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Accounting Questions: Deferred Income of Finance Companies

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Accounting Questions

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DEFERRED INCOME OF FINANCE COMPANIES

Question: We are interested in learning the method or methods that have been found most satisfactory and practical in determining the amount to be set up as deferred income of finance companies.

Often the amount reserved as deferred income includes several classes of items, such as unearned interest on notes purchased, interest on borrowed money, operating expenses and other items that might be incurred during the collection of the note. In other cases the unearned interest is carried in one reserve and the amount reserved for expenses in another.

In your reply please give a complete explanation and also advise if the varying maturities of notes have any effect upon the calculations.

Answer: We infer that your correspondent is not in sympathy with the practice of some companies of taking into the current income account the apparent profit which has been made at the time the notes were purchased, disregarding any unearned interest, possible collection expenses or losses. This method is so fundamentally unsound that it requires no further comment.

There does not seem to be any standard method in use by finance companies for determining that portion of income which should be deferred until some later accounting period. In all cases, the interest charge or discount which, together with the service charge, is usually deducted from the face value of the note or notes before the loan is made, is a factor which is definitely ascertainable as to the period in which it is earned. The service charge, on the other hand, is an item which gives rise to many questions as to its proper treatment. It may contain the interest expense for borrowed capital, certain operating expenses, an arbitrary charge for estimated future collection expenses, the cost of acquiring the loan, or selling expense, a provision for probable bad debts, and other sundry items.

Several methods for segregating this differential (the difference between the face amount of the note and the actual amount advanced thereon) into current and deferred income are set forth below:

1. Interest or discount, being definite in amount, is allocated to the period in which earned. No difficulty is encountered as to this item. The service charge, on the other hand, is spread pro-rata on a flat percentage basis over the life of the note or notes on the theory that the cost of collection and other operating expenses which may be included are approximately the same for any note regardless of maturity.

2. Interest is treated in the same manner as above but the service charge is spread on the basis of the reducing balances of loans outstanding on the theory that this charge is primarily to cover possible losses which are likely to be suffered due to the nature of the business.

It would seem that the choice between these methods depends upon the nature of the items included in the service charge. When this is determined, the desirability of either method should be fairly obvious.

3. The average maturity of all notes is first determined and the net increase in the unearned finance charges account during the current accounting period is then spread equally over as many periods as there are to the average maturity date, beginning the distribution with the current period. This will give the amount which is to be taken into current income as earned finance charges. The method has the virtue of being fairly simple in its workings.

4. Interest or discount is set up as deferred until earned. The service charge, representing as its title implies, the fee for the accommodations and services rendered or to be rendered is segregated into so-called reserves for future expenses or costs and current expenses already incurred. For example, experience will furnish data on the average percentage of loss per loan, collection expenses, etc. Reserves are then set up for these items. Expenses in obtaining the account are deducted from the service fee and the balance of such service charge taken into current income. The method is as simple as any and is sound from an accounting point of view.

Each of the above methods has its advantages and the choice of any one will depend on the nature of the accounts which are maintained and the charges which are included in the service charge.