Journal of Accountancy

Volume 58 | Issue 5 Article 7

11-1934

Accounting Questions: Verification of Accounts Receivable, Accounting for the Exchange of Municipal Bonds, Cash Surrender Value of Life Insurance on Balance-Sheet

American Institute of Accountants. Bureau of Information

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

VERIFICATION OF ACCOUNTS RECEIVABLE

Question: With reference to verification of accounts receivable; what percentage of replies do you think are sufficient to certify to their correctness, where there are three hundred (300) accounts amounting to approximately $75,000?

Answer No. 1: Naturally the complete verification of accounts receivable would involve a 100% reply to the confirmations, with the exception of the accounts upon which payment in full was received between the date of the balance-sheet and the signing of the report. Such a complete response, however, is seldom received and ordinarily accountants will certify by stating the method of verification and indicating the percentage of replies that have been received and the percentage of the amount of the accounts receivable covered by such replies.

While it is true that anything less than 100% verification does not fully satisfy the accountant, yet he recognizes the fact that if the confirmations have been duly delivered to all debtors, indicating therein the amount of their indebtedness as shown by the books, that any debtors who disagree with the amounts shown by the accountants' confirmation form will be sure to reply. He, therefore, considers that he has made a reasonable investigation and is reasonably safe in assuming that such debtors as do not reply accept the amounts stated in the confirmation forms as being correct.

This is predicated on the assumption that the replies that are received confirm the accuracy of the accounts which they represent. If replies indicate many differences resulting in disclosing that the books of the client are not accurate, then the accountant will not feel satisfied until he has received as near a 100% confirmation as it is feasible to achieve. This is usually accomplished by sending out one or more "follow-ups" by registered mail with a return receipt requested.

Answer No. 2: It is not possible in our judgment to make a specific reply as a satisfactory percentage of replies to confirmations on accounts receivable depends on the company's system of internal control, the nature of its business, the probability of replies from the type of customers, the amount in dollars of confirmations returned, the payments by customers subsequent to the date at which the examination is made, etc. In short, the question is one of accounting judgment and experience which can not be answered in general percentages.

Answer No. 3: If the writer intends to certify as to the correctness of the accounts receivable, I do not see how any less than 100% of replies to the request for verification can be considered satisfactory. We do not ordinarily expect to certify to the correctness of customer's accounts, but usually are only interested in knowing that the total of all accounts is substantially correct. It is rarely possible to get more than a two-thirds return from requests for verification, and it is usual in reporting on verifications merely to state the percentage of returns and the results indicated on those replies received.

ACCOUNTING FOR THE EXCHANGE OF MUNICIPAL BONDS

Question: One of our clients operates a quasi-public trust in which is held a considerable quantity of municipal bonds, most of which were purchased several years ago. The bonds of some of these municipal communities have a present market value considerably less than cost and the directors of the company contemplate exchanging some of these bonds for bonds of other municipal units which they feel have a better chance to recover values than those of the communities sold. On these exchanges the actual cash involved will be comparatively small amounts necessary to make up the differences of value in the exchange. Furthermore, no question of income tax liability is involved because the corporation is exempt from income tax.

It is our opinion that in the case of such exchanges it is necessary, from the point of view of proper accounting procedure, to have the books reflect each of these transactions in detail rather than to have the new securities show on the books value equal to the cost of the securities which were exchanged, subject to whatever cash adjustment there may be. The directors of the company feel that the latter procedure is permissible.

Answer No. 1: We wish to advise you that we agree with the person who made the inquiry that in the case of such exchanges it is necessary to treat the respective phases of the exchange as closed transactions, i.e., to treat the disposition of securities as a sale at the then market value, and the acquisition of the new securities as a purchase at the then market value. While in certain circumstances the procedure in determining taxable gain or loss might permit of the acquired securities taking the base of those exchanged, the accounting treatment accorded the transactions on the books of the company should, nevertheless, comply with the principle stated.

Answer No. 2: We think it would not be good accounting practice to record the new securities on the books at a value equal to the securities which were exchanged, subject to whatever cash adjustment there may be. It seems to us that a profit or loss should be registered when securities such as those mentioned in your letter are disposed of either by sale or by exchange, that profit or loss to be measured by the fair value of the consideration to be received. The fact that the disposition of these securities is effected by an exchange does not, to our mind, alter the conclusion that there has been a consummated transaction, resulting in a loss (in this case) to the trust, and that the new securities should be recorded on the books of the trust at their fair market value as of the date of the exchange.

CASH SURRENDER VALUE OF LIFE INSURANCE ON BALANCE-SHEET

Question: A corporation carried an insurance policy on the life of a former officer. This policy had been carried for a considerable time and had a substantial cash surrender value. The corporation had borrowed money from the insurance company on this policy. The insured became permanently disabled and the corporation called upon the insurance company to meet the terms of the contract, the insurance company, naturally doing its best to protect its own interest and pay out no money for which it was not contractually liable.

At the close of the corporation's fiscal period, when the audit was made, the controversy was in progress, and a short time later, in the next fiscal period, the insurance company acknowledged liability and made a cash payment and cancelled the outstanding notes on the policy.

The accountant, in his report, listed the surrender value of the policy as an asset and the notes outstanding against the policy.

What notation, if any, should be made on the corporation's balance-sheet or what comments should be made in the report concerning the controversy between the corporation and the insurance company and the subsequent settlement?

Answer No. 1: It is my understanding that the question which reads in part —"What notation, if any, should be made on the corporation's balance-sheet, etc. . . ."—is intended to refer to the balance-sheet and to comments included in the auditor's report.

There are several possible interpretations of the question. The first paragraph states "The insured became permanently disabled," and it then refers to the "terms of the contract" without furnishing complete information as to what the terms were.

If it be assumed that the corporation was asking for payment by the insurance company of the excess of cash-surrender value over loans made in accordance with amounts shown in the balance-sheet, and if the settlement was made before the auditor's report was completed, then it would hardly seem necessary for the auditor to make any special reference to the controversy in his report.

On the other hand, if the insurance policy carried a "disability" clause or some other provision under which the corporation was claiming an amount substantially different from any shown in the balance-sheet or one which could be computed therefrom, then I believe different procedure would be in order. In such circumstances it would seem to me that if the auditor's report was actually completed prior to the time of settlement of the controversy between the corporation and the insurance company the auditor's duty would be reasonably fulfilled if, in his comments, he stated the amount which the corporation was claiming from the insurance company, gave a brief statement of his understanding of the controversy, and indicated the effect which the corporation's winning or losing the controversy would have on the balance-sheet.

If, on the other hand, the controversy related to amounts different from those on the balance-sheet and was settled before the completion of the auditor's work, it would seem to me that it would be advisable for the auditor to include in his comments a brief statement as to the result of the settlement and to indicate the effect of the settlement upon the balance-sheet. If the amount of the settlement was sufficiently large to affect substantially the results shown by the balance-sheet, then it might be well to state in a note on the balance-sheet the date of settlement, the fact that settlement had been made and to indicate the effect of the settlement on the balance-sheet. I think that decision as to whether notation should be made on the balance-sheet or only in the comments would have to depend upon opinion and judgment in the light of all of the circumstances in the case.

The foregoing paragraphs are written on the assumption that the delay in payment was due to a real controversy and not merely to time consumed in furnishing required proof of a fact, such as disability; also on the assumption that the amounts involved are large enough to be of importance in the balance-sheet. If the amounts are relatively unimportant, then it might be unnecessary for the auditor to comment upon the matter at all or to make any notation regarding it upon the balance-sheet.