordinarily the finance charge and insurance premium, if the article is to be insured, are included in the face of the notes. The amount of money advanced by the finance company is thus the face value of the note less finance charges and, if the paper be purchased with recourse, an additional amount commonly known as the "holdback" or dealers' equity. This latter amount is retained by the finance company as additional security and is paid to the dealer either upon complete liquidation of the note or as each instalment is collected. The amount varies, but ordinarily it is from 10% to 20% of the face of the note. The notes may be purchased either with or without recourse, and the finance charge is usually higher if purchased without recourse. Collections on the notes may be made direct by the finance company, or, if the dealer prefers to conceal from his customers the discounting transaction, collections may be made by him and forwarded intact to the finance house. A similar arrangement consists of direct discount transactions between the finance company and the purchasers of merchandise, but in this case there are no dealers' equities retained, since the dealer is not a guarantor of the notes.

(2) The receivables purchased may be in the form of open accounts. In this case it is customary to deduct from the face value of the accounts purchased only the amount of the "hold-back" and to bill the dealer monthly for the amount of service charges, which are generally based on the average amount of accounts outstanding during the month. As evidence of the genuineness of the account sold the dealer delivers to the finance company copies of the invoice and bill of lading or delivery receipt.

(3) A third common form of financing consists of a loan to the dealer by the finance company and a pledge by the dealer of collateral having a book value somewhat in excess of the amount

lent. The collateral may consist of notes or accounts receivable or may be merchandise deposited in a public warehouse. A loan secured by collateral of the latter type entailing the delivery of warehouse receipts to the finance company is of common occurrence and needs no further comment. If notes or accounts receivable are pledged as collateral, the collections are made by the dealer and ordinarily have only an indirect relation to the repayment of the dealer's loan. The finance company relies on periodical audits of the dealer's books made by its own staff for determination of the sufficiency of the collateral. Financing arrangements of this third class in which notes or accounts receivable are taken as collateral entail a somewhat greater element of risk to the finance company and usually obtain a higher rate of discount or service charge.

When one understands the conditions under which the receivables were acquired, their verification presents no unusual features. Since most finance houses operate to a considerable extent on borrowed capital, the greater portion of the acceptances purchased will ordinarily be found to have been pledged as security to loans, and the notes, conditional sales contracts, chattel mortgages, insurance policies, etc. will be in the custody either of individual creditors or of a trustee for the common benefit of all creditors from whom loans have been obtained by the finance company. All acceptances on hand at the date of the audit should, of course, be verified by actual inspection, while the acceptances pledged will be substantiated by certificates obtained direct from the custodians. Under the most common method of obtaining borrowed capital the finance company deposits collateral with a trustee who thereupon issues collateral trust notes which may be sold by the finance company, usually to banks. Where this arrangement is in effect, a careful perusal of the trust indenture must be made by the auditor to determine the pertinent conditions of the trust. Ordinarily the provisions of the indenture cover, amongst others, the following matters:

- (1) Denominations, term and nature of security of collateral trust notes.
- (2) Amount of trust notes which may be issued against the total collateral or, conversely, the amount of collateral required to secure trust notes of a given amount.
- (3) Particular requirements concerning trust property as to term of maturity, insurance, necessity of recording title, access by finance company for collection purposes, etc.

- (4) Degree of responsibility assumed by the trustee and by the finance company respectively as to genuineness and adequacy of collateral.
- (5) Rights and remedies of the holders of collateral trust notes in event of default in payment.

The collateral trust notes are usually non-interest bearing and are discounted by the finance company at varying rates, dependent on the current money market.

Following verification of the existence of notes and other documents underlying the receivables, the next matter to be considered is a determination of the collection status and an estimate of the required provision for bad-debt losses. A word of warning should be given here as to the danger involved in placing too great a reliance on the past experience of the company in respect of such losses. It must be borne in mind that the ratio of losses already experienced is no infallible guide to the future, particularly if the company is constantly acquiring new customers from whom to purchase acceptances. The credit problems of a finance company involve consideration of two distinct elements: the dealer or manufacturer from whom the acceptances are acquired and the customers of the party from whom the paper is purchased. This fact is apparent if the acceptances are purchased with recourse on the dealer, who thereby becomes a guarantor of the paper, but it is also true even though the receivables be purchased without recourse, for in that case the integrity of the dealer must be relied upon as to the genuineness of the indebtedness and the merit of the goods sold or services performed by him. It should also be noted that the customary arrangement in purchasing recourse paper is to require the guaranty of the officers or certain stockholders of the dealer company as individuals, in addition to the guaranty of the company itself, and the finance company may, if necessary, call upon the individual guarantors to make good purchased notes which are in default.

While past records showing a low percentage of bad-debt losses are an indication of careful and conservative extension of credit by the management and of an efficient collection procedure, it must be remembered that some element of good fortune has also been present and that unfavorable conditions in the consumer market or unwitting extension of credit to untrustworthy dealers or manufacturers may occur at any time. It follows, therefore,



that all outstanding accounts, and particularly those delinquent at the date of the audit, should be the subject of careful consideration and discussion with the management. Special inquiry should be made as to the existence of insolvent dealers, accounts disputed by customers as to either collections or original debt, and instances where the collateral has been repossessed by dealer or finance house without proper entry having been made to record the changed status of the account. In addition, the customary comparisons with former periods should be made as to percentage of losses and of delinquent accounts. The auditor must be on the lookout for refinancing transactions whereby delinquent balances are removed from the records through either extension of maturities or substitution of new notes for those in default.

It is the practice of some finance companies to base the reserve for bad-debt losses on the amount of receivables outstanding at any given date rather than to provide a certain percentage of acceptances purchased or to estimate the probable loss on particular accounts. If this method is followed, the resultant adjustment to profit-and-loss should be shown as a separate item in the income statement, after determination of the results from operations, because the amount of the adjustment will not in most instances be a true reflection of the actual losses sustained during the period. A decrease in the amount of receivables outstanding at the present time as compared with the date of the previous balance-sheet will result in a credit to profit-and-loss unless the reserve previously established has been materially decreased by losses actually sustained, while conversely an increase in the amount of outstandings will occasion a charge to profit-and-loss even though no losses may have been sustained during the intervening period.

Another matter that may well be given consideration by the auditor is comparison of the term of liquidation of the various classes of receivables with the estimated period of resale value of the underlying collateral. While the auditor will not ordinarily be in a position to decide exactly what the period of resale value of a given class of merchandise may be, he should at least satisfy himself that the company is not extending credit for the purchase of goods on notes having a period of liquidation which is materially in excess of the term during which it might reasonably be expected that such goods could be repossessed and disposed of at an amount approximating the uncollected balance of the debt.

To illustrate by an extreme case—it is obvious that the sale of radios on notes maturing over a five-year period would result in a disappearance of the underlying collateral value long before complete liquidation of the notes, and had such notes been purchased by the finance company, particularly without guaranty by manufacturer or dealer, an unusually liberal allowance for bad-debt losses would be required. In estimating the probable period of resale value of an article, not only the estimated useful life, but the element of obsolescence due to developments in the industry should be given careful attention.

The proper balance-sheet presentation of the various classes of receivables may now be considered. Primarily, there should be a sufficient segregation and description of the receivables to indicate clearly, first, the form of the obligation and the nature of the underlying security; second, the total amount of the company's receivables pledged as collateral to loans; and, third, the collection status of the receivables, i. e., a separation between current and past due notes and accounts.

A further classification as to the periods of maturity of the obligation is of great interest to both management and creditors, but it is not always feasible to present this information in the balance-sheet and it may be contained in the report or in a supplementary statement. If a portion of the acceptances purchased has been rediscounted, the conditions of the transactions must be ascertained and any material points should be set forth in the financial statements. Assuming that acceptances of a certain face value have been delivered to the rediscount company which has advanced cash equivalent to a stated percentage of the face amount of the notes, the outstanding balance of such rediscounted paper, as well as the amount advanced, should be confirmed by correspondence with the holders of the acceptances. The preferable balance-sheet presentation of such a transaction is to show both amounts on the asset side of the balance-sheet with the net amount extended as the equity in rediscounted acceptances. The company ordinarily will receive only the excess of the face value of the acceptances over the amounts advanced and will not be called upon to repay the amounts advanced unless the acceptances in question are in default. However, if it is desired by the company to show the face value of the rediscounted acceptances on the asset side of the balance-sheet and the advances received against them on the liability side, no serious

objection may be raised, provided appropriate references are made to the contra items.

In making a classification of delinquent receivables for balance sheet presentation, four factors should be borne in mind, viz.:

(1) Where notes and accounts purchased are guaranteed as to collection by dealers or manufacturers, the agreements ordinarily specify the period after maturity during which the seller must repurchase or make good the account. Hence, it is sometimes customary to classify as delinquent only those accounts or note instalments which are past due longer than the period specified in the agreements. If this is done, however, the fact should be clearly shown on the balance-sheet.

(2) If the receivables in whole or in part are pledged as security to loans payable under a trust indenture, the indenture ordinarily specifies that notes and accounts on which the collections are delinquent for a certain number of days must be replaced by the finance company with current collateral. While this stipulation would not necessarily be reflected in the balance-sheet classification of delinquents, it might be required if the balance-sheet were primarily for presentation to the trustee and the holders of collateral trust notes, or such a classification might well be presented to the management in a supplementary statement with the report.

(3) As the delinquency of one or more instalments of a note raises some question as to the collectibility of the entire unpaid balance of the note, there should also be stated on the balance-sheet the total present face value of notes having past due instalments, particularly in the case of notes purchased without recourse.

(4) The auditor, in the course of verifying the outstanding receivables and ascertaining the amount delinquent, will, of course, compile a record of collections on delinquent accounts during the period from the balance-sheet date to the completion of his examination. Since the best proof of the collectibility of an account is the receipt of part or full payment thereon, it would appear reasonable, in order to avoid giving undue importance to delinquencies of only a few days' duration, to take cognizance of this fact by classifying as current rather than past due the note instalments delinquent at the balance-sheet date but collected within, say, the following week.

It is not expected that the receivables of the company will be set forth in such detail as outlined in the foregoing paragraphs in

a condensed balance-sheet prepared for general distribution, but such a comprehensive classification giving all essential information should be used in a balance-sheet for submission to the management and, when required, to the company's bankers.

As previously stated, a further analysis of receivables may be submitted in the report, or in a supplementary statement, which will be of interest and value to both the management and the bankers from whom borrowed capital is obtained. For example, an analysis of the outstanding instalment notes receivable by nature of businesses and periods of maturity will furnish pertinent information as to the extent of diversification obtained by the management and the approximate period required to collect the principal assets. The amount of time involved in the preparation of such statements, provided the company's records are properly arranged, will be fully warranted, in most instances, by the value of the information so obtained.

The policy of the company with respect to repossessed collateral forfeited by the debtors on delinquent notes has two phases of importance to the auditor. There first arises the question of whether or not proper entries have been made recording the change in nature of the asset where merchandise has been repossessed by the discount company because of failure of the debtor to meet his obligations. The note-receivable account should, of course, be closed and the collateral recorded on the books as an asset at a value not exceeding the amount of the uncollected balance of the note. While certain writers have taken exception to this procedure by stating that repossessions should be regarded as a change in the legal status of the account pending disposition of the collateral rather than as an accounting transaction, the principal argument advanced by these writers in support of their view is one of labor-saving expediency. This advantage is more apparent than real because in a majority of cases collateral once repossessed is not redeemed by the debtor and must be disposed of by the finance company. Repossession of collateral is resorted to by the finance company only where the accounts have been purchased without recourse or when the dealers from whom recourse paper was acquired are unable to repurchase their delinquent accounts, and the finance company is usually satisfied before repossessing the collateral that the debtor is definitely either unwilling or unable to continue payments. Therefore, since an entry recording the repossession must eventually be

made in most instances, it would appear advisable to make the entry immediately on repossession of the collateral and thus obviate all possibility that (a) the management will be allowed to lose sight of the true status of the accounts and (b) the accounts will be incorrectly presented on financial statements. Any expenses incurred in repossessing the article should be charged to current profit-and-loss, unless a reserve has been provided for such expenses. They should not be added to the value placed on the collateral.

Secondly, the policy of the management concerning the disposal of such collateral should be considered. Unless the debtor is given a certain period in which to redeem the article by meeting his delinquent payments (a somewhat uncommon practice) it will ordinarily be found a wise policy to dispose of the merchandise promptly and to absorb any losses sustained currently rather than to permit an accumulation of repossessed collateral. If this procedure is followed, the practice of carrying such merchandise on the books of the finance company at a value equal to the uncollected balance of the notes at date of repossession is usually acceptable, but if it is found that a considerable amount of repossessed collateral is on hand at the date of the balance-sheet, inquiry should be made as to the probable realizable value of such assets, and any estimated loss should be written off by reducing the assets to this value. Theoretically, losses, either realized or anticipated, arising from disposition of repossessed collateral, should be charged to the reserve for bad debts, but the practice of some finance companies is to charge such losses against current operations, combining them with repossession expenses in the profit-and-loss statement.

In verification of the company's indebtedness to banks and others for borrowed capital (ordinarily in the form of collateral trust notes authenticated by a trustee, as previously described) it is advisable to obtain both a certificate from the trustee as to the total amount of notes outstanding and direct confirmation from the several holders of the notes covering the individual indebtedness to each. This routine may be readily followed if it is the company's practice to discount collateral trust notes at banks where they are held to maturity; but if the notes obtain general distribution as commercial paper it will no doubt prove impracticable to circularize the individual holders, some of whom may be unknown, and the auditor must rely solely on a certificate

from the trustee for verification of the total amount of notes outstanding as shown by the company's records. It should be ascertained that the amount of collateral pledged with the trustee as security to the outstanding notes is in compliance with the provisions contained in the trust indenture.

A substantial test comparison should be made between the amounts of equities due to dealers and manufacturers, as shown by the books, and the percentages specified in the underlying contracts with dealers relative to the obligations purchased. If the contracts specify that the amounts retained by the finance company are to be refunded to the dealers as and when each instalment of the outstanding obligations is collected, the amount of the dealer's equity should at all times be the specified percentage of the uncollected balance of obligations purchased from that dealer. It is customary for the finance company to maintain a detail record of dealers' equities as well as controls of the outstanding receivables by dealers from whom they were acquired. If, on the other hand, the agreements provide for refund of the equities only upon complete realization of the purchased obligations, the equities shown by the books should be in excess of the amounts computed by applying the specified percentages to the uncollected balances of each dealer's receivables, and the exact amount may be ascertained by reference to the original schedules of acceptances purchased from any particular dealer.

The balance-sheet presentation of the item of dealers' equities is a matter that has not been treated uniformly in the published statements of finance companies. Some companies have shown it as a deduction from the receivables, some as a current liability and others as a reserve on the liability side of the balance-sheet. Each of these methods is open to certain criticism because the nature of the item embraces to some extent all three elements. While it is true that the item must be deducted from the outstanding receivables in order to find the company's actual equity in them, the gross outstandings are an asset of the company, which acts as a collecting agent for the dealers, and upon complete realization of the receivables the dealers' equities become a definite and current liability of the finance company. It must also be pointed out that as the receivables should be stated on the balance-sheet in considerable detail, as already explained, the dealers' equities can be deducted only from the total, else the balance-sheet presentation becomes too lengthy and involved

to be readily understood. The account is a reserve only to the extent that it may be used to make good particular receivables which are in default, and it is in no sense a reserve applicable to the receivables as a whole. It would, therefore, appear that the account should be set forth on the liability side of the balance-sheet as a separate and properly described item, unless the balance-sheet is so drawn as to present a current position, and in that case that portion of the equities which will become payable during the ensuing year, under the terms of the relative notes and financing agreements, should be classified as a current liability and the remaining portion should be excluded. Regarding the value of the account as a reserve for losses, it should be borne in mind that its value as security is much less if the financing agreements provide for payment to the dealers when each instalment is collected than if the equities are payable on receipt of the final instalments of the notes receivable. A corresponding segregation of the total equities should be made on the balance-sheet if both conditions exist.