University of Mississippi

eGrove

Statements of Position

American Institute of Certified Public Accountants (AICPA) Historical Collection

1983

Audits of Finance Companies, Draft 10/4/83

American Institute of Certified Public Accountants. Finance Companies Guide Special Committee

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_sop

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

American Institute of Certified Public Accountants. Finance Companies Guide Special Committee, "Audits of Finance Companies, Draft 10/4/83" (1983). *Statements of Position*. 764.
https://egrove.olemiss.edu/aicpa_sop/764

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Statements of Position by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

DRAFT
10/4/83

AUDITS OF FINANCE COMPANIES

Prepared by
Finance Companies Guide Special Committee
Accounting Standards Division
American Institute of Certified Public Accounts

TABLE OF CONTENTS

Activities of Finance Companies	pp. 1 - 18
Consumer Finance Activities	pp. 2 - 6
Direct Consumer Loans	p. 2
Retail Sales Contracts	p. 4
Insurance Services	p. 5
Commercial Finance Activities	pp. 6 - 14
Factoring	p. 7
Revolving Loans	p. 9
Receivables Portfolio Purchase Agreements	p. 10
Installment Loans	p. 11
Floor Plan Loans	p. 11
Leases	p. 12
Participations	p. 14
Debt Financing of Finance Companies	pp. 14 - 15
Regulation	pp. 15 - 18
Direct Consumer Lending	p. 15
Retail Sales Financing	p. 16
Federal Consumer Credit Protection Act	p. 16
Uniform Commercial Code	p. 17

Finance Receivables, Finance Income, and Operating Procedures pp. 19 - 95

Accounting for Finance Receivables pp. 19 - 20

Accounting for the Allowance for Losses pp. 20 - 21

Accounting for Interest Income pp. 22 - 28

Measurement p. 23

Recognition p. 23

Nonrefundable Fees p. 26

Rebates p. 28

Loan Acquisition Costs pp. 28 - 29

Accounting for Factoring Commissions pp. 29 - 30

Accounting for Advances and Overadvances to Factoring Clients pp. 30 - 31

Accounting for Repossessed Assets Acquired in Liquidation of Receivables pp. 31 - 36

Recourse Arrangements on Sales of Retail Contracts p. 32

Lower of Unpaid Balance and Net Realizable Value p. 34

Accounting for Dealer Reserves and Holdbacks p. 36

Financial Statement Presentation and Disclosure pp. 36 - 38

Internal Accounting Controls pp. 39 - 50

Receivables and Income p. 39

Loan and Related Files p. 44

Repossessed Assets Acquired in Liquidation of Receivables p. 46

Dealer Reserves p. 47

Branch Offices p. 48

Audit Objectives for Receivables and Finance Income p. 50

Auditing Receivables and Allowance for Losses — pp. 51 - 53

Credit Approval Policies — pp. 54 - 61

- Consumer Credit Approval — p. 54
- Commercial Credit Approval — p. 55
- Factoring — p. 58

Collections — pp. 61 - 62

Aging Schedules — pp. 62 - 65

Charge Off Policies — pp. 65 - 67

Other Credits to Receivables — pp. 67 - 69

- Chargebacks — p. 68
- Anticipations — p. 68

Confirmation Procedures — pp. 69 - 72

- No Mail Accounts — p. 71
- Confirming Purchased Customer Receivables — p. 71

Ratios — pp. 72 - 75

Loans to Related Parties — p. 76

Collateralized Loans — pp. 76 - 82

- Consumer Goods — p. 77
- Receivables — p. 77
- Inventories — p. 79
- Property and Equipment — p. 81

EDP Considerations — pp. 82 - 83

Branch Audits — pp. 83 - 88

Leases — pp. 88 - 90

Income — pp. 90 - 92

- Statutory Regulations — p. 92

Repossessed Assets Acquired in Liquidation of Receivables — p. 93

Dealer Reserves and Holdbacks — pp. 94 - 95

Capitalization of Finance Companies pp. 96 - 110

Bank Lines of Credit pp. 98 - 99

Commercial Paper pp. 99 - 100

Interest Coverage Ratios pp. 101 - 103

Credit Questionnaires pp. 103 - 105

Accounting pp. 105 - 106

Financial Statement Presentation pp. 106 - 107

Auditing pp. 107 - 110

Compliance Reports p. 108

Credit Questionnaires p. 109

Participations pp. 111 - 113

Accounting p. 112

Financial Statement Presentation p. 112

Auditing p. 113

Captive Insurance Activities pp. 114 - 128

Types of Insurance Coverage pp. 114 - 117

Credit Life p. 115

Credit Accident and Health p. 116

Property and Liability p. 117

Writing Policies pp. 117 - 118

Commissions p. 118

Consolidation Policy p. 119

Accounting pp. 119 - 124

Premium Income p. 119

Commissions p. 122

Policy and Claim Reserves p. 122

State Laws p. 123

Investment Portfolios p. 124

Financial Statement Presentation pp. 124 - 127

Auditing p. 128

Acquisitions of Finance Companies and Operations pp. 129 - 133

Appendix A: Glossary pp. 134 - 163

Appendix B: Illustrative Financial Statements pp. 164 - 177

Activities of Finance Companies

Finance companies provide lending and financing services to consumers (consumer financing) and to business enterprises (commercial financing). Some finance companies engage solely in consumer or commercial financing activities while others provide both types. Consumer and commercial financing encompass wide varieties of activities, many of which are discussed in this chapter.

Manufacturers, retailers, wholesalers, and various other business enterprises may provide financing to encourage customers to buy their products and services. Such financing, generally known as captive finance activities, may be provided directly by those companies or through affiliated companies. Although most such companies originally financed only their own products and services, many have expanded their financing activities to include a wide variety of products and services sold by unaffiliated businesses. This Guide applies to all finance companies and to both independent and captive financing activities of nonfinancial companies.

Consumer Finance Activities

Consumer finance activities comprise direct consumer loans, including mortgage loans, and retail sales financing. Many companies that provide consumer financing also offer a variety of insurance services to their borrowers.

Direct Consumer Loans. Direct consumer loans usually are repayable in installments and may be collateralized by household goods and other chattels or may be unsecured. The creditworthiness of the individual borrower is generally the lender's primary consideration in making direct consumer loans; however, as the size of the loan increases, other factors, such as the existence and value of collateral or the presence of a comaker, may become increasingly important.

Mortgage loans on real estate are a form of direct consumer lending in which the collateral are the borrowers' equity interests in their homes. Such mortgage loans differ from purchase money mortgages, in which sellers or third parties grant borrowers the mortgages as part of the purchase price. Many mortgage loans issued by finance companies are second mortgage loans that are subordinate to the claims of one or more prior lenders if borrowers default.

Mortgage loans generally have larger principal amounts and lower average interest rates than other direct consumer loans. Lenders consider borrowers, who are homeowners, to be good credit risks because the loan collateral are the borrowers' homes and, even if the borrowers default, residential real estate tends to hold resale value to a greater degree than other forms of collateral. In addition, those who own homes tend to have more equity and stability than those who do not own homes. Loss experience on mortgage loans generally has been less than on other forms of consumer loans.

Mortgage lending, however, involves other risks. If the real estate market weakens, perhaps due to severe unemployment in a geographical area, substantial losses may be incurred. Mortgage loans tend to have longer repayment periods than other types of direct consumer loans, which increases a lender's risk. Because first mortgage loans have priority, a second mortgage lender generally must buy out prior lenders or take title subject to the rights of such lenders. Therefore, second mortgage lenders may need to make significant cash payments to protect collateral.

Retail Sales Contracts. Many sales of consumer goods and services are financed through retail sales contracts. Those contracts are made, directly or through retailers and dealers, with individual consumers. The contracts often are sold to a finance company. Retail sales contracts are commonly called three party paper because they involve three parties: an individual borrower, a dealer or distributor, and a finance company.

Retail sales contracts usually are sold at a discount to a finance company under terms that permit the dealers or distributors to share a portion of the finance charges paid by each borrower. Provisions for dealers' shares of finance charges vary among finance companies and dealers as well as among dealers who sell their retail contracts to the same finance company. The dealers' shares of finance charges may be based on percentages of the finance charges or the principal amounts of the retail contracts, on a fixed amount for each contract, or on other negotiated terms.

Some agreements provide for a portion of amounts due to the dealers to be withheld to cover certain contingencies. Other agreements provide no such conditions. Terms for payment of balances withheld from dealers, called dealer reserves, also vary. Dealer reserves may be reduced for losses and rebates on

related loans. The remaining balances generally are paid periodically when amounts exceed agreed minimum percentages of related outstanding receivables. Minimum percentages generally are based on loss experience for contracts previously bought from such delaers. Alternatively, dealer reserves may be paid only after customers' loans are paid off in full.

Dealer holdbacks on cash advances are portions of net cash proceeds withheld from dealers on specific contracts. Dealer holdbacks may be required when greater than normal credit risks are involved or for other reasons, including market conditions which help the finance company negotiate such security. The risks involved may relate to the types of collateral, excessive loan periods, or credit ratings of the borrowers involved. Dealer holdbacks may be required regardless of whether applicable contracts are bought with or without recourse.

Insurance Services. Many companies engaged in consumer finance activities also offer insurance coverage to their customers. Those coverages may include life insurance to assure that the remaining loan balance is repaid if the borrower dies before the loan is repaid; accident and health insurance to help continue loan payments if the borrower becomes sick or

disabled for an extended period; and property insurance to protect the value of the loan collateral against damage, theft, or destruction. Some lenders may provide insurance through insurance subsidiaries. Others may act as brokers and, if licensed, receive commissions from independent insurers. Lenders also may receive retrospective rate credits on group policies issued by independent insurers. In still other instances, policies may be written by independent insurance companies and then reinsured by insurance subsidiaries of finance companies.

Commercial Finance Activities

Commercial and industrial finance activities provide a wide range of services, including factoring arrangements, revolving loans, installment loans, wholesale loans, portfolio purchase agreements, and lease financing to a variety of clients, including manufacturers, wholesalers, retailers, and service organizations. Many commercial finance activities are called asset based financial services because of the lender's reliance on collateral. This Guide refers to all such activities as commercial finance activities.

Commercial loans generally are collateralized by various types of assets, including notes and accounts receivable, inventories, and property, plant, and equipment.

Factoring. Factoring is the purchase, usually without recourse, of trade accounts receivable. A company that purchases trade accounts receivable is commonly called a factor. The factor buys trade accounts receivable from clients. Clients' customers often repay factors directly by means of a lockbox arrangement. Factored accounts receivable are not collateral for loans to clients; rather, the receivables are purchased outright. Except in certain instances involving advance factoring as described below, no loan is made. However, the client continues to remain contractually responsible for customer claims for defective merchandise.

A factor buys the client's invoices, net of trade and cash discounts granted to customers, and provides services to the client that include assuming the client's responsibilities of credit review, bookkeeping, and collection. The factor also assumes risks of credit losses if it has approved a customer's credit before the client ships goods. If the factor does not approve a customer's credit, shipment is made at the client's risk. A factor buying accounts with recourse, however, provides bookkeeping and collection services and assumes no credit risk,

unless both the client and its customers become insolvent. A factor receives fees for services rendered to the client, usually computed as a percentage of net receivables bought.

Factoring usually requires that customer notification be placed on the face of invoices indicating that accounts have been sold and that factors are to be paid directly. Under nonnotification contracts, customers continue to pay the client and normally are unaware of factor ownership of the related accounts.

Two types of factoring arrangements are maturity and advance. Maturity factoring requires the factor to pay the client only when each related account is due (generally based on an average due date) or collected. In contrast, advance factor-allows a client to draw cash advances against the balance of the receivables before they are due or collected. The factor charges interest from the date advances are drawn to the date the receivables are due or collected, at rates usually based on a stipulated percentage over commercial banks' prime rates.

In calculating limits for payments under an advance factoring arrangement, the factor generally retains a reserve against unpaid receivables to cover claims, returns, allowances, and other adjustments. The reserve ordinarily is a percentage of

outstanding receivables based on the factor's experience and judgment. Overadvances occur when a client draws cash advances that exceed uncollected receivable balances. A factor may permit an overadvance to finance a client's seasonal business requirements. Such overadvances often can be anticipated. Overadvances also may result from unanticipated chargebacks, such as those resulting from defective merchandise and price disputes, because the client continues to remain contractually responsible for such items. Overadvances may be collateralized by other assets, such as inventory or fixed assets, or may be secured by personal guarantees. Under certain circumstances, overadvances also may be unsecured. Overadvances generally are reduced when receivables from additional sales are factored.

Revolving Loans. Revolving loans, sometimes called working capital loans, generally provide a borrower with cash needed for business operations. The loans usually are collateralized by accounts receivable and generally cannot exceed agreed percentages of the face values of those receivables. Such loans may be referred to as accounts receivable loans. Collections against such receivables usually are remitted daily by the borrower to

the lender. Depending on terms of the agreement, new accounts receivable acquired by borrowers and pledged to lenders may immediately qualify as collateral.

A lender's policy may permit eligible collateral for revolving loans to be expanded to include inventories if borrowers require additional cash. In such cases, additional advances may be referred to as <u>inventory loans</u>. Inventory loans supplementing accounts receivable loans are common when seasonal businesses generate relatively low amounts of accounts receivable but require large inventories in anticipation of the selling season. When the inventories are sold, loans are paid off or accounts receivable generated by the sales replace inventories as collateral for such loans.

<u>Receivables Portfolio Purchase Agreements.</u> Unlike factoring arrangements, a receivables portfolio purchase is a bulk purchase of trade accounts or finance receivables, often intended to provide the seller with cash for operations or improved financial ratios. Because the buyer usually assumes all credit risks, a stipulated percentage of the purchase price is often retained to absort credit losses. Credit losses in excess of that amount are borne by the finance company.

Terms of portfolio purchase agreements vary. Some provide for single purchases; others provide for continuing purchases on a revolving basis. Also, customers may not be notified of purchases or may be required to pay the finance company directly. Receivables acquired under this type of agreement generally are accounted for as assets owned by the finance company and are not considered to represent collateral for loans made to sellers.

Installment Loans. Finance companies may make commercial installment loans collateralized by capital assets. The amount of such installment loans usually are based on percentages of the collateral market value and vary depending on policies of the finance company, financial condition of the borrower, and liquidity of the pledged collateral. Finance companies also may make mortgage loans to commercial borrowers. Some installment loans are made under conditional sales contracts, in which title to the collateral is in the name of the lender until loans are repaid.

Floor Plan Loans. Floor plan loans, commonly called wholesale loans, are made to businesses to finance inventory purchases. Some finance companies make floor plan loans primarily to induce dealers to allow the finance companies to buy

the retail contracts generated from sales of inventories. Inventories serve as collateral for floor plan loans, the amounts of which usually are limited to the wholesale values of the inventories. Unlike revolving loans collateralized by inventory, floor plan loans generally are collateralized by specific inventory items. They also require minimum payments, known as *curtailments*, over time with balances becoming due when collateral is sold or at the end of a stipulated period.

Leases. Leases are a common form of financing the acquisition of equipment. Despite similarities between leases and other forms of installment loans, continuing legal and tax changes have resulted in language and procedures unique to leasing activities.

Operating leases generally run for periods shorter than useful lives of related assets. Under an operating lease, the lessor retains legal title and is considered to be the owner for tax purposes. At the expiration of the lease, the asset is either sold or leased again.

Direct finance leases are similar to other forms of installment lending in that virtually all of the risks of day to day operations are transferred to the lessee. However, unlike

other forms of installment lending, most of the other benefits and risks of ownership are retained by the lessor.

Leveraged leasing involves at least three parties: a lessee, a long term creditor, and a lessor (commonly called the equity participant). The lessor may, however, be represented by an owner trustee. Finance companies frequently enter into leveraged lease transactions as lessors or equity participants. A substantial portion of the purchase price of assets is supplied nonrecourse to the trust by unaffiliated long term lenders. If a lessee defaults on lease payments, the long term lender has no recourse to the lessee but usually has recourse to the specific property being leased. The gross return to a finance company is measured by the discounted net cash receipts generated from the sum of investment tax credits and depreciation tax effects, rental payments less debt service costs, and the estimated residual values of equipment leased.

Leasing arrangements also may be categorized as transactional, involving direct negotiations between a lessor and lessee, and as vendor leasing. Transactional lease financinq tends to be a time consuming and expensive process that is economically feasible only for transactions sufficiently large to generate profits in excess of the costs of preparing custom made

leases. Vendor leasing has developed to finance asset acquisitions that would not be profitable to finance with transactional leasing arrangements. Vendor leasing involves a third party lessor that offers a vendor's or manufacturer's customers a basic finance package. The lessor usually fixes interest rates within given dollar ranges and uses a standardized credit scoring process to approve credit and keep documentation simple. As a result, vendors are promptly paid for sales and avoid the need to perform inhouse financing operations.

Participations. A commercial finance company sometimes enters into participation agreements with other lenders to maintain acceptable levels of risk or to provide the borrower with lower costs or additional services. The agreements generally provide for losses to be shared mainly in proportion to the cash invested by each.

Debt Financing of Finance Companies

The basic activity of finance companies is to borrow money at wholesale and lend it at retail. Finance companies usually are leveraged with outstanding borrowings equal to several times equity. A finance company may have senior debt, senior subordinated debt, and junior subordinated debt. The existence of restrictive covenants in debt agreements are common.

Robert Morris Associates, an organization of bank lending officers, has developed financial information questionnaires for lenders engaged in retail sales financing, direct cash lending, commercial financing, and captive financing activities. Finance companies generally complete and submit the questionnaires as a prerequisite to obtaining credit from commercial banks. Bank officers use the information to analyze the operations and creditworthiness of finance companies.

Regulation

Regulation of finance companies historically has not been as pervasive as that applied to banking, insurance and certain other financial activities. Nevertheless, numerous state and federal statutes affect finance companies' operations. Some statutes apply only to specific types of activities. Regulations affecting finance companies generally are limited to matters such as repayment terms, loan amounts, interest rates, and collateral; they do not deal with financial accounting and reporting.

Direct Consumer Lending. State laws regulating consumer finance operations are designated as licensed lending, small loan, or consumer financing statutes. Diverse state statutes usually regulate mortgage loans and other direct consumer loans.

Usually, each branch office of a company that makes direct consumer loans must be licensed by the state in which the office is located. State licensing authorities, many of which are divisions of state banking departments, may examine loans made to ascertain that loans comply with statutory provisions and to determine whether rebates and refunds are properly computed.

Retail Sales Financing. Laws governing retail sales financing may require offices to be licensed or registered. The laws vary widely among states. For example, all goods statutes may govern consumer goods loans; other goods laws may govern loans for consumer goods excluding automobiles. Additional statutes may affect revolving credit arrangements.

Federal Consumer Credit Protection Act. The Federal Consumer Protection Act (Truth in Lending Act), through Federal Reserve Regulation Z, requires disclosure of finance charges and annual percentage rates so consumers can more readily compare various credit terms. It does not set maximum or minimum rates of charges.

<u>Uniform Commercial Code</u>. The Uniform Commercial Code (UCC), fully adopted by all states except Louisiana at the date of this Guide, is a set of statutes designed to provide consistency among state laws concerning various commercial transactions. Article 9 of the UCC, which deals with secured transactions, contains the most significant laws that affect financing activities. It applies to two party collateralized loan transactions as well as to sales of accounts receivable and retail sales contracts, which are essentially three party transactions.

Article 9 generally provides certain rights to the parties involved in a secured transaction, in particular, the secured party and the debtor. The definition of a secured party includes a lender who obtains a security interest as well as a buyer of trade accounts receivable or retail sales contracts. The definition of a debtor similarly includes both the individual obligor and the seller of trade accounts receivable or retail sales contracts.

Under Article 9, all transactions creating a security interest are treated alike. The Article sets forth various procedures necessary to safeguard, or <u>perfect</u>, the potential creditor's interest in collateral against the interests of other creditors. Those procedures generally require that the creditor file a

financing statement at a specified public office. The statement, available for public inspection, provides legal notice of a perfected security interest. Consequently, before making collateralized loans, prospective lenders generally search the public files to determine if other lenders have already filed financing statements against the collateral.

For certain commercial financing activities, Article 9 permits continuing general lien arrangements, in which a security interest applies continuously to all present and future collateral of the type described in the financing statement for as long as the financing statement is effective. That provision simplifies, for example, maintaining security interests in purchased receivables and in collateral securing revolving loans. The underlying collateral become subject to the security interest as soon as they come into existence or the debtor's possession.

The financing statement is generally effective for five years from the date of filing and then lapses, unless a continuation statement is filed within the month period before the expiration date. The continuation statement extends the security interest for another five years.

Finance Receivables, Finance Income, and Operating Procedures

Finance receivables normally are the most significant portion of a finance company's total assets. This chapter describes many aspects of accounting for and auditing finance receivables and related accounts.

Accounting for Finance Receivables

Finance receivables include both interest bearing (simple interest) and precompute (discount) loans. State regulatory laws often prescribe the types of loans that can be made; otherwise, the type of loan is a matter of operating and customer choice. The face amount of an interest bearing loan equals the amount of cash loaned; unearned interest is not determined. In a discount loan, however, the amount of cash loaned to the borrower is less than the face amount of the loan. The difference represents unearned interest income to be earned by the lender over the life of the loan. The borrower generally is entitled to pay less than the remaining unpaid face amount if the balance due on a discount

loan is paid off faster than contractually scheduled. That difference, commonly called a rebate, represents a cancellation of a portion of the precomputed interest charge.

Sales type leases and direct finance leases are substantially similar to other forms of installment loans. However, accounting for lease transactions may differ from accounting for other financing transactions. FASB Statement No. 13, Accounting for Leases, and its related amendments and interpretations, prescribe accounting for leases and their financial statement presentation.

Accounting for the Allowance for Losses

Expected credit losses, which should be provided for in the allowance for losses, should be recognized as expenses when the losses are deemed probable and their amounts can be reasonably estimated in accordance with FASB Statement No. 5. The adequacy of the allowance for losses may be considered in two segments. First, the enterprise's credit loss experience percentage may be applied to loans as they are made or acquired. That technique is particularly useful for relatively homogenous

consumer loans. Second, outstanding loans may be periodically evaluated to determine which loans appear likely to result in credit losses.

Credit losses that result from substantial changes in economic conditions or other unexpected events should be reflected in the allowance for losses and recognized as expenses when they occur or are estimable. Information available before the issuance of the financial statements should indicate that those conditions or events are at least probable and the amount can reasonably be estimated.

All identifiable bad debts should be written off before a company assesses the adequacy of the remaining allowance for losses. Evidence of bad debts may include deficiency balances remaining after collateral has been sold, repossessed properties for which net realizable values are obviously less than the book balances, accounts delinquent for an extended period, accounts placed with attorneys for collection, loans receivable from bankrupt borrowers, and wholesale loan receivables for which related collateral have been sold out of trust or are insufficient to repay loan balances.

Accounting for Interest Income

The distinction between interest bearing and discount basis loans has no economic significance and no accounting significance. Paragraph 15 of APB Opinion 21 requires, among other things, that discounts on receivables and payables be amortized as interest income or expense. The concepts and principles discussed in this chapter therefore apply to both types of loans.

Interest income should be measured and recognized in a manner that reflects the economic substance of the transactions. Interest income derived from a loan accrues continuously over the periods that a finance company's resources are held by others. The major factors that determine interest income are

- the amount of money provided to others,
- the periods over which the money is provided, and
- the effective interest rate.

With any two of those elements held constant, the amount of revenue varies directly with the remaining element.

Measurement. The interest (actuarial) method should be used to account for interest income because it best reflects the economic substance of loans as described above. Under that method, interest on fixed rate installment loans is measured and accrued over the lives of the loans to produce constant rates of interest (yields) when applied to the outstanding loan balances at any time in the lives of the loans. Application of the method produces loans carried at amounts equal to future receipts discounted at interest rates implicit in original loan agreements, excluding differences resulting from credit losses.

Recognition. A finance company's revenues from loans should be accrued over time in accordance with terms of the contracts, not solely when money is paid or received. The amount of the enterprise's total assets increases as interest is earned over periods that its resources are held by others. Even if collections are not timely, the amounts at which assets are recorded in the form of receivables generally should continue to increase. If collection is doubtful, continuing to accrue income would not reflect economic substance. Accruals or amortization

Accruals or amortization of discount should therefore be suspended if collectibility of interest or principal becomes uncertain. Examples of events that could cause such uncertainty on consumer loans are

- the borrower is in default under the terms of the loan agreement and interest or principal payments are a certain number of days past due,
- the ability of the borrower to repay is in doubt because of events such as loss of employment or bankruptcy, and
- the loan terms have been renegotiated.

Identifying commercial loans on which interest should be suspended is, at least mechanically, more difficult because, unlike consumer loans they lack homogeneous characteristics. In addition to the factors described above, considerations may include whether

- significant unsecured balances are due from debtors suffering continued operating losses,
- the financial condition of the debtor is weak,
- the outlook for the debtor's industry is unfavorable,

- the ratio of collateral values to loans has decreased due to changes in market conditions, and
- a portion of the unpaid principal or accrued interest has been written off.

Accrued but unpaid interest should not be eliminated; rather potential uncollectibility should be covered by the allowance for losses.

Accrual of interest generally should not be resumed until future collectibility of the loan is reasonably assured. Determining future collectibility is a matter of judgement that depends on considerations such as

- whether the customer has resumed making regular payments for a certain number of installments,
- whether the reason for the customer's delinquency has been eliminated (such as reemployment of a consumer borrower or an improved economic outlook for a commercial borrower) or was an isolated circumstance unlikely to recur,

- whether an increase in the ratio of collateral values to loan amounts has occurred, and
- other substantive indications of the customer regaining an ability to repay the loan.

Nonrefundable Fees. Finance companies may charge various types of fees to customers in connection with lending transactions, including

- origination fees - amounts charged for originating loans. The amounts may be intended to cover the cost of underwriting, loan application processing, and reviewing legal titles to properties involved in the loans. Origination fees commonly are called points.
- commitment fees - consideration potential borrowers pay to potential lenders for promises to lend money in the future.
- extension fees (also known as deferments) - consideration debtors pay to extend payment terms of discount loans.
- delinquency fees - amounts debtors pay because of late payments on discount loans.

- prepayment penalties - amounts borrowers pay to liquidate loans before contractual maturity.

In its basic revenue earning process, a finance company is compensated for allowing others to use its resources. The designation of that compensation, either as interest or fee income, does not alter the economic substance of the services rendered. Therefore, nonrefundable fees charged at the inception of loans, such as origination fees, are adjustments to the effective yields on loans and should be recognized in income over the lives of the loans using the interest method. Commitment and extension fees also represent adjustments to the effective yields on loans and should be recognized in income using the interest method. Delinquency fees, which are not adjustments to unearned interest income, should be recognized in income when collected, not when charged. That approach prevents recognition of delinquency fees before their receipt since collection on such loans generally is not assured beyond a reasonable doubt. Prepayment penalties also are not adjustments to unearned interest income and should be recognized in income when collected.

<u>Rebates</u>. Rebates are cancellations of portions of the initially calculated or precomputed finance charges on discount loans when balances due in installments are paid ahead of schedule. Rebate calculations generally are governed by state law. Accrual of interest income on discount loans should not be affected by rebate contingencies, because such amounts merely correct original estimates of interest income. Rebates should be recognized as adjustments to income when loans are prepaid or renewed.

<u>Loan Acquisition Costs</u>

Loan acquisition costs should be narrowly defined as initial direct costs of new loans that are directly associated with the production of new loans. Those costs include commissions or other fees paid to acquire loans, costs of credit investigations, and other costs that clearly vary directly with the production of new loans.

Initial direct costs should be capitalized and amortized on the interest method over the shorter of the expected lives or the contractual terms of the loans. Such costs should not be capitalized beyond the term of the original loan in anticipation

of extensions, renewals, or refinancing. The types of costs capitalized should be disclosed in the notes to the financial statements.

For a loan acquisition cost to clearly vary with the production of new loans, there must be a direct cause and effect relationship between loan activity and the cost. Internal costs rarely if ever meet the requirement to clearly vary with the production of new loans and qualify for deferral.

Certain costs, such as advertising and marketing costs, will affect or be affected by the volume of new business. However, the intent of the narrow definition of initial direct costs is to exclude such costs because it is difficult to demonstrate that such costs clearly vary directly with the production of new loans.

Accounting for Factoring Commissions

Finance companies consider the extent of services to be provided under factoring arrangements by reviewing prospective clients' business operations. The amount a finance company charges as a factoring commission is based on such considerations as sales volume, number of invoices issued monthly, collection activities, and patterns of returns and chargebacks. If the

finance company buys a client's receivables, the client is charged a commission, usually based on a percentage of receivables purchased, which is derived from the extent of services expected to be provided and the degree of credit risk assumed.

Finance companies generally compute commissions and recognize the entire amount as revenue at the time customer receivables are bought. However, only a portion of the services is rendered when the factor approves the customer credit; the remainder is provided over the period to the date that the customer account is settled. Recognizing a portion of factoring commissions as revenue over the entire period in which services are provided is therefore conceptually preferable. Nevertheless, finance companies rarely do so for practical reasons. First, establishing the reasonableness of a method of allocation would be difficult. Second, the effects of recognizing entire amounts of commissions without allocation generally are immaterial because the services are usually provided over a short period.

Accounting for Advances and Overadvances to Factoring Clients

Under an advance factoring arrangement, a finance company generally does not treat advances to a client as receivables for

financial statement purposes. Instead, advances are offset against amounts owed to the client from the purchase of the client's customer receivables. Such treatment is based on the finance company's expectation of repayment through collections of customer receivables rather than direct repayment from the client.

Finance companies generally limit advances to a percentage of the unpaid amount of factored receivables. If a client requires advances in excess of the maximum permitted under the factoring arrangement, the finance company may renegotiate the percentage limitation on advances or require the client to grant a security interest in inventory or other assets. Overadvances, which are amounts in excess of outstanding receivables bought, create additional credit risk exposure for the lender. Such overadvances are recorded as loans receivable and are segregated from customer receivables bought under factoring arrangements.

Accounting for Repossessed Assets Acquired in Liquidation of Receivables

When a finance company forecloses on a loan deemed uncollectible, it may repossess goods or other properties that collateralize the loan. After repossession, the collateral is

usually sold as quickly as possible to minimize loss. Repossessed assets acquired in loan liquidations may be significant because they absorb or reduce credit losses from defaulted loans.

Certain types of collateral may be readily saleable in wholesale or other markets. Repossessions of such collateral are common. Repossessions of other types of collateral, such as household goods, usually entail losses because the market values of such collateral are so low that costs of repossession exceed expected sale proceeds. The primary purpose of such collateral may be to prompt a borrower to repay a loan out of concern that a repossession could occur.

Repossessions on commercial loans may be difficult to evaluate and result in substantial losses because of the bargain prices usually associated with reselling inventories and property, plant, and equipment. Auctioneers or other specialists may be needed to help sell the specialized types of properties that usually collateralize commercal loans.

Recourse Arrangements on Sales of Retail Contracts. Whether the finance company or the dealers are responsible for repossession losses originating from retail contracts depends on

how the agreements provide for recourse between the parties. Terms of recourse arrangements, which vary considerably, include

- <u>full recourse</u> -- The dealer is required to pay off the uncollected receivable balance to the finance company at the date of repossession. Such balances ordinarily are net of unearned insurance premiums and finance income, and dealers are responsible for selling the repossessed property.
- <u>partial or limited recourse</u> -- The dealer is liable for repossession losses up to an agreed amount (for example, the balance in his dealer's reserve account). The dealer's liability also may be partialy or fully limited after passage of a defined period of time.
- <u>nonrecourse</u> -- Loss is borne entirely by the finance company.

Repurchase agreements, which may incorporate recourse provisions as described above, also may exist between the finance

company and dealers. While such agreements vary, the finance company usually repossesses the collateral for sale to the dealers before the dealers can be held responsible for repossession losses. The dealer may settle a repurchase obligation in cash or, if permitted by the finance company, through substituting other retail contracts.

Lower of Unpaid Balance and Net Realizable Value. Repossessed goods should be recorded at the lower of the unpaid loan balances and net realizable values of such goods, with offsetting credits to the borrowers' unpaid loan balances. Net realizable values should be measured by fair market values of the goods less estimated disposal costs. The fair values of such goods are amounts that reasonably could be expected to be received for them in current sales between willing buyers and willing sellers, that is, other than in forced or liquidation sales. Borrowers' accounts should be charged for expenses of repossessions and credited with proceeds from cancellation of insurance, rebates of unearned finance income, and proceeds from sales of repossessed properties. Borrowers' accounts also may be credited for amounts transferred from dealer reserves in accordance with provisions of

retail sales financing agreements. The remaining balances in the borrowers' accounts, commonly called <u>deficiency balances</u>, are adjustments of previous loss estimates and should be charged to the allowance for losses. Repossessed goods may be included with receivables unless the assets are expected to be held for a significant time. That may occur if an asset is not readily saleable or the finance company intends to operate the asset as a business activity.

Costs of capital improvements incurred in readying the repossessed properties for sale that increase net realizable values should be charged to the carrying amounts of the repossessed properties. However, no amounts should be capitalized that would increase the carrying amounts above net realizable values. Maintenance and other holding costs regularly incurred after repossession should be expensed as incurred. The difference between the carrying amount of repossessed assets and the amount at which they are subsequently sold should be charged to the allowance for losses. However, if the finance company has

converted the repossessed assets into operating assets, the difference between the carrying amount of the assets and the amount at which they are subsequently sold should be recognized as a gain or loss.

Accounting for Dealer Reserves and Holdbacks

Finance companies account for dealer reserves and holdbacks as liabilities. Dealer reserve accounts are credited for the contractually agreed dealer's share of the finance charges, Dealer reserve accounts may be charged for portions of finance income not earned as a result of customers paying off contracts before maturity. Charges also result from losses on full or partial recourse contracts and from payments to dealers in excess of minimum requirements.

Financial Statement Presentation and Disclosure

Discount loans and interest bearing loans should be presented similarly in the balance sheet, because the economic substance of the transactions is essentially the same. To accomplish that, discount loans should be presented net of unearned interest. Disclosure of the unearned interest is generally not meaningful; if disclosed, it should be in the notes and not on the face of the balance sheet.

In the balance sheet, the allowance for losses should be deducted from receivables. The provision for credit losses should be presented separately as an expense item in the income statement.

The composition of finance receivables should be disclosed in a manner that best sets forth the types of risk and liquidity involved. For example, the balance sheet or the notes to the financial statements may separately show the major types of loans. In addition, financial statements should disclose interest and finance charges earned separately from other types of income such as insurance premiums. Repossessed assets acquired in liquidations generally may be included with receivables in the balance sheet and separately disclosed in the notes. However, repossessed assets should not be combined with receivables if the assets are not readily saleable, or if the finance company intends to operate the assets as a business.

Similarly, the expanded possible range in size and term of receivables within each receivable type has created a need for

disclosure of information regarding terms and maturities. However, disclosures of contractual maturities may not be as meaningful as disclosures of collections on certain types of loans, particularly direct consumer loans, because renewal policies often permit borrowers to repay such loans over time periods that differ from contractual maturities and customer repayment practices may result in liquidation well ahead of contractual terms. Therefore, contractual maturities of those loans should be disclosed in the financial statements along with an indication of prior cash collection experiences.

The summary of significant accounting policies should explain the method of income recognition used. Policies for suspending and resuming accruals of income on delinquent loans and policies for charging off uncollectible loans should clearly disclose the basis of determining such decisions. Vague statements such as "charged off when considered to be uncollectible" are not meaningful and fail to disclose the substance of such policies. In addition, the amount of nonearning assets represented by consumer and commercial loans for which accruals have been suspended because of doubtful collectibility should be separately disclosed.

Internal Accounting Controls

The auditor should study and evaluate the finance company's system of internal accounting control to establish a basis for reliance on selected controls. Tests of compliance should be performed on those controls which are relied to determine the nature, extent, and timing of substantive tests of account balances. The purpose of compliance testing is to evaluate the degree to which internal accounting controls are in use and operating as planned. If the results of compliance tests indicate that the controls are not effective as expected, the auditor generally should modify the original audit program and consider expanding the scope of substantive tests.

An overview of various internal accounting controls over finance receivables and related accounts is included in the next section of this chapter. While all controls identified are not found in every finance company, the following section lists considerations that may provide guidance on evaluating the internal controls.

Receivables and Income. Internal accounting controls over loans are determined partly by the type of loan and inherent

risks involved. In evaluating internal accounting controls related to loan transactions, the auditor should consider whether

- loans are made only in accordance with established policies,
- credit reports are obtained for loans,
- loans are properly approved by officers or branch managers and, if required, reviewed by a loan committee,
- loan approval, disbursement, and collection (access to assets), are checked, performed by, or adequately tested by other employees,
- management established dollar limits and minimum credit standards on loans,
- management reviews or internal audit procedures are sufficient to detect problems early,
- receivable balances are confirmed as part of management review or internal audit procedures,
- physical protection of notes, collateral, and supporting documents is adequate,

- employees who do not process or record loan transactions prepare and reconcile ledger trial balances with subsidiary and other control accounts on a timely basis,
- paid notes are cancelled and returned with collateral agreements, if any, to the borrowers,
- collateral are reviewed and physically inspected periodically,
- U.C.C. filings are updated periodically,
- personal or corporate guarantees are updated periodically,
- corporate borrower's or guarantor's financial statements are received and reviewed periodically,
- supporting documents on new loans are inspected for proper form, completeness, and accuracy by someone other than the lending officer or branch manager,
- loan balances are periodically compared with current collateral values,

- status reports are prepared indicating the condition of collateralized receivables, turnover of inventory collateral, and other information and such reports are reviewed by management,
- loans are reviewed timely for collectibility, the adequacy of allowance for loan losses is evaluated and documented, and write offs are recorded as soon as loans are reasonably expected to become uncollectible,
- aging schedules are accurately and periodically prepared and are used to help collection efforts and assess collectibility,
- control is maintained over charged off loans,
- reasonable collection efforts continue after the date of charge off,
- adequate procedures assure that income is accurately computed on the interest (actuarial) method,

- loans are regularly reviewed to determine whether income accruals should be suspended or reinstated in accordance with company policies,
- remedial action programs are in place for all substandard loans and are being carried out in a timely manner,
- changes in state laws and regulations are monitored to make sure that lending activities continue to be in compliance,
- payment extensions, deferments, or other modifications to repayment terms are made only in accordance with established policies and are reviewed by management,
- rebates of precomputed interest and insurance premiums made in connection with renewals and early pay offs are computed in accordance with state regulations, and
- extension fees, service fees, and late charges are computed in accordance with state regulations.

Loan and Related Files. Loan files for most types of finance receivables are a significant source of information. The documents of loan files vary depending on the types of loans. The timely receipt and review of those documents provide a basis for granting credit, reviewing extensions, and maintaining an awareness of loan status.

The principal support for most consumer loans is the signed note and security instrument. In addition to that support, consumer loan files may contain loan applications, credit agency or scoring sheets used to evaluate the creditworthiness of the borrower, a history of collection activites, and evidence of existing insurance coverage. Consumer loan files also should contain indication of compliance with consumer credit disclosure requirements of the Truth in Lending Act. That statute, which provides for mandatory disclosure of effective interest rates being charged to the consumer, applies to all lending institutions.

Documents in mortgage loan files may depend in part on local statutory requirements and company policy. In addition to various documents found in consumer loan files, the basic documents generally include but are not necessarily limited to the note, loan application, appraisal report, deed of trust, mortgage, title insurance or opinion, insurance policy, settlement statement, and V.A. guarantee or F.H.A. insurance, if applicable.

A typical commercial loan file generally includes financial statements of the borrower, financial statements of guarantors (individual or corporate), copies of supplemental agreements between the finance company and the borrower, and other related correspondence. Other materials in commercial loan files may include copies of UCC filings, documentation of loan approvals summarizing the reasons for granting credit, documentation of ongoing reviews of the borrowers' credit standings, information on loan collateral and histories of collection activities. Commercial loan terms tend to be tailored for the individual borrower unlike consumer loans, which generally have standardized terms. Therefore, commercial loan files may be more important than consumer loan files for maintaining control over the loans.

Documentation of the company's control and review of collateral should indicate the adequacy of the pledged collateral. The documentation may be kept as part of the detailed loan file or in separate files.

All or part of a company's loan and related files may be computerized. If so, paper source documents may not exist. Therefore, the auditor may have to rely solely on the contents of such electronic files.

Repossessed Assets Acquired in Liquidation of Receivables. Policies on repossessed assets acquired in liquidations may vary considerably among companies and by the nature of the collateral. In evaluating controls related to repossessed assets, the auditor should consider whether

- separate subledger accounts are maintained for assets acquired in liquidations even though amounts of such assets held at a particular time may be immaterial,
- repossessions are authorized and disposed of in accordance with company policies,
- repossessions are promptly reported and recorded,

- operating procedures provide for reasonable valuation of repossessed assets acquired in liquidations,
- net realizable values of unsold repossessed assets are reviewed periodically to determine whether carrying amounts should be written down,
- controls are established over reconditioning and other costs of repossessions and proceeds from sales of repossessed properties, and
- controls assure that accounting entries are accurate for recourse arrangements with dealers that provide for sharing of repossession risks and responsibilities.

Dealer Reserves. In evaluating the internal accounting controls related to dealers' reserves, the auditor should consider whether

- dealer reserve arrangements are established only in accordance with company policies,
- documentation is sufficient to provide enforceability of the contract terms,

- accounting procedures are adequate to ensure that improper charges are not made to dealer reserve accounts for rebates, delinquent accounts, charge offs, and other items,
- charges to dealer reserve accounts are adequately reviewed and approved by management
- debit balances are followed up for collection, and
- statements of the dealer reserve are sent to dealers if required by terms of the dealer agreements.

Branch Offices. Finance companies that lend to consumers often operate branch offices to make and service loans because of the importance of convenience, close personal contact with customers, and competitive considerations. Branch offices usually have limited numbers of personnel so complete segregations of duties may not be feasible. To compensate for that, many finance companies rely on central computerized controls and on management personnel to regularly review branch office operations. On visits to branch offices, management may

- review the extent of collection efforts and control over delinquent accounts,
- review a sample of loans made since the last visit for proper approval and for quality and adequacy of documentation,
- review a sample of loans for terms and financing charges,
- count cash and confirm selected receivables,
- observe branch employees to appraise their performance, and
- prepare a report to review with the branch manager, which serves as a checklist for follow up work and provides documentation of the visit.

Some of those procedures may be performed by the internal audit staff. Existence and effectiveness of internal audit procedures may provide additional controls beyond those provided by management reviews. In addition, each level of management may be continuously monitored by the next higher level of management to determine whether operating policies and procedures for review

of branch operations are complied with. The auditor's examination of branch offices therefore may be limited to cover the work of internal auditors or management reviews.

With the increased reliance on EDP systems, many branch office procedures have become streamlined, permitting less detailed records to be maintained in branch offices. The increased willingness of regulators to accept EDP records in place of hard copy records further encourages the performance of many procedures at main offices rather than branch offices.

Audit Objectives for Receivables and Income

An audit of finance receivables and finance income should determine whether

- loan and receivable balances are fairly stated at the date of the financial statements and due from the indicated borrowers,
- the allowance for related losses is adequate to provide for estimated probable losses,
- accrued interest revenues on both interest bearing and precompute loans are fairly stated, and
- adequate disclosures are included in the financial statements.

Auditing Receivables and Allowance for Losses

The auditor uses information from tests of finance receivables and the allowance for losses to assess the collectibility of receivables and to determine whether the allowance for losses reasonably covers expected losses.

The auditor should become familiar early in the audit with the finance company's policies and procedures affecting receivables and the allowance for losses, including those pertaining to

- credit approvals,
- delinquent loan charge offs,
- collateral requirements,
- collections,
- aging finance receivables,
- repossessed assets acquired in liquidations, and
- disposal of repossessed collateral.

Compliance tests should be designed based on the auditor's preliminary evaluation of internal accounting controls over transactions affecting finance receivables. If such controls are deemed ineffective, substantive tests of account balances should be appropriately modified.

Receivables from consumer loans usually are evaluated in total rather than on the basis of individual loans because they consist of large volumes of relatively small balances. In such situations, it is more difficult to judge collectibility of specific loans than to evaluate collectibility of portfolios taken as a whole. Therefore, auditing procedures for consumer lending generally emphasize review, documentation, and reliance on data processing systems, internal accounting and management controls, and accounting policies. Ratio analyses, historical statistics, current aging conditions, and other general trends are particularly important in evaluating collectibility. A change in composition of receivables may affect the allowance for losses, because greater risks are associated with certain types of loans than with others.

Many commercial loans are tailor made and relatively large. The size and uniqueness of commercial receivables necessitates a greater focus on specific loans and problems than is required for more homogeneous direct cash loans and retail sales contracts. Thus, auditing procedures in connection with

commercial lending tend to place less emphasis on statistical data and historical trends and focus more on current collateral values, industry concentration, and financial conditions of individual borrowers. Particular attention should be given to loans in economically distressed industries. The auditor should discuss questionable loans with management and obtain written representations, if deemed necessary. Commercial loan files should be reviewed on a test basis for information such as borrowers' audited financial statements and loan histories. Reviewing internal audit workpapers or field examination reports also may be useful.

A significant factor affecting the adequacy of the allowance for losses on commercial loans and receivables is the value of the underlying collateral. Depending on the nature of the collateral, independent appraisals of current collateral may be obtained. Adequacy of collateral in a loan default requires special attention if the collateral is not readily marketable or is susceptible to decline in realizable values.

Credit Approval Policies

Understanding credit approval policies is an important facet of an audit of a finance company. If the auditor is concerned about the adequacy of the finance company's credit policies, or if controls over compliance with credit policies are deemed to be ineffective, the auditor may need to expand the audit scope to evaluate credit risks assumed by the finance company.

The auditor should be alert for changes in credit requirements during the period, particularly to less conservative requirements, and evaluate the effect of those changes on the quality of the portfolio. Also, the auditor may evaluate whether the company reviews its credit approval policies in light of changes in the economic environment that might affect a creditor's ability to repay.

Credit approval policies and procedures differ significantly for consumer and commercial lending activities.

Consumer Credit Approval. Finance companies generally follow standard procedures to assess creditworthiness of prospective borrowers before approving consumer loans. Such procedures

usually include investigation of a prospective borrower's employment history, salary, credit history, and completion of a credit scoring sheet, on which an overall evaluation is made of the borrower's creditworthiness. Specific procedures may vary by type of loan (for example, real estate versus unsecured loans) and by type of customer (for example, new customers versus present customers). The auditor should understand and evaluate the reasonableness of the procedures required by the company's credit approval policies and the effectiveness of controls over those procedures. A sample of new loans made should be examined to test compliance with those procedures.

Commercial Credit Approval. Collateral for commercial loans generally is required to equal at least an amount sufficient to secure repayment in the event of a forced liquidation, thus requiring a thorough review of collateral value. However, repayment of a commercial loan generally depends on the borrower's ability to generate cash principally through operations. Therefore, a finance company usually performs a thorough review to assess the quality of management and financial position

of a prospective commercial borrower and the overall prospects for the borrower's type of business to generate sufficient cash to liquidate the loan.

In approving commercial loans, a finance company generally analyzes the prospective borrower's financial statements and may consider factors such as the prospective borrower's financial position and operating results compared to other businesses in the same industry. Various statistics, such as inventory and receivable turnover, are developed to facilitate the analysis. Receivable aging schedules also may be studied to help determine the quality of accounts receivable. Potential effects on the borrower of prevailing economic conditions may be considered. Projections of future cash needs may be prepared, particularly when considering the need for overadvances in factoring or revolving credit arrangements.

Credit reports, such as those prepared by rating agencies, may be considered and references may be obtained from the borrower's bank and other sources. The borrower's corporate structure should be studied to determine the existence and the extent of possible related party transactions. Additional procedures may be necessary to estimate the value of inventory and

fixed assets pledged as collateral. Finançe companies often send field representatives to visit borrowers' places of business to physically inspect inventories and premises, review agings of receivables and accounting records, evaluate internal accounting and management controls, and obtain direct impressions of the quality of operations and management.

The auditor should become familiar with and evaluate the reasonableness of credit approval policies and procedures for commercial loans. The auditor should consider testing supporting documentation to determine whether all procedures have been satisfactorily completed. Loan approvals generally are documented in the loan files and sometimes in minutes of the meetings of loan committees and the board of directors. If the finance company sends field representatives to prospective borrowers' places of business to review their business operations, the auditor may wish to accompany that person on one or more visits to assess the quality of the review or review that person's written report. Loan approvals deemed questionable by the auditor should be discussed with management to better evaluate their judgment and ascertain that undue risk of default does not exist.

Factoring. Finance companies review potential clients' operations to determine whether to factor receivables. Many procedures used for those reviews are similar to those used to approve other types of commercial loans. A loan officer usually is designated to oversee the review; final approval by a loan committee may be required.

If the finance company decides to buy the client's receivables, the review is used for several other purposes. The commission to be charged for bookkeeping and collection services is calculated from information provided by review of sales volume, the number of invoices processed monthly, the amount of returns and chargebacks, and collection activities. The review also is used to set limitations on the maximum amount of receivables that the finance company is willing to buy and, if needed, the amounts of seasonal overadvances to be permitted. Such limitations ordinarily are reviewed periodically for changes in a client's needs or circumstances.

If a client's business fails, the finance company usually has problems collecting the remaining customer accounts because of an inability to settle unresolved disputes between customers

and the client that otherwise would have resulted in chargebacks to the client. Therefore, the auditor should consider the reasonableness of initial and subsequent reviews of the client's operations and financial condition in determining whether the finance company faces undue risks of default on customer accounts.

In addition to the review client of a client's financial position, finance companies review customers' credit for approval before goods are shipped. Finance companies usually establish a line of credit for each customer, which periodically is reviewed (for example, every 90 days) to determine whether it should be raised or lowered based on changes in payment patterns, sales, credit ratings, and other circumstances. Periodic reviews should be documented in customer files. A customer may buy goods or services from several of the finance company's clients; the credit line of such a customer is typically prorated among the clients with which it does business. Therefore, a finance company's accounting system provides aggregate information on total receivables due from a customer, to help control credit approvals.

A client usually submits orders to the finance company by telephone, teletype, or mail. Orders below a certain amount may be approved automatically. Orders for established customer accounts that have not exceeded their lines of credit also may be automatically approved. Some finance companies use a computerized credit checking system to initially review orders for approval or rejection or to signal that additional investigation is required or both.

The auditor should consider reviewing and evaluating the reasonableness and adequacy of compliance with customer credit approval policies, including those pertaining to periodic or continuous review of customer credit standings. Approved and rejected customer orders usually are recorded on client approval sheets. The auditor may select a sample of client invoices recorded by the finance company and trace them to the approval sheets to verify that invoices booked represent approved orders. The auditor also may select a sample of both approved and rejected customer orders from the approval sheets for confirmation with clients. If the client responds that the finance company approved an order listed as rejected, the auditor should

question the effectiveness of customer credit controls and consider whether the client has a potential legal claim against the factor for that customer order.

Controls over customer credit limits also may be examined by selecting customers that buy goods or services from several clients of a factor. Amounts owed should be added to determine that each customer's credit limit has not been exceeded.

Collections

The extent of collection efforts on accounts written off and procedures for controlling previously written off accounts should be investigated. If a finance company has many branch offices, it may be appropriate to investigate and test collection efforts at selected branch offices. Accounts written off may be confirmed on a test basis to determine whether collections, if any, have been properly recorded.

Changes in the intensity of collection efforts are likely to affect the adequacy of the allowance for losses. Decreases in amounts budgeted for salaries and other collection costs may indicate that collection efforts have been reduced and that delinquencies and bad debts may increase. Collection efforts also may be adversely affected by increased turnover of employees

assigned to such efforts, indicating the use of less qualified persons, or by concentrating employee effort on making new loans with a consequent lessening in efforts to collect existing receivables.

Aging Schedules

Finance companies prepare aging schedules to review collectibility of loans. A finance company uses aging information to help assess collectibility of accounts and determine where to concentrate collection efforts. Collectibility of receivables more than a stipulated number of days delinquent should be questioned. Some companies automatically write off such delinquent receivables. Management may decide to write off certain delinquent accounts because the costs of collecting them outweigh potential benefits. If liberal extension policies or practices exist, extended accounts should be given special attention even though they are not delinquent.

Accounts receivable from retail sales contracts typically are aged by the contractual method, which is based on the status of payments under the original terms of the contracts. Such agings generally are modified for deferments and extensions of original contractual terms. Direct consumer loans historically

have been aged by many lenders using the recency of payment method. Under that method, loans are aged based on the month in which the most recent collections were received, regardless of contractual payment terms for amounts of payments or loan periods.

The recency of payments method of aging was developed years ago, when direct consumer loans were for relatively modest amounts due over relatively short periods. Under those circumstances, lenders were interested in regular collections of principal and accrued charges and less concerned with contractual terms of the loans. That emphasis is reflected in the recency method. More recently direct consumer loans, particularly second mortgage loans, have been for larger amounts and longer periods. Therefore, lenders increasingly have emphasized collections of principal and charges in accordance with contractual terms. That emphasis is apparent in the Robert Morris Associates Direct Cash Lending Questionnaire, which has prescribed the contractual method for large direct cash loans.

The contractual method is considered more conservative than the recency of payments method; however, some finance companies weaken the basis of the contractual method by modifying their calculations. For example, such companies may consider accounts contractually current when two timely payments have been made on an account previously considered delinquent. Therefore, regardless of which aging method is used, understanding whether and how clients may reclassify delinquent loans to current status is especially important.

The auditor can compare results of current agings with results of past agings to identify unusual variances. The auditor should become familiar with aging policies and refer to Robert Morris Associates questionnaires, in which the aging policies are to be defined. The auditor should be aware that recent payments, which may have altered the classification of particular accounts, may not indicate the ultimate collectibility of those accounts. The auditor also should consider the effect of partial payments on the aging.

The aging of receivables also is affected by extension and renewal policies. Loan renewals involving little or no advances

of additional cash to customers deserve special attention. Some managements believe renewals, sometimes called salvage renewals, should be granted only with additional cosigners or collateral, unless customers can demonstrate increased ability or willingness to repay such loans. Other managements believe renewals should never be granted. Though different circumstances may exist, a customer usually demonstrates increased willingness to repay a delinquent account by making regular monthly payments at reduced amounts after paying off a significant portion of the initial loan balance. Renewals without evidence of increased ability or willingness to repay may diminish reliability of aging schedules.

Charge Off Policies

Charge off policies vary among finance companies and types of loans. Some policies automatically require accounts to be written off when they are overdue a stipulated number of days. Such policies typically are used for loans with homogeneous characteristics, such as consumer loans and, sometimes, for customer receivables bought under factoring agreements. Alternatively, a finance company may determine that a loan should be

charged off based on review of the status of individual loans, changes in borrower financial positions, prevailing economic conditions, and other considerations.

Factors should charge off customer receivables bought from a factoring client when the accounts become uncollectible. As a practical matter, some factors may charge off customer receivables only when there is an act of bankruptcy by the customer. Some finance companies also may charge off customer receivables prior to a bankruptcy filing.

The auditor should be aware of the effect of charge offs on the adequacy of the allowance for losses. A slower rate of charge offs than in previous years, perhaps resulting from changes in charge off policies, may indicate the need to increase the allowance for losses. Conversely, a faster rate of charge offs than in previous years may indicate the need to decrease the allowance for lossess.

The auditor should consider reviewing and evaluating the reasonableness of charge off policies and test compliance with them. The auditor should consider whether charge offs are reviewed and approved by officials who do not also approve loans,

whether charge offs for deficiencies on repossessed properties are adequately reviewed and approved, and whether losses charged to dealer reserve accounts are consistent with dealer agreements. The auditor also should be alert to the effects of changes in charge off as well as credit granting policies.

If charge off policies require automatic loan write offs when overdue a stipulated number of days, the auditor should consider the appropriateness of the number of days specified and whether controls make sure that such procedures are followed. The auditor also should consider how partial payments on loans are treated under the policies. If procedures requiring automatic write offs are not used, the auditor should consider how the use of such procedures would affect the allowance for losses.

The auditor also may consider requesting confirmation of loans charged off. However, the auditor should be careful to avoid communications prohibited by bankruptcy or other laws.

Other Credits to Receivables

Credits to finance receivables for reasons other than cash receipts or charge offs to the allowance for losses should

be tested to determine whether the reasons for the credit are appropriate, for example, whether an error has been corrected, and whether the credit was properly authorized.

Chargebacks. Under factoring arrangements, typical non-cash credits to receivables represent chargebacks to client accounts. Chargebacks may result from disputes, for example, over freight charges, defective merchandise, deliveries, prices, and cancelled orders. The auditor should study and evaluate aspects of internal accounting controls relating to chargebacks to determine that they are reasonable and properly documented. Inability to collect an account because of a customer's insolvency, for example, generally represents a credit loss and ordinarily should not result in a chargeback because the finance company assumes the risk of customer default when receivables are factored.

Anticipations. Under factoring arrangements, most finance companies accept customer payments of less than the amount of the related receivables if the customers pay before due dates. The differences, called anticipations, may be allowed because a finance company obtains earlier use of the cash. Amounts of

anticipations allowed usually fluctuate monthly and interest usually is charged to the client based on some relationship to prime rates.

The auditor should consider reviewing the finance company's policies on anticipations, and, if allowed, the reasonableness of the amounts deducted.

Confirmation Procedures

Finance companies may confirm receivable balances as part of their internal audit procedures. The extent and nature of those procedures vary. Some finance companies use written confirmations; others orally confirm information by telephone. The auditor should study and evaluate those confirmation procedures, if they exist, to determine the extent on which reliance may be placed. After considering such internal confirmation procedures, the auditor should establish a reasonable scope to confirm a representative number of loans. The auditor may wish to stratify loans selected for confirmation not only by statistical, techniques but by categories such as loans collateralized by real estate and unsecured loans.

Positive confirmations should be used when individual account balances are relatively large or when a substantial number of accounts are believed to be disputed, inaccurate, or irregular. Negative confirmations may be used when internal accounting controls are deemed effective and a large number of relatively small balances are involved. In addition to the amount of the loan and the loan balance, the auditor should consider confirming other information, such as the last payment date and the amount and type of collateral.

Though use of return receipt requested mailings may improve response rates, the auditor should consider applying alternative procedures for all significant unanswered positive confirmations, that is, those likely to influence the evaluation of accounts selected for confirmation. Such a determination depends on the number and amount of confirmations requested, the method of selecting the sample, and any unusual considerations. To apply alternative procedures, the auditor should consider reviewing subsequent cash receipts, orally confirming information by telephone, and examining additional loan documentation. Consideration may be given to the possibility of using finance

company employees not involved in the original lending and collection process to help follow up on unanswered confirmations. For example, they may prepare schedules of subsequent cash receipts or perform other alternative procedures and the auditor can test their schedules to assess reasonableness of the accounts.

No Mail Accounts. Some consumer loan customers may request that direct correspondence not be sent to them. They are typically called no mail accounts and usually are insignificant in relation to the total loan portfolio. If such loans are selected for confirmation, alternative procedures normally should be applied. Such procedures might include, after obtaining authorization from supervisory personnel, making direct telephone contact with the borrowers.

Confirming Purchased Customer Receivables. Confirmation procedures may lead to various issues, such as disputes over prices, quantities, or shipping terms, payments made by customers directly to factoring clients, unrecorded merchandise returns, fictitious receivables, consignments, or prebilling. Prebilling is when a client sends invoice copies to the finance company with

billing dates earlier than those on copies sent to customers, a practice that inflates the company's customer receivables. If a confirmation is not answered, the auditor should consider comparing the dates on the finance company's copies of client invoices to dates of invoices listed as paid on the check voucher accompanying customers' payments. An alternative procedure possible for finance companies that have or have access to shipping documents is to compare dates on the finance company's invoice copies to such documents.

If a finance company buys receivables under a nonnotification arrangement, the auditor cannot confirm the receivables directly with customers. Instead, the auditor may confirm the receivables under a pseudonym, indicating that the confirmations have been sent on behalf of the client. The auditor, however should not use the name of the client's auditor on the confirmation requests.

Ratios

Ratios are useful for analyzing trends affecting collectibility. Receivables should be segregated by types (for example, retail contracts, direct consumer loans, and commercial

finance receivables) before computing ratios because of their diverse characteristics. The comparability of receivables to those of prior periods should also be evaluated. For example, tightening of credit standards, changes in extension policies and other factors can change the quality of the receivables and render statistical comparisons invalid.

Two ratios commonly used to determine loss experience trends are

- net credit losses to receivables liquidated (beginning balance plus volume during period, excluding old balances renewed, less ending balance) and
- net credit losses to average monthly outstanding receivables for the period (annualized if less than one year).

The first ratio is useful in estimation of the amount a finance company will write off for each dollar collected on loans. The second ratio has been used primarily for smaller loans with relatively short term maturities. If trends show increasing rather than decreasing ratios, the allowance for losses may need to be increased.

Ratio analysis has certain weaknesses. For example, the ratio of net credit losses to average monthly outstanding receivables measures only losses for one year. Because most loans extend beyond one year, the ratio does not include all losses that would be expected to result from liquidation of all outstanding loans. Growth situations also hamper ratio analysis, particularly if net credit losses to average monthly outstanding receivables is used. The increasing portion of new business used in the calculation may cause comparisons with previous results to be meaningless. That is because, in such situations, the rate of increase in credit losses lags behind the rate of increase in receivables until growth levels off. For that reason, net credit losses to receivables liquidated provides better measure in growth situations.

Other common ratios include

- percentages of allowances to outstanding receivables,
- percentages of delinquencies to outstanding receivables,
- ratios of recoveries to charge offs,

- net charge offs as a percentage of cash collections, and
- ratios of provision for losses to volume.

Computers and sophisticated mathematical models can be used to improve ratio analysis and identify trends that otherwise may be camouflaged. For example, computers can readily apply regression analysis techniques to loans stratified by such criteria as the year made, type of loan, location of borrower's residence or place of business, and borrower's credit rating. Thus, volumes of detailed data may be readily summarized and analyzed to provide more sophisticated information than possible without computers.

Though no one group of statistics is conclusive, trends may indicate significant changes that warrant attention. Industry or other published statistics on delinquencies and allowances for losses may be helpful but should be used with regard for the facts and circumstances affecting individual companies. If using ratios, the auditor should consider all relevant circumstances, such as changes in credit approval and collection policies and general economic conditions.

Loans to Related Parties

Loans to officers, directors, and employees (and loans to organizations with which such individuals are affiliated) should be reviewed. SAS 6, Related Party Transactions, provides auditing guidance for such matters.

Collateralized Loans

Consumer loans may be collateralized by consumer goods or by real property. Commercial loans may be collateralized by accounts receivable, inventories, or property and equipment. Loans also may be guaranteed by co-signers and guarantors.

Depending on the type of collateral and its importance in assuring repayment, the auditor should test physical existence and proper assignment to the finance company. Examination of loan documentation should include testing adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on such collateral. For guaranteed loans, the auditor should review financial statements and other evidence of the financial conditions of cosigners

and guarantors. The auditor should be alert to possible concentrations of loans in one borrower, in a group of related borrowers, or in a particular industry. The auditor also should consider general economic conditions that may affect the value of underlying collateral as well as overall collectibility and quality of the loan portfolio.

Consumer Goods. Many direct consumer loans and most retail sales contracts are collateralized by consumer goods. Resale values of most consumer goods, such as major appliances and furniture, may be significantly less than related loan balances. As a result, many lenders prefer not to repossess such collateral. Audit of those collateral values is, therefore, less important than for other consumer goods, such as automobiles, which may be readily saleable and be of more significance when compared to related loan balances.

Receivables. Trade accounts receivable and installment notes sold or pledged as collateral generally are sold or assigned to a commercial finance company on a nonnotification basis (that is, the borrower does not inform its customers that their accounts have been sold or assigned to a finance company).

The industry trend in recent years has been to maintain total dollar control of such receivables (bulk basis) rather than detailed receivable records (ledger card or specific assignment basis). The finance company and its auditor usually have access to the seller's or borrower's accounting records if collateral records are maintained in bulk. The seller or borrower may receive all collections on the receivables but is required to turn over such collections in their original form, usually through use of a bank account designated by the finance company.

In addition to the effectiveness of credit approval policies, collection activities, internal confirmation procedures, and visits by field representatives to the client's or borrower's place of business, the auditor should study and evaluate other accounting and management controls over receivables sold or pledged as collateral. For example, the auditor's evaluation may be affected by the amount of collateral receivables maintained on a bulk basis, the frequency with which borrowers submit aged trial balances to the finance company, and the extent of management reviews of those schedules.

Based on the evaluation of the finance company's procedures for examining and monitoring assets sold or collateral pledged, the auditor should consider the need to examine evidence of or otherwise be satisfied as to nonnotification receivables pledged as collateral. The examination may consist, in part, of a review of the borrower's records. Accounts receivable agings may be compared against the borrower's customer accounts subsidiary ledger with additional review of items such as unusual invoice terms, past due accounts, and invoices paid out of order. Familiarity with trade or industry discounts, the right of return, warranties, and other terms of sale offered by the borrower facilitates analysis of collateral values of receivables. A review of trade creditors could indicate whether a right of offset exists against the receivables because the borrower buys from and sells to the same enterprise. The auditor also should consider studying the borrower's corporate structure to help identify posible receivables due from affiliated companies.

Inventories. Inventories pledged as collateral may result from a wholesale loan, for which specific items of inventory are

pledged, or from an inventory loan, for which the entire inventory is pledged but individual items are not identified. Inventories also may be pledged as additional collateral for a loan initially collateralized by receivables when the loan exceeds the prime collateral value assigned to the receivables. Inventory collateral values may be more difficult to evaluate than receivable collateral because such collateral is more subject to economic risks such as deterioration and obsolescense. Therefore, the percentage of loan advances made against inventory collateral generally is less than that made against receivable collateral.

Based on the preliminary evaluation of controls over inventory pledged as collateral, the auditor should consider reviewing reports by finance company personnel who inspect such inventories on field visits or, if considered desirable, inspecting inventory in custody of the borrower on a test basis. Perpetual inventory records, if maintained by the borrower, may be tested against periodic physical counts made by internal auditors in the field. Many finance companies do not maintain such records because pertinent, accurate, and updated inventory information is difficult to get, particularly for revolving loans.

Inventories pledged as collateral that are stored in public warehouses and supported by warehouse receipts may be confirmed by direct communication with the warehouses. Owners of warehouses are primarily liable for damages resulting from nonexistence of goods listed in receipts and from failure of the goods to conform to the descriptions on warehouse receipts. A field warehousing arrangement, in which a warehouse company segregates and controls the collateralized inventory in a portion of the borrower's warehouse, may provide some control but the control is generally less than that in a public warehouse. For example, the custodian may be an employee of the borrower who is technically an employee of the warehouse but whose primary loyalty may be to the borrower. Nevertheless, a field warehousing arrangement may be more practical than using a public warehouse because of costs and difficulties of transporting inventory between warehouses and borrowers' premises.

Property and equipment. Loans to companies that have major items of property, plant, and equipment generally are collateralized by such assets. In addition, property, plant, and equipment may be pledged as additional collateral for a receivable or inventory loan or as collateral for a separate loan

made to a company that borrows against receivables and inventory. The difference between the loan amount and the collateral value usually is substantial for loans collateralized by property, plant, and equipment.

Recent appraisals by specialists of liquidating values of property, plant, and equipment may be helpful in evaluating security. The auditor may review those appraisals and collateral records. The auditor should be satisfied with the professional qualifications and reputation of a specialist whose work is to be relied on. If the auditor chooses to rely on the valuation of a specialist who is a related party, the auditor should consider the need to perform additional procedures on some or all of the specialist's assumptions, methods, or findings to determine their reasonableness. For further guidance, the auditor should refer to SAS 11, Using the Work of a Specialist.

EDP Considerations

Most finance companies use some form of computerized EDP records. Audit considerations for computerized EDP systems are comparable to those for manual systems, though specific audit procedures should be tailored to the type of system used. For

example, manual systems rely on mathematical formulas or rate charts to calculate finance income; in computerized systems, software programing incorporates the formulas. Some significant concerns for auditing EDP systems include whether the duties of employees involved with the system are adequately segregated, source documents are available, and audit trails are sufficient to follow up on individual items. The auditor should refer to SAS No. 3, The Effects of EDP on the Auditor's Study and Evaluation of Internal Control, for further guidance.

Some finance companies subscribe to computer systems operated by outside businesses. Internal or independent auditors usually review internal accounting controls over those computer systems and issue reports that should be considered carefully by user's auditors.

Branch Audits

The auditor should determine the need and extent of branch office examinations based on considerations of materiality, the effectiveness of internal controls, and the locations at which supporting documentation are maintained. Another consideration is whether there is an updated operating manual that prescribes all phases of branch operations, including accounting procedures.

Such manuals may provide significant information for the auditor to complete preliminary evaluations of controls over branch operations.

The use of centralized electronic data processing (EDP) operating systems has reduced the need for the auditor to visit branches to inspect subsidiary records and supporting documentaton for loans. Even without such a centralized system, duplicate records may be maintained at the home office of a finance company. Consequently, the auditor may decide to limit branch examinations and focus solely on determining the effectiveness of controls over branch office operations such as management reviews and internal audit procedures. If the home office maintains duplicate receivable ledgers, much or all of the substantive tests involving confirmation procedures and evaluation of collectibility often can be performed without visiting the branch offices.

If branch visits are warranted, the auditor should ordinarily make surprise examinations of selected branches if cash is to be counted or collateral inspected. The auditor's examination of branch records normally may include tests of the system of internal control, comparisons of data submitted to the home

is maintained only in the branch office, all the usual audit steps for loans. If floor plan loans are made, the auditor should consider examining related collateral on a test basis. The auditor may test postings of collections to customer accounts, and test procedures for extensions, renewals, and rebates on all types of loans to determine the reliability of the accounting records. The auditor also should consider the following possible audit procedures in examining a branch:

- Check accounts receivable ledgers for clerical accuracy, compare totals to appropriate branch controls, and trace totals to general ledger balances at the home office.
- Select a representative number of accounts for confirmation and test aged trial balances for clerical accuracy and compliance with the company's aging policy.
- If accounts receivable ledgers are maintained in the home office and accounts are confirmed using home office records, compare balances of

selected accounts in home office records to records maintained at the branch.

- Compare supporting documentation for a selected number of loans with loan cards and other supporting documents. Documentation might include signed notes; security agreements; loan applications; financing statements; insurance policies; and notices of lien filings. New and renewal loans should be tested for proper recording of discount, dealer reserve, insurance premiums, and so on. Rebates, extension fees, and late charges should be tested similarly.
- Test cash payment records for miscellaneous expenses.
- Review procedures used to account for and control repossessed collateral. If the branch is responsible for selling repossessed collateral, test sales of collateral by tracing proceeds to cash reports, bank deposits, and

other pertinent documentation. Compare proceeds to estimates of value at time loans were made and at the time collateral was repossessed. Examine evidence of ownership.

- If the branch is located in a state that requires interest to be computed each time a payment is received, test computations of application of interest and principal.
- Follow up on unusual bank reconciling items from home office.
- Review the recent State Consumer Finance Division Examiner's Report or its equivalent for significant exceptions.
- Review adequacy and documentation of branch manager's or area supervisor's reviews of loans made, collection efforts, and cash counts.
- Review controls over cash collections, deposits, and disbursements.
- Review for duplicate loans to one borrower.

- Review for compliance with manager's lending limits.
- Review for compliance with policy relating to waiver of interest and late fees.

Some procedures may be inappropriate or need modification if the finance company uses an EDP system.

Leases

Audits of leases resemble in some ways audits of other finance receivables. For example, auditors should evaluate the collectibility of minimum lease payments and consider whether allowances for losses on leases are adequate. If repossessions have occurred, the auditor should consider current values of collateral not yet disposed of in evaluating the adequacy of the allowance for losses. The auditor also may confirm lease terms and existence of leased properties directly with lessees and test authorization for purchase of assets to lease files. Revenue recognition calculations can be tested for accuracy and compliance with FASB Statement No. 13 and related amendments and interpretations.

The auditor should evaluate unguaranteed residual values included in gross investments recorded at the inception of leases. Residual values are the estimated fair values of leased properties at the end of their lease terms that generally are not guaranteed to lessors by lessees or third parties. The clients' methods and internal controls used to estimate residual values should be evaluated. The possibility of changes in residual values should be considered. Values of standard products or equipment may be compared to market prices. Resale dealers and trade publications may be consulted. Values of specialized equipment may be difficult to evaluate. Special emphasis is warranted for high technology equipment often declines quickly in value because newer, more advanced, or less expensive models are introduced. Purchase options included in lease terms may provide additional evidence of values but should be used with caution because they generally would not indicate subsequent declines in value.

If reviews of residual values indicate permanent declines have occurred, estimated residual values should be adjusted and losses should be recognized when estimates change.

For leveraged leases in which the finance company is the investor, the auditor should verify that the related assets qualify for investment tax credits. The terms of loan agreements usually are reviewed and compared to the long term lenders' contracts. The projected net cash flow analysis used to account for leveraged lease transactions should include income tax effects of the transactions. Tax effect calculations may be tested. Auditors should review and evaluate the validity of assumptions for projecting tax effects. Such reviews may include timing of receipt of tax benefits or payments of charges. Rates used to quantify the tax effects of transactions also should be reviewed. Effects on carrying values of leverage lease investments caused by changes in original assumptions should be recognized in the period of change.

Income

Finance income account balances usually are tested together with finance receivables. Tests of details, analytic review procedures, or both may be relied on. Tests of details may include recalculation of finance income and nonrefundable fees for selected loans, such as those selected for confirmation, or blocks of loans. Analytic reviews may include comparisons of

monthly recorded income amounts with those recorded in months of past years, prior months of the current year, and budgeted amounts, as well as with industry information by type of receivables. Monthly ratios of finance income to finance receivables may be compared to prior years' months and budgeted amounts.

Finance income earned on discount receivables also can be tested using unearned finance income account as follows:

Unearned Finance Income:	Test Method
Beginning balance	• tested in prior year
+ credits (total precomputed interest of new loans)	• recompute total unearned interest for a sample of new loans (possibly using loans selected for tests of cash payments)
- debits (finance income earned	• balancing amount
= Ending balance	• Recompute balance of unearned finance income for a sample of loans outstanding (possibly using loans selected selected for confirmation)

That formula should be modified as necessary for such items as prepayments and loan renewals.

Statutory Regulations. Regulatory compliance is an important consideration in auditing finance income. State laws often restrict three major elements that determine interest income: the amount of loan, the length of maturity, and the interest rate. State laws also may prescribe certain rebate calculations. Other regulatory restrictions may pertain to origination, delinquency, or extension fees. Compliance with the various state laws should be reviewed. Formulas used to calculate finance income should be tested to verify that results conform to applicable laws and regulations as well as to generally accepted accounting principles.

The Truth in Lending Act and regulations issued by state supervisory authorities generally affect lending transactions. The auditor may learn of possible violations of such regulations during the audit. If so, the auditor should refer for guidance to SAS No. 17, Illegal Acts by Clients.

Repossessed Assets Acquired in Liquidations of Receivables

The objectives of auditing repossessed assets acquired in liquidations are to test for the existence and evidence of ownership of the repossessed assets and to evaluate reasonableness of estimated net realizable values. Accounting controls over timing and methods of recording repossessed assets should be evaluated to determine the necessary extent of substantive tests of account balances.

Inspecting repossessed properties may be an appropriate test for existence. The auditor may compare carrying values of repossessions to subsequent sales, published wholesale price lists, or independent appraisals of the same or similar properties to determine reasonableness. If feasible, the auditor may group repossessions by product types and compare unit carrying amounts to the company's recent history of average losses or gains on sales of similar repossessions. Evidence of ownership may be established by reviewing legal or other pertinent documents. The financial condition of dealers under recourse or repurchase agreements also may be investigated to determine whether additional risk may exist.

Dealer Reserves and Holdbacks

Before planning detailed audit tests, the auditor should become familiar with company policies and procedures on dealer reserve arrangements and evaluate internal accounting controls over dealer reserves and holdbacks. For example, the auditor should evaluate the extent of review and approval of changes to dealer reserve accounts. Though uncommon, if dealers know amounts of the dealer reserve accounts, perhaps from regular statements issued by the finance company, the risk of disputes may be lessened and it may be feasible for the auditor to confirm the related liabilities to dealers. If not, the auditor may review activities in dealer reserve accounts for propriety and consider the overall adequacy of reserve balances in relation to the volume of loans bought, dealer credit status, and credit status of the dealers' customers.

Other auditing considerations may include reviewing compliance with significant provisions of dealer agreements, reconciling totals of individual dealer balances with applicable control accounts, and testing detailed transactions to the accounts and supporting documentation. Particular attention should be given to accounts with debit balances classified as

assets or offset against credit balances of dealer reserves. The rationale for such classification generally is that future purchases of retail contracts from dealers will eliminate the debit balances. The auditor should question that justification because, if past purchases of retail contracts from a dealer have resulted in debit balances in the dealer reserve accounts, future purchases may be unlikely to produce different results. The auditor should consider whether debit balances are losses that should be charged off.

Capitalization of Finance Companies

Finance companies borrow funds to lend to others. Debt to equity ratios of finance companies generally are higher than those of manufacturing companies because finance company assets are more liquid receivables than inventories and fixed assets. Debt to equity ratios of four or five to one are not uncommon for finance companies. However, finance companies leverage has traditionally been much lower than leverage of banks and savings and loan associations.

Finance company debt may be classified as senior, senior subordinated, and junior subordinated. The classifications describe declining priorities, which become especially significant when solvency becomes questionable. When two or more types of debt are issued simultaneously with diverse priorities, the lower priority debt ordinarily carries a higher interest rate.

Company policy and credit rating goals cause companies to establish diverse target amounts for each priority category of debt. Moreover, debt agreements usually contain restrictions on

the amount of debt that may be incurred in each category. For example, a common restriction in debt securities issued to the general public prohibits pledging assets to secure new or existing debt. Other common restrictions may limit dividend payments and the amount of additional senior debt that can be incurred. Negative pledge clauses are common in private debt issues as well as public issues. If an issuer has other restrictions in its current typical public issue, lenders commonly demand the same restrictions in a private placement.

Generally, bank borrowings on lines of credit and commercial paper sold in the open market are sources of debt that mature in less than one year. Larger finance companies usually rely heavily on commercial paper markets but smaller finance companies may not have access to such a market and therefore may rely on bank borrowings as a source of funds.

Debt with maturity terms greater than one year is a major source of funds for most finance companies and is intended to reduce volatility of the cost and source of money. In large finance companies, such debt frequently constitutes more than half of the liabilities of finance companies. Smaller finance companies, with limited access to public debt markets, have a much greater reliance on short term bank debt.

The related debt instruments traditionally have been acquired by insurance companies; but banks, pension funds, and the general public increasingly have purchased those instruments. Interest rates are determined by the credit rating of the issuer and prevailing money market conditions.

Bank Lines of Credit

Finance companies may pay commitment fees, maintain compensating balances, or both to have bank lines of credit available. When a finance company borrows under a line of credit, it is charged interest at a rate usually based on a specified percentage related to the bank prime rate. Banks generally determine the percentage based on analyzing the quality of the finance company's receivables and operations.

Bank borrowings are a type of senior debt commonly issued in the form of 90 day notes, of which renewal may be negotiated before maturity. Banks generally require finance companies to pay off notes under lines of credit for a specified period, such as one month, each year. Sometimes, finance companies are allowed to meet such requirements by borrowing under a second line of credit to pay off the first. They may therefore continuously borrow from banks though individual bank notes are due

in relatively short periods. Alternatively, they may be required to simultaneously settle all bank lines of credit for 30 days or more.

Some bank lines of credit are obtained with little expectation that the finance companies will borrow under them. For example, rating agencies strongly emphasize liquidity when they rate commercial paper. All issuers of commercial paper are expected to have bank lines of credit to back up such notes. The rating agencies view that support as security to provide temporary liquidity and they probably would not rate a company's commercial paper without adequate coverage. Bank lines also are maintained to protect finance companies from unforeseen withdrawals of other credit sources. Some finance companies may test the availability of bank lines periodically by borrowing under each line, particularly if those agreements are not formalized.

Commercial Paper

Commercial paper, another form of senior debt, matures in a few days to as long as 270 days from issuance. The majority of commercial paper is issued for maturities of 5 to 60 days,

depending on market conditions. Commercial paper generally comprises the major portion of debt due in less than one year of larger finance companies because interest rates on commercial paper are usually lower than those available from banks.

Companies with significant amounts of commercial paper outstanding generally issue and redeem commercial paper continuously. Maturity of a large amount of commercial paper or a long term debt issue in the near future may make it necessary for a company to sell larger than normal amounts of commercial paper. More commercial paper than needed also may be sold on certain days to maintain an orderly market when regular customers have money to invest beyond the finance company's current needs.

Excess proceeds from sales of commercial paper usually are reinvested at comparable rates of return. Proceeds may be invested for very short periods, usually overnight, by entering into repurchase agreements with investment brokers, or buying interest bearing Eurodollar time bank deposits and commercial paper of other issuers.

Interest Coverage Ratios

Rating agencies generally consider interest coverage ratios to be significant in evaluating the creditworthiness of a finance company's debt obligations. Rating agencies assign a credit rating to a company's debt obligations and commercial paper based on detailed ratio analyses and evaluation of other factors. The ratings significantly affect the lender's cost of borrowing and, more importantly, its ability to borrow money.

Many institutional investors, such as insurance companies, banks, trusts, mutual funds, and pension and profit sharing plans rely heavily on credit ratings in making their investment decisions. Many of those investors are prohibited by law or by formal agreement from investing in corporate obligations rated below a specified minimum level. For example, some states prohibit licensed domestic insurance companies from investing in corporate obligations that do not meet specified fixed charge coverage ratios. In addition, many government agency pension funds are prohibited by law from investing in securities that do not have an investment grade rating. Those pension funds are significant buyers of finance company commercial paper and term debt securities.

A strong pattern of interest coverage ratios is an important indicator of a company's ability to pay its interest obligations when due. Two key ratios are pretax interest coverage and fixed charge coverage:

- Pretax Interest Coverage =

$$\frac{\text{Pretax Income + Interest}}{\text{Interest}}$$

- Fixed Charge Coverage =

$$\frac{\text{Net Earnings Before Taxes + Interest Cost}}{\text{Interest Cost}}$$

In addition to coverage ratios, rating agencies analyze the interrelationships of several other factors, including

- loan portfolio quality,
- degree of leverage determined by the amount of debt in relation to the company's equity or capital base,

- operating performance as demonstrated by historical earnings patterns, and
- financial flexibility.

Credit Questionnaires

A finance company furnishes its creditors with financial and operating information through standard questionnaires developed by a joint committee of representatives from industry and the Robert Morris Associates. The credit questionnaires are revised periodically for changes in operations of finance companies and the needs of lenders.

In 1982, there were four credit questionnaires for finance companies: Sales Finance Company Questionnaire; Direct Cash Lending Questionnaire; Commercial Financing Questionnaire; and Credit Questionnaire for Captive Finance Companies. The first two generally apply to independent companies that finance retail sales and make direct cash loans to consumers. The Commercial Financing Questionnaire applies to independent finance companies that provide financing services for business enterprises, including lease financing. The fourth questionnaire applies to captive finance companies formed to finance the sales of products by affiliated companies.

Some finance companies engage in several types of financing and lending activity and are required to furnish information on several types of questionnaires. For example, a finance company that both finances automobile retail sales contracts and lends directly to consumers generally would furnish information for the pertinent sections of the Sales Finance Company Questionnaire and the Direct Cash Lending Questionnaire. The various questionnaires are not all inclusive; each reporting company must adapt the questionnaire to fit its own circumstances. The Credit Questionnaires for Captive Finance Companies especially reflect the wide diversity among individual companies. It consists of a series of questions designed to elicit the basic information needed for credit analysis, with the form of presentation left to the individual companies. The other questionnaires are much more specific.

Each credit questionnaire covers a specific reporting period, such as six months or a year. All have certain basic questions in common. Each requires information on the types of finance and lending activities of the company, details of business volume during and receivables at the end of the reporting period, aging of receivables, summary of credit loss experience

for the period, description of certain basic operating and accounting policies, and information on the terms and liquidity of finance receivables.

Other required information pertains to the particular lending activities covered by the individual questionnaire. The Sales Finance Company Questionnaire requires analysis of the volume and type of retail sales financing receivables, such as those for automobiles, appliances, and home improvement, and indication of any significant concentration in one or more dealers. The Direct Cash Lending Questionnaire requires a schedule of collection results on direct consumer loans outstanding and an analysis of loan volume by type of borrower. The Commercial Financing Questionnaire requires specific information on larger commercial loans in each receivable classification and on significant concentration of loans to any one debtor or group of affiliated debtors.

Accounting

The discount or premium on debt should be amortized to interest expense over the life of the related debt using the

interest method. That method is consistent with the one recommended in APB Opinion 21, Interest on Receivables and Payables, for debt requiring imputation of interest.

Finance companies commonly offset interest income from short term investments of excess proceeds from sales of commercial paper against interest expense on the commercial paper because the association of that income and expense is direct and the transactions are closely related. If significant, such amounts should be disclosed in a note to the financial statements. Those interest items also should be offset for computing interest coverage ratios.

Financial Statement Presentation

The major components of debt should be disclosed on the face of the balance sheet or in the notes. Paragraph 19 of APB Opinion 15, Earnings Per Share, provides examples of information to be disclosed, such as liquidation preferences, participation rights, sinking fund requirements, interest rates, and maturity dates. In addition to the various types of subordinations, bank borrowings and commercial paper should be separately disclosed, as should components of debt that mature in more than one year. Such components may be grouped into significant categories for

disclosure. The existence of bank lines of credit and their relevant terms and amounts also should be disclosed.

Finance companies traditionally have not described their assets as current and noncurrent in balance sheets but typically have described their debt as short term or long term. That inconsistency is eliminated if a finance company classifies its debt as senior and subordinated rather than as long term and short term. Furthermore, classifying debt as short term and long term may be somewhat meaningless if unused revolving credit arrangements are maintained with banks. Such arrangements provide back up sources of funds to assure a finance company's creditors that bank debt and commercial paper due in one year or less will be repaid. Though the duration of those unused credit arrangements may exceed twelve months, some contain clauses that allow the banks to withdraw commitments based on subjective evaluations of the finance company's operations.

Auditing

The auditor should discuss the various forms of debt with management. Terms of the debt instruments may be reviewed to

understand the nature of each agreement, including any restrictive provisions. Once terms of the debt agreements are understood, the auditor can test compliance with its provisions and consider what disclosures are needed if the provisions are violated. Positive confirmations may provide evidence that a company's liabilities for principal and accrued interest at a given date are fairly stated. Confirmations may be used not only to verify the amounts of the liabilities but also to reveal changes in the various covenants of the agreements pertaining to such matters as guarantees, payment terms, interest rates, and restrictions on assets. Confirmations of bank lines of credit also may be used to identify conditions under which lines are available or may be withdrawn and whether compensating balances are required.

Compliance Reports. Some debt agreements may require companies to have their independent auditors issue compliance reports on various restrictive convenants involving matters such as restrictions on assets, payments of interest, and dividend payments. Such reports, which normally are in the form of negative assurance, are discussed in SAS 14, Special Reports.

Credit Questionnaires. Robert Morris Associates questionnaires may be included as information supplementary to the basic financial statements of the finance company. Some information required in the questionnaires will have been derived from accounting records tested by the independent auditor as part of the auditing procedures followed in the examining the finance company's financial statements. For example, information relating to reserve for losses, delinquent accounts, repossessions, deferred finance income, and borrowings will have been derived from financial records tested by the independent auditor. However, the auditor is not required to audit information included in the questionnaires unless the finance company requests such services.

If one or more questionnaires are included with the basic financial statements, the auditor should follow the reporting guidelines in SAS 29, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents, which require that the auditor's report state that the examination was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The report should identify the

accompanying questionnaire and further state that it is presented for additional analysis and is not part of the basic financial statements. The auditor should express or disclaim an opinion on the information included in the questionnaire depending on whether the information has been subjected to auditing procedures applied in examining the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

Participations

In a participation agreement, a finance company shares a loan with another financial institution by selling a portion of the loan or buying an interest in a loan originated by another financial institution. Sellers of participations sometimes retain a small portion of the buyer's share of interest on loans to cover overhead incurred in servicing the loans. Terms of participation agreements ordinarily provide for sharing of credit risks in proportion to cash invested by each participant. However, some agreements provide for a disproportionate sharing of the risk in relation to the cash invested. For example, an agreement may require one participant to suffer the first loss up to a specified amount. A participation may benefit the borrower by providing a lower effective interest rate based on the average of the participating parties' interest rates.

A participation may result from a company's reluctance to carry an unusually large receivable from a single customer or to carry a receivable from a borrower who is deemed to be an unusual

credit risk. To transfer some of the liquidity and rate risk, lenders may sell a portion of such loans to other lenders.

Accounting

Participations bought and sold usually are accounted for individually loan by loan. Control accounts also may be maintained for each participating financial institution.

Financial Statement Presentation

Participations should be classified according to the substance of the agreement, including any separate but related agreements. A participation that provides for pro rata sharing of risk, commonly called pari passu, should be shown on the balance sheet net of the portions sold or at net amounts bought. The amount of such a participation generally is combined with other finance receivables on the balance sheet and needs not be disclosed unless material in relation to total receivables. A participation that provides priority to one of the participants in liquidation of the loan, commonly called first out, should be classified as a liability in the balance sheet of the participant that lacks priority and the gross amount of the related receivable should be presented because risk is not shared and the agreement is essentially a financing arrangement.

Auditing

The auditor should consider reviewing compliance with the significant provisions of participation agreements, reviewing subsidiary listings of participations bought from or sold to other institutions, and testing transactions to supporting documentation. The auditor generally cannot confirm directly with the debtors if the finance company bought its participating shares under nonnotification arrangements. Instead, the auditor may correspond directly with the auditor of the other participating company to determine the adequacy of the other auditor's procedures. For example, the auditor may ask whether the participating share was included in the sample tested by the other auditor and, if not, request the other auditor to confirm the loan or obtain permission from the participating finance company to confirm the loan directly, perhaps using a pseudonym.

Captive Insurance Activities

Insurance operations ordinarily are an integral part of consumer finance activities. The auditor of a finance company that has captive insurance activities should be familiar with FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises. This chapter deals primarily with captive insurance business resulting from consumer finance operations, though it also addresses insurance coverage obtained from independent insurance companies.

Types of Insurance Coverage

Captive insurance activities of finance companies involve insuring risks related to loan transactions. The three general types of insurance coverage associated with those transactions are

- credit life coverage for loan repayment in the event of the debtor's death,
- credit accident and health (A&H) coverage for installment loan payments in event of the debtor's illness or disability for an extended period, and

- property and liability coverage on collateral or other property associated with the loan transaction.

Credit Life. Credit life insurance is a form of term insurance providing for loan repayment if the debtor dies before the loan is fully paid. It ordinarily is written on a single premium basis with the amount of the premium added to the loan balance and paid as part of the scheduled installments on the loan.

Credit life insurance includes level term insurance and decreasing term insurance. Level term insurance provides a fixed amount of coverage, generally the original amount of the loan. Decreasing term insurance, the more common type, insures the debtor's life to the extent of the unpaid balance of the loan, sometimes less any delinquent payments, at the date of death. However, decreasing term insurance usually is based on the contractual loan period. Therefore, the insurer may not pay off the entire uncollected balance on the loan if it is in delinquency status at the time of the debtor's death. The extent that delinquent installments are covered generally depends on the insurance contract and applicable state insurance rules and regulations.

The insurance company's risk exposure on a policy at a point in time under level term differs from that under decreasing term credit life insurance. Since level term insurance provides coverage equal to the original amount of the loan, the insurance company's risk exposure is constant throughout the term of the loan. In contrast, the insurance company's exposure under decreasing term insurance decreases as scheduled loan repayments become due, usually in direct proportion to the regular monthly reductions of the loan balance.

Credit Accident and Health. Credit accident and health insurance requires the insurance company to make the debtor's monthly loan payments during extended periods of illness or disability. It is ordinarily written on a single premium basis with the premium added to the loan amount and, hence, paid as part of the periodic installments. Under an accident and health policy, the insurance company's total risk exposure decreases, like a decreasing term credit life insurance policy, as loan repayments are made. However, the size of potential claims and the related risk exposure do not decrease in direct proportion to the reduction in the unpaid loan balance, because most credit accident and

health insurance claims are for short duration disabilities that are cured in a period shorter than the remaining loan term.

Property and Liability. Ordinarily, a finance company requires that the collateral pledged as security to a loan be protected by property insurance. Such coverage is substantially identical to property insurance that the debtor may otherwise carry on property used to collateralize the loan. The amount of coverage is usually based on the value of the collateral and does not necessarily bear a relationship to the unpaid balance of the loan. Property insurance policies issued in connection with finance transactions can be written either on a single premium basis for the loan term or for an annual or other period of less than the remaining loan term with the policy renewed as required during the term of the loan. Property insurance premiums related to finance transactions are frequently added to the loan amount and paid as part of the regular installment payments on the loan.

Writing Policies

A captive insurance subsidiary may be a direct writing or a reinsurance company. A direct writing company writes the insurance policies in its name. A reinsurance company reinsures

policies written by direct writing insurance companies. Insurance coverage also may be obtained from independent insurance companies with no participation by a captive subsidiary.

The insurance can be issued on either a group or an individual policy basis. The insurance company will issue a group insurance policy to the finance company which, in turn, will issue individual certificates to its debtor-customers. The group policies sometimes are subject to experience rated premium adjustments to the finance company; such adjustments depending on the experience and profitability of the group being covered.

Commissions

Both captive insurance subsidiaries and independent insurers may pay commissions to the finance companies. Those payments may be advance commissions computed as percentages of premiums, retrospective or experience rated commissions, or combinations of advance commissions and retrospective commissions.

Consolidation Policy

Captive insurance company subsidiaries should be fully consolidated with parent finance companies if a substantial portion of insurance revenue originates with finance customers of the parent companies. Full consolidation for all other insurance subsidiaries also may be most meaningful because both loans and insurance are types of financial services.

Accounting

Accounting for insurance activities generally is dealt with in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises.

Premium Income. Captive insurance subsidiaries should recognize premium income consistent with the methods described in FASB Statement No. 60. The Statement classifies insurance contracts as short or long duration contracts. Insurance policies issued in connection with consumer lending generally are considered to represent short duration contracts. Premiums from such contracts are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. According to FASB Statement No. 60, "that generally results in premiums being recognized as revenue evenly over the

contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule."

The following summarizes the revenue recognition principles for the various types of insurance policies:

- Credit life insurance. Straight line recognition of premium income should be used for level term credit life insurance because the risk exposure is constant throughout the term of the policy. An interest method should be used for recognizing premium income on decreasing term credit life insurance because the risk exposure declines in proportion to the scheduled reduction of the unpaid loan balance.
- Credit accident and health insurance. The risk exposure on credit accident and health insurance decreases throughout the term of

the policy as the unpaid loan balance decreases. However, since the risk exposure does not decrease in direct proportion to the unpaid loan balance, accident and health claim experience studies generally support the view that recognizing credit accident and health insurance premium income based on an average of the straight line and interest methods establishes a reasonable relationship to the anticipated claims. Such accounting is preferable to straight line or interest method recognition of premium income, because it tends to more closely conform to the recognition requirements of FASB Statement No. 60.

- Property and liability insurance. Property insurance premiums should be recognized on a straight line basis because the risk exposure generally is constant over the term of the policy. However, the premiums should be recognized on a decreasing basis in proportion

to the coverage if the amount of coverage declines on a predetermined schedule.

Commissions. Insurance commissions received should be credited to a liability account and systematically amortized to income over the life of the related insurance contracts. The method of commission amortization should be consistent with the method of premium income recognition for that type of policy as set forth in FASB Statement No. 60.

Income from experience rated or retrospective commission arrangements should be accrued over the applicable insurance risk period. Insurance companies generally can provide statistics from which a finance company can accrue estimated experience rated or retrospective commissions if the finance company does not maintain its own statistical experience data.

Commissions paid to a finance company from a captive insurance subsidiary are eliminated in consolidation.

Policy and Claim Reserves. Insurance policy and claim reserves for unearned insurance premiums and allowances for unpaid claims may result from related party transactions with

captive insurance subsidiaries. Policy acquisition costs, which are costs that both vary with and are primarily related to the acquisition of insurance contracts, should be deferred and amortized to income over the terms of the policies by the same method used to account for insurance premium income. Commissions paid to the affiliated finance companies and premium taxes are normally the most significant elements of acquisition costs for captive insurance companies. Deferred costs associated with payment of such commissions and other intercompany items should be eliminated in consolidation.

State Laws. Insurance companies are regulated by state insurance laws, which require maintenance of accounting records and adoption of accounting practices in compliance with the laws and regulations of the state of domicile. Some prescribed or permitted statutory accounting practices differ from generally accepted accounting principles. Accordingly, the financial statements of insurance subsidiaries prepared for submission to regulatory authorities must be adjusted to conform to generally accepted accounting principles before they can be consolidated with the parent companies.

Investment Portfolios. Captive insurance subsidiaries maintain investment portfolios typically composed of the same types of securities found in the portfolios of independent insurance companies. Under FASB Statement No. 60, marketable equity securities are carried at market value and unrealized gains and losses are carried in equity until recognized. Bonds generally are carried at amortized cost. Gains or losses are recognized in income when the securities are sold, mature, or otherwise disposed of. Permanent declines in values of investments also are recognized in income. Insurance subsidiaries disclose amounts of securities, if significant, deposited with state regulatory authorities when their financial statements are presented.

Financial Statement Presentation

Presentation of revenues and policy and claim reserves related to captive insurance activities varies in consolidated financial statements. In consolidated income statements, some companies combine revenues from captive and independent insurance activities and revenues from finance activities to present a total revenue amount; others do not. Some companies present credit life and credit accident and health insurance policy and

claim reserves related to captive insurance activities as liabilities in their consolidated balance sheets; others deduct such reserves from total finance receivables.

Captive insurance policy unearned premium and claim reserves may represent intercompany items because premiums are added to the consumer loan account, which is, in turn, classified as a receivable until paid, and because most or all of the payments on claims are applied to reduce the related finance receivables. Policy and claim reserves, therefore, should be deducted from finance receivables in the consolidated balance sheet. The deduction of such reserves will cause the receivables to be stated at net realizable value. The following illustrates that type of presentation:

Finance receivables	XXX
Less:	
Allowance for losses	(XXX)
Insurance loss and policy reserves related to finance receivables	(XXX)
Finance receivables, net	XXX

Alternatively, the balance sheet may present only the net finance receivables if the notes to the financial statements contain sufficient disclosure of policy and claim reserves and the allowance for losses.

Property insurance and a portion of level term life insurance claim reserves, however, may not be applied against related finance receivables because the finance company generally does not receive proceeds from such claims. That prohibition also applies to credit life and accident and health coverage written on policies for which the related receivables are assets of other unrelated enterprises. Such reserves should, therefore, be classified as liabilities.

Revenues from captive insurance activities may be presented as part of revenues from the finance business. That presentation may be preferable because it better portrays the relative significance of captive insurance activities to the earnings of the enterprise. The following illustrates that presentation:

Revenues from finance business:

Interest and finance charges earned on finance receivables	XXX
Insurance premiums and commissions	XXX
Investment and other income	XXX
Total revenues	XXX

Alternatively, if the income statement emphasizes presentation of net interest income, revenues from captive insurance activities may be presented separately below net interest income.

FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise, requires public enterprises to present in their financial statements industry segment information on revenues, profitability, identifiable assets, and other matters. For such reporting purposes, captive insurance business should be included in the finance business segment. However, if a captive insurance company is consolidated and a significant portion of the premium income, insurance reserves, or both originate from sources other than the parent company's customers, separate financial information on that business may be necessary to provide users with the most meaningful financial presentation.

Auditing

The AICPA Industry Audit Guides, Audits of Stock Life Insurance Companies and Audits of Fire and Casualty Insurance Companies, provide guidance on auditing concepts and procedures for captive as well as other insurance companies. The auditor should consider reviewing those AICPA industry audit guides for information. In addition, the auditor should consider whether accounts between the finance company and the insurance companies are reconciled regularly.

Since the insurance premiums and commissions associated with captive insurance activities ordinarily are an integral part of the related finance and loan transactions, the audit procedures used to test and evaluate the accounts for the loan and finance transactions also should apply to those insurance activities. Similarly, branch office controls over loans usually apply to insurance products. The auditor also should be satisfied that the income recognition methods for insurance premiums and commission income conform to the principles discussed in this chapter.

Acquisitions of Finance Companies and Operations

APB Opinion 16, Business Combinations, requires that the purchase price of a company be allocated among all assets, including identifiable intangible assets, based on their fair values. The remaining unassigned portion of the purchase price is then accounted for as goodwill. Bulk purchases of receivables portfolios of an existing finance company also result in similar allocations among tangible and intangible assets. Some considerations that may affect such allocations, or the purchase price of a finance company or receivables portfolio are as follows:

- A finance company may seek to expand its operations to geographical areas where it presently does not do business. The finance company therefore may be willing to pay a premium to buy another finance company that operates in such areas to avoid incurring start up costs of establishing new branch offices. Further,

the finance company may be especially willing to pay a premium if licenses are difficult to obtain or if regulatory or competitive conditions otherwise complicate entry in those areas.

- A finance company may buy another finance company or a receivables portfolio to obtain an established base of loans and customers base. The acquiring company may pay a premium, particularly for a portfolio of direct consumer loans and retail sales contracts, in the expectation that the purchased accounts will provide new customers that will borrow from the acquiring company in the future.
- The acquiring company may have no finance operations and seek to buy an existing finance company to obtain valuable loan licenses, management expertise, and customer lists. The buyer therefore may be willing to pay a premium for an initial entry into the business.

- A finance company may be willing to pay a premium to buy another finance company with an attractive debt structure. For example, the acquired company may have issued long term debt in prior years at favorable interest rates compared with rates prevailing at the date of purchase.
- The seller may enter into an agreement not to compete in a specified geographical area or for a specified period. The acquiring company may pay a premium for such a noncompete agreements.

To compute the net premium paid for the finance receivables, loans may be examined or graded and assigned to one of several rating categories to determine its estimated fair value. Considerations in determining fair values may be current market rates of interest and statutory limits on rates as well as quality of the accounts.

APB Opinion No. 17, Intangible Assets, addresses accounting for intangible assets including goodwill acquired in business combinations. The Opinion requires that useful lives of identifiable intangible assets be estimated separately so that appropriate periods of amortization may be determined. Amortization periods for intangible assets must not exceed 40 years.

Net premiums paid for finance receivables generally are amortized over the estimated life of the existing receivable portfolio. The estimated life may include expected renewals and generally is a relatively short period such as five to seven years. However, the existence of valuable loan licenses or noncompete agreements may indicate longer amortization periods are warranted. Nevertheless, conservatism should be a mitigating factor in determining those amortization periods because changes in state laws and regulations or in the competitive environment may render such loan licenses or noncompete agreements valueless. Amounts paid that are identified as relating to long term debt with attractive interest rates should be amortized using the interest method and over the lives of the related debt.

APB Opinion 17 requires goodwill to be amortized on the straight line method unless another rational and systematic method is demonstrated to be more appropriate. If a finance company was purchased for territorial expansion of operations or some purpose other than an initial entry into the finance business, consideration should be given to whether amounts designated as goodwill would be more appropriately accounted for as yield adjustments to the acquired receivables. A review of specific facts and circumstances, such as economic conditions and competition, generally must be considered. Also, effects of deregulation on financial institutions suggests that a forty year amortization period may be too long and difficult to justify.

Amounts of intangible assets may be presented in the balance sheet in one or more categories, depending on the materiality of the accounts. Intangible assets are usually presented as the last asset item or items in the balance sheet.

Appendix A: Glossary

- Accounts receivable aging. A schedule of delinquent accounts receivable in chronological order, grouped by intervals such as less than 30 days past due, 30 to 60 days, and so on. Finance companies prepare agings on either a contractual or recency of payments approach.
- Accounts receivable loan. A revolving or liquidating loan collateralized by the accounts receivable of the borrower.
- Accrual with suspension. A method of recognizing interest income based on the contractual terms of the loan (accrual basis). The accrual of interest is suspended when certain conditions occur that cast doubt on the collectibility of the unpaid loan.
- Acquisition costs. Costs related to making or acquiring loans.
- Actuarial method. See interest method.
- Advance payment. A payment on account made prior to the contractual due date.

- Adequate protection. A secured creditor's legal right under the U.S. Bankruptcy Code to have its collateral position not become impaired, impeded, or downgraded without sufficient protection against loss.
- Advance factoring. A factoring arrangement that allows a client to draw cash advances against the receivables before they are due or collected. Advance factoring also is called discount factoring.
- Anticipation. An extra allowance taken by customers on bills paid to the factor before the maturity date. The amount is based on the current interest rate.
- Appraisal. A formal valuation often made by an independent third party of property that will serve as collateral.
- Asset based financial services. Financial services related to secured commercial and

industrial lending activities. Asset based financial services include leasing and factoring activities.

- Asset based lending. Lending collateralized by the borrower's assets.
- Assignment. A written transfer of title to property or a grant that is a method by which client sales are transferred to become accounts receivable of the factor.
- Availability. The amount that can be loaned as a percentage of collateral. The percentage is determined individually by formula, for example, 70-80% of accounts receivable and 30-60% of inventory.
- Average due date. The average maturity date for purchased receivables in a given month under a factoring agreement.
- Borrowing base. An amount, usually defined in a note agreement or indenture, used in computing the maximum amount permitted to be borrowed as a particular class of debt. It

generally is determined by subtracting deferred charges and intangible assets from stockholder's equity. Subordinated debt is usually included in the borrowing base of debt senior to the subordinated debt. Also called the capital base.

- Bulk purchase. The purchase of a group of loans receivable as a single transaction. Also called a receivable portfolio purchase.
- Call option loan. A loan with a provision that permits the lender to require immediate repayment.
- Capital base. See borrowing base.
- Captive finance activities. Financing provided by a manufacturer or dealer through an affiliated finance company, generally with the intention of encouraging potential customers to purchase products of the controlling manufacturer or dealer.
- Carrying charge. Amount that the purchase of consumer goods agrees to pay to the retail

dealer or finance company (if the loan is obtained directly from the finance company) for the privilege of paying the principal balance in installments over a period of time.

- Chargeback. Under a factoring agreement, the charging of an unpaid invoice against the factored client's account for amounts due to a merchandising dispute, credit, offset, or other reason for nonpayment other than due to the customer's inability to pay.
- Charges. All amounts charged, contracted for, or to be received in repayment of an obligation, excluding principal but including interest and compensation for expenses incurred by the lender; the difference between net funds advanced and total amounts to be repaid.
- Charges only account. An account on which collections are applied entirely to finance,

deferment, or default charges with no portion serving to reduce the principal balance of the loan.

- Chattel. Personal property such as automobiles, furniture, and appliances.
- Chattel mortgage. An instrument under which the borrower (mortgagor) gives a lender (mortgagee) a lien on chattel property as security for payment of an obligation. The borrower continues to use the property. When the obligation is fully paid off, the lien is removed.
- Client. In a factoring arrangement, the business enterprise from which the factor buys trade accounts receivable.
- Collateral. Property pledged as security for loans. For consumer loans, collateral typically includes automobiles, furniture, and appliances. For commercial loans, collateral

typically includes accounts receivable, inventory, plant and equipment, and marketable securities.

- Collateral management. Routine monitoring by a finance company of assets that a commercial borrower has pledged as security. Such procedures generally allow the lender to provide more financing than would otherwise be available.
- Collateral trust. A trust arrangement under which a finance company deposits collateral with a trustee as security for borrowings. Notes issued for borrowings under such arrangements generally are called collateral trust notes.
- Collection. A system of methods and procedures for obtaining payment of overdue accounts receivable.
- Collection days. The time required for a finance company to have payments received

from customers collected and credited to the company's bank account.

- Comaker loan. Loan made by more than one debtor, generally unsecured. The second debtor is required because of insufficient or unknown credit standing of first debtor.
- Commission. A service fee paid to a finance company for arranging a transaction involving the sale or purchase of assets or services.
- Commitment fee. Consideration paid by a potential borrower to a potential lender for a promise to lend money in the future.
- Compensating balances. Deposit balances, frequently not interest-bearing, maintained in banks as compensation for advancing lines of credit, generally at some percent of the amount of line of credit. Such amounts are shown in balance sheets as restricted funds when there is a formal, contractual agreement restricting use of such funds.

- Concentration. The percentage of a company's sales made to a single customer.
- Conditional sales contract. Legal instrument used in credit sales of personal property providing that title remains with the seller until the purchase price is paid in full but that purchasers retain possession so long as there is no default.
- Confidential account. See no mail account.
- Consumer. Any individual who purchases goods or merchandise for personal or family use.
- Consumer revolving credit and credit cards. Contracts with consumers to finance personal lines of credit that are continuously available to the consumer either for the purchase of goods or direct advance of cash.
- Contracts sold under repurchase agreement. The seller, generally an equipment manufacturer, retailer, or dealer, agrees to pay within a designated period the unpaid balance

of defaulted loans by repurchasing repossessed collateral from the finance company after reasonable collection effort, repossession, and delivery of the collateral to the seller.

- Contracts sold with recourse. Receivable contracts sold with the seller (generally an equipment manufacturer, retailer, or dealer) guaranteeing payment. If loans are not paid in accordance with terms, the finance company may force the seller to redeem the defaulted loans.
- Contractual method. A method of determining delinquent accounts based on contractual terms of the original loan agreement.
- Contractual rate. The rate of interest stated explicitly in a loan contract.
- Coupon book. A book of coded payment forms to be used by borrowers in remitting payments.

- Creditback. A credit to a factored client's account, typically to reverse prior chargebacks for payments subsequently received from customers or for credits issued by the client.
- Credit bureau. An organization which accumulates and makes credit information available to its members.
- Credit department. Department of a financing organization responsible for establishing credit limits, maintaining credit histories, and controlling authorizations.
- Credit loss. The loss associated with a loan that is uncollectible.
- Customer. In a factoring arrangement, the individual or business enterprise that is the account debtor on the trade account receivable bought by the factor.
- Dealer. Retail merchant who generally purchases automobiles, furniture, appliances, or other consumer goods at wholesale and sells to customers at retail.

- Dealer holdbacks. Portions of dealer reserves withheld from dealers on retail contracts with greater than normal credit risk until a certain amount of payments on the contracts have been received or contract balances have been reduced to specified amounts.
- Dealer reserves. Liabilities for dealers' shares of finance charges on retail contracts purchased from dealers.
- Deficiency balances. Amounts remaining in borrowers' accounts after they have been credited for proceeds of sale of repossessed collateral.
- Deficiency judgment. Legal claim against a debtor for the balance of debt remaining after repossession and sale of the collateral, plus allowable expenses.
- Delinquency (default) fees. Fees paid by debtors because of being late with scheduled payments.

- Demand loans. A loan that has no fixed maturity date but is payable on demand by the lender.
- Direct consumer loan. A two party transaction in which the finance company lends funds directly to the borrower; such a loan may or may not be collaterized.
- Discount. Percentage of the face value of the loan deducted in advance as a charge for the loan; a deduction for interest at the time of the loan; any charge for credit which is precomputed and included in the face of the instrument.
- Discount factoring. See advance factoring.
- Discount loan. A loan that is written with the interest or finance charges included in the face amount of the note. Discount loans also are called precompute or add-on loans.

- Down payment. That portion of the cash price required to be paid by the purchaser as a condition for delivery of goods or services on credit.
- Effective interest rate. The implicit rate of interest based on the amount advanced and the amount and timing of the specified repayments over the period of the contract.
- Eligible accounts. Receivables that meet the criteria specified in a lending, factoring, or portfolio purchase agreement to entitle the borrower or client to a cash advance or payment.
- Equity participant. In a leveraged lease, an individual investor or group of investors who hold trust certificates evidencing their beneficial interest as owners under an owner trust.
- Evergreen loan. A loan that is neither re-paid periodically nor according to a fixed

amortization schedule; rather, it remains constant in relationship to assets that qualify as collateral.

- <u>Extension (deferment) fee</u>. Consideration paid by a debtor to extend the contractual payment terms of a discount loan.
- <u>Face amount of notice</u>. The total sum of money specified to be repaid.
- <u>Factor</u>. A term used to describe a company that engages primarily in factoring.
- <u>Factoring</u>. Purchase, usually without recourse, of individual accounts receivable arising in the client's ordinary course of business. Under a factoring agreement, the finance company also provides the client with credit checking and recordkeeping services.
- <u>F.H.A. mortgage</u>. Mortgage in which the lender is insured by the Federal Housing Administration against loss due to nonpayment by borrower.

- Financing statement. A notice filed in the location required by state law under Article 9 of the Uniform Commercial Code (UCC) necessary to perfect a security interest in collateral.
- First out. A participation agreement that provides for a participant to have priority over all others in liquidation of a loan.
- Fixed charge coverage. The number of times a company's interest cost is covered by earnings before taxes, measured by the ratio of earnings before taxes plus interest cost divided by interest cost.
- Fixed charge, gross. Difference between the amount advanced to a dealer for a conditional sales contract or to a debtor in the case of a direct consumer loan and the total amount to be repaid over the life of the related obligation exclusive of insurance charges.

- Floating rates. A rate of interest that, by the terms of the loan, fluctuates up or down depending on other widely followed market rates of interest, such as the prime rate, treasury bill rate, or Federal Reserve discount rate.
- Floor plan checking. Physical inspection of dealer's inventories that are collateral for advances to the dealer to be repaid from the proceeds from sale of specific items.
- Floor planning. Financing of dealers' inventories, particularly automobiles and other consumer goods, sometimes referred to as wholesaling. The dealers are obliged to repay from proceeds of sale of specific items, even though inventory is not sold, after a designated period of time.
- Foreclosure. A legal sale of mortgaged property to obtain satisfaction of the mortgage out of proceeds of sale.

- Garnishment. The attachment of salaries through court action to collect on a defaulted obligation.
- Interest bearing loan. A loan that is written at the principal amount advanced to the borrower and bearing interest computed monthly on the unpaid balance.
- Interest method. An actuarial method of computing interest income under which interest income on fixed rate obligations is accrued over the life of the loan to result in a constant rate (percentage) of interest on the outstanding loan balance.
- Inventory loan. A revolving or liquidating loan collateralized by inventory of the borrower.
- Lease. An agreement conveying the right to use property, plant, or equipment in exchange for cash payments over a stated period of time.

- Legal rebate obligation. The adjustment of precomputed interest required by state statutes on discount loans paid off prior to the end of their contractual terms.
- Letter of Credit. A document issued by a financial institution to a company guaranteeing payment of a specified amount on presentation before the expiration date of documents confirming shipment of goods. Generally, an irrevocable agreement.
- Leverage. The ability to finance operations through a combination of equity and debt funding.
- Leveraged lease. A lease involving at least three parties: a lessee, a long term creditor, and a lessor (commonly called the equity participant). The long term creditor commonly has recourse only to the leased assets.

- Lien. The right to satisfy a claim, if default occurs, by seizing the debtor's property subject to the lien and converting the property in accordance with procedures provided by law.
- Line of credit (bank line). An agreement by a bank to lend a specified amount of money to a finance company at an agreed rate as long as there is no material adverse change in the business of the finance company; such a line does not have to be used, but the funds normally are available upon request.
- Loan application. A form for completion by the prospective borrower generally providing space for personal data such as family, residence, salary, employer, other indebtedness, and resources. The form is used to document certain matters considered significant by the lender before deciding whether to make a loan.

- Loan file. An envelope or folder usually containing the loan application and documenting credit checks, references, records of past loans, and other matters. Notes, contracts, titles, and collateral usually will be physically stored elsewhere for security reasons.
- Mandatory securities valuation reserves. Reserve required by law or regulation to provide for possible losses on securities held by insurance companies.
- Maturity. Date on which, or time period in which, repayment of a debt is to be made.
- Maturity date (in factoring). The average due date of a month's invoices plus collection days.
- Maturity factoring. Factoring arrangement under which a client is not entitled to cash advances before invoice maturity dates.

- Maturity spread. A tabulation of estimated or scheduled maturities of installment receivables by months or year due.
- Mortgage loans. Loans collateralized by real estate.
- Net interest spread. The excess of interest income accruable over interest expense incurred in a period.
- No mail account. An account on which no contact is to be made with the borrower by mail.
- Nonaccrual loans (nonearning assets). Loans on which accrual of interest has been suspended because collectibility is uncertain.
- Nonnotification financing. Sale of trade accounts receivable in which the debtor is not informed of the sale. Such transactions may occur loan by loan, as part of a bulk purchase of a receivables portfolio, or as part of a continuing purchase.
- Nonrecourse. A situation in which a finance company has no legal right to compel payment

from a seller of accounts receivable or from a prior endorser or drawer of a negotiable instrument in the event of default.

- Nonrefundable fee. Any charge made in connection with a loan that does not have to be refunded to the borrower when the loan is prepaid.
- Notification. Informing debtors that their account has been sold to and is now payable directly to a finance company.
- Old line factor. A factor engaged primarily in the nonrecourse purchase of accounts receivable with notification.
- Open account sales. Credit extended that is not supported by a note, mortgage, or other formal written evidence of indebtedness, for example, shipments of merchandise for which a buyer is billed later.

- Open approvals. Credit is granted without immediate proof of a borrower's ability to repay.
- Origination fee. An amount charged by finance companies for originating (closing) or refinancing or restructuring a loan. The amount may be intended to cover costs such as underwriting, loan application processing, and reviewing legal title to property involved.
- Overadvance (in factoring). An amount advanced in excess of the amount of uncollected receivables bought.
- Pari passu. A participation that provides for a pro rata sharing of risk among all lenders.
- Partial payment. Payment of an amount less than the contractually scheduled installment.
- Participation. A loan funded by two or more financial institutions. Participations may be either first out or pari passu.

- Participation manager. Commercial finance company originating and supervising a loan shared by one or more participants.
- Perfection. Protecting a security interest in collateral against conflicting claims through proper filings under the UCC. See Uniform Commercial Code.
- Points. Amounts charged for granting loans, which primarily are adjustments of yield but also may be intended to cover costs such as underwriting, loan application processing, and reviewing title to collateral.
- Precompute loan. See discount loan.
- Prepayment penalty. An amount that the borrower pays to the lender, in addition to the remaining outstanding principal, if the borrower pays off the loan prior to contractual maturity.

- Rebate. Cancellation of a portion of the pre-computed interest charge when the balance due on a discount loan is paid off prior to the originally scheduled maturity date.
- Receivable portfolio purchase agreements. The bulk purchase of a portfolio of accounts receivable, either on a single liquidating or a revolving arrangement. The purchase is typically nonrecourse and without customer notification. The seller continues to handle all communications, billings, and collections with customers.
- Recency of payments method. A method of determining delinquent accounts based on when recent collections have been received without regard to when they were scheduled to be received in the original loan agreement.
- Recourse. The legal right to compel payment from a prior guarantor or drawer of a negotiable instrument if dishonored.

- Recourse (in factoring). The right to charge an uncollectible customer's account back to the client.
- Renewed (refinanced) loan. A direct loan to a present borrower that is rewritten by the execution of a new note with or without an additional amount of funds being advanced.
- Repossess. To gain custody; to take collateral from debtor for nonpayment or default on a loan.
- Retail sales contracts. Receivables arising from sales of consumer goods such as automobiles, furniture, and appliances by retail dealers. Retail sales contracts also are referred to as three-party paper (customer, dealer, and finance company).
- Revolving loan. A continuous loan made against an agreed percentage of the value of collateral, usually accounts receivable or inventory. The amount of the loan varies with the amount of collateral securing the

loan and generally provides the borrower with cash needed for business operations.

- Rewrite. Renewal of an account, when little or no payment has been received, with purpose of removing delinquency status.
- Robert Morris Associates. The National Association of Bank Loan and Credit Officers.
- Security agreement. An agreement between a borrower and a lender in which the borrower gives the lender a lien on equipment, accounts receivable, or other assets as security for amounts due to the lenders.
- Security interest. An interest in or lien on collateral to secure payment of an obligation.
- Senior debt. Borrowings that, by their terms, are not subordinate in payment priority to other debt.
- Service costs. Costs a finance company incurs in the administration of its loan portfolio.

- Springing lien. An interest in, or lien on, collateral that secures payment of an obligation, which is perfected on the occurrence of an agreed event, such as a default.
- Subordinated debt. Borrowings that by their terms are subordinate and junior in priority of payment, under certain conditions, to senior borrowings. Various levels of subordination include both senior and junior subordinations.
- Tax lease. An agreement that qualifies under tax rules that permit the lessee to claim rental payments as tax deductions and the lessor to claim tax benefits of ownership, that is, investment tax credits and depreciation.
- Three party paper. See retail sales contracts.
- Throughput. The annual dollar volume of invoices processed by a factor.

- Uniform Commercial Code (UCC). A set of statutes designed to provide consistent state laws dealing with commercial transactions, including secured transactions, negotiable instruments, and sales of goods.
- Vendor leasing. Arrangements under which a finance company offers leases through a vendor's sales representatives to the vendor's customers as a basic financial package.
- Wholesaling. See floor planning.
- Working capital loan. See revolving loan.
- Yield. Annual rate of return to the lenders on a loan.

Appendix B: Illustrative Financial Statements

XYZ FINANCE CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 19XX AND 19XX

(thousands of dollars)

ASSETS	19XX	19XX
Finance receivables, net	$336,616	$274,490
Investments in securities	32,760	30,838
Cash	6,015	4,907
Property and equipment	4,689	3,830
Other	8,661	7,253
Total assets	$388,741	$321,318

LIABILITIES AND EQUITY	19XX	19XX
Senior debt	$164,064	$113,700
Senior subordinated debt	84,204	74,572
Junior subordinated debt	30,400	30,523
Accounts payable and accrued liabilities	6,508	6,050
Income taxes	5,079	4,855
Unearned insurance premiums	11,483	9,636
Credit balances of factoring clients	4,120	3,112
Total liabilities	305,858	242,448
Equity		
Common stock, $1 par value, 4,269,000 shares authorized and issued	4,269	4,269
Additional paid-in capital	18,945	18,945
Net unrealized depreciation on marketable equity securities	(4,000)	(3,500)
Retained earnings	63,669	59,156
Total equity	82,883	78,870
Total liabilities and equity	$388,741	$321,318

The accompanying notes are an integral part of these financial statements.

FORMAT #1

XYZ FINANCE CORPORATION AND SUBSIDIARIES
STATEMENT OF CONSOLIDATED EARNINGS
AND RETAINED EARNINGS
YEARS ENDED DECEMBER 31, 19XX AND 19XX

(thousands of dollars, except per share amounts)

	19XX	19XX
Interest income:		
Interest and fee income	$ 55,510	$ 47,302
Interest expense	(18,825)	(16,283)
Interest income before credit losses	36,685	31,019
Credit losses	(5,489)	(4,609)
Net interest income	31,196	26,410
Other income	13,040	11,650
Other expenses:		
Salaries	(14,560)	(12,451)
Operating expenses	(8,008)	(7,115)
Insurance benefits	(6,644)	(5,600)
Income before income taxes	15,024	12,894
Income taxes	(7,211)	(6,189)
Net income	7,813	6,705
Retained earnings		
Beginning of year	59,156	55,551
Dividends	(3,300)	(3,100)
End of year	$ 63,669	$ 59,156
Earnings per share	$ 1.83	$ 1.57
Dividends per share	$ .77	$ .73

The accompanying notes are an integral part of these financial statements.

* An income statement presentation that does not emphasize net interest income may be more appropriate for companies that engage primarily or solely in factoring operations or otherwise derive a substantial portion of their income from and commissions for services rather than from interest earned on loans.

FORMAT #2

XYZ FINANCE CORPORATION AND SUBSIDIARIES
STATEMENT OF CONSOLIDATED EARNINGS
AND RETAINED EARNINGS
YEARS ENDED DECEMBER 31, 19XX AND 19XX

(thousands of dollars, except per share amounts)

	19XX	19XX
Interest and fee income	$ 55,510	$ 47,302
Other income	13,040	11,650
Total revenues	68,550	58,952
Interest expense	18,825	16,283
Insurance benefits	6,644	5,600
Credit losses	5,489	4,609
Salaries	14,560	12,451
Operating expenses	8,008	7,115
Total expense	53,526	46,058
Income before income taxes	15,024	12,894
Income taxes	(7,211)	(6,189)
Net income	7,813	6,705
Retained earnings		
Beginning of year	59,156	55,551
Dividends	(3,300)	(3,100)
End of year	$ 63,699	$ 59,156
Earnings per share	$ 1.83	$ 1.57
Dividends per share	$ .77	$ .73

The accompanying notes are an integral part of these financial statements.

XYZ FINANCE CORPORATION AND SUBSIDIARIES
STATEMENT OF CHANGES IN FINANCIAL POSITION
YEARS ENDED DECEMBER 31, 19XX AND 19XX

(thousands of dollars)

	19XX	19XX
Cash at January 1	$ 4,907	$ 3,328
Cash provided by operations:		
Net income	7,813	6,705
Add items not affecting cash		
Provision for credit losses	5,489	4,609
Other, net	5,724	5,847
Cash provided by operations	19,026	17,161
Less dividends to stockholders	(3,300)	(3,3100)
Cash provided by operations and retained in the business	15,726	14,061
Cash invested in operations:		
Increase in finance receivables	(68,606)	(52,667)
Other, net	(5,885)	(2,770)
Cash invested in operations	(74,491)	(55,437)
Cash from financing transactions:		
Senior debt	50,364	32,000
Senior subordinated debt	9,632	10,000
Junior subordinated debt	(123)	955
Cash from financing transactions	59,873	42,955
Cash at December 31	$ 6,015	$ 4,907

The accompanying notes are an integral part of these financial statements.

XYZ FINANCE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 19XX AND 19XX

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Consolidation - The consolidated financial statements include the accounts of XYZ Finance Corporation (the "Company") and all subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Income Recognition - Income on loans is recognized using the interest (actuarial) method. Accrual of interest income on finance receivables is suspended when the loan is contractually delinquent for 90 days or more with accrual resumed when the loan is contractually current. In addition, a detailed review of each commercial loans will cause earlier suspension if collection is doubtful. Revenue from premiums on credit life insurance is recognized using the interest method. Revenue on credit accident and health insurance is recognized over the terms of the contracts based on an average of the straight line and interest methods.

Credit Losses - Provisions for credit losses are charged to income in amounts sufficient to maintain the allowance at a level considered adequate to cover anticipated losses resulting from future liquidation of the existing portfolio in the ordinary course of business. Consumer loans are charged to the allowance when such loans become more than 180 days contractually past due. Factored receivables are charged off when 90 days overdue. All other receivables are charged to the allowance based on a detailed review of each loan as soon as such assets are deemed to be uncollectible.

Investments - Investments in marketable equity securities are carried at lower of market value and cost and investments in bonds and notes are carried at amortized cost. The amount by which the aggregate cost of investments in marketable equity securities exceeds the market value is reported as deduction from equity. Net realized gains or losses resulting from sales or permanent impairment in value of investments are included in income.

Loan and Insurance Acquisition Costs - Initial direct costs associated with the orgination of loans and acquisition of insurance policies are deferred and amortized using the same methods and periods that are used to recognize the related income. Initial direct costs represent commissions and other out-of-pocket fees and expenses paid to acquire the related assets.*

Assets Acquired in Liquidation of Receivables - Assets acquired in liquidation of receivables and held for sale are recorded at estimated net realizable values.

* The description of initial direct costs is subject to revisions on completion of the AICPA issues paper, "Accounting for Nonrefundable Fees of Originating or Acquiring Loans and Acquisition Costs of Loan and Insurance Activities."

(2) FINANCE RECEIVABLES AND ALLOWANCE FOR CREDIT LOSSES

Finance receivables at December 31 consisted of the following (thousands of dollars):

	19XX	19XX
Consumer:		
Real estate secured loans	$131,691	$104,078
Other consumer loans	121,810	99,997
Assets acquired in liquidations of consumer loans and held for sale	500	410
Commercial:		
Accounts receivable loans	32,002	27,440
Factored accounts:		
Receivables	21,404	18,594
Inventory loans to clients	2,965	2,876
Overadvances to clients	2,947	2,260
Floor plan loans	5,441	5,763
Other commercial loans	30,942	24,453
Assets acquired in liquidations of commercial loans and held for sale	220	180
Total finance receivables	350,192	286,051
Less:		
Allowance for credit losses	(6,539)	(5,515)
Insurance loss and policy reserves related to finance receivables	(7,037)	(6,046)
Finance receivables, net	$336,741	$321,318

Contractual maturities at December 31, 19XX were as follows (thousands of dollars):

	19XX	19XX	19XX	19XX	Thereafter	Total
Consumer:						
Real estate secured loans	$ 65,543	$46,248	$20,170			$131,961
Other	60,501	39,425	12,590	$6,792	$ 2,502	121,810
Commercial:						
Accounts receivable loans	32,002					32,002
Factored accounts	27,316					27,316
Floor plan loans	4,686	755				5,441
Other	16,131	10,219	3,084	1,508		30,942
Total	$206,179	$96,647	$35,844	$8,300	$ 2,502	$349,472

Accrual was suspended on consumer loans of $4,086 and on commercial loans of $2,107.

A substantial portion of the Company's consumer loan portfolio generally is renewed or prepaid prior to contractual maturity dates. The above tabulation, therefore, is not to be regarded as a forecast of future cash collections. During the years ended December 31, 19XX, and 19XX, cash collections of consumer loans totalled $57,670,000 and $45,719,000, respectively, and the ratio of cash collections to average balances was 52% and 51%, respectively.

Changes in the allowance for credit losses were as follows (thousand of dollars):

19XX

	Jan.1 Balance	Provision charged to income	Loans charged off	Recoveries	Dec. 1 Balance
Consumer:					
Real estate secured loans	$ 1,749	$ 1,842	$(2,083)	$ 625	$ 2,133
Other	1,550	1,635	(1,847)	554	1,982
Commercial:					
Accounts receivable loans	731	664	(808)	243	830
Factored accounts	643	583	(710)	213	729
Floor plan loans	133	121	(147)	44	151
Other	709	644	(784)	235	804
	$ 5,515	$ 5,489	$(6,379)	$ 1,914	$ 6,539

19XX

	Jan.1 Balance	Provision charged to income	Loans charged off	Recoveries	Dec. 1 Balance
Consumer:					
Real estate secured loans	$ 1,406	$ 1,466	$(1,604)	$ 481	$ 1,749
Other	1,246	1,300	(1,423)	427	1,550
Commercial:					
Accounts receivable loans	628	627	(749)	225	731
Factored accounts	556	534	(639)	192	643
Floor plan loans	112	129	(154)	46	133
Other	620	553	(662)	198	709
	$ 4,568	$ 4,609	$(5,231)	$ 1,569	$ 5,515

(3) INVESTMENT IN SECURITIES

Investments in securities at December 31 were as follows (thousands of dollars):

	19XX			19XX		
	Cost	Market	Carrying Amount	Cost	Market	Carrying Amount
Marketable equity securities:						
Common stocks			$ 9,828			$ 9,151
Preferred stocks			5,897			5,551
Other:						
Government bonds			6,552			6,167
Corporate bonds			4,586			4,318
Commercial paper			5,897			5,551
			$32,760			$30,838

All but $XXX and $XXX thousand of the above investments were held by insurance subsidiaries at December 31, 19XX and 19XX, respectively. At December 31, 19XX, investments in bonds with a cost of $XXX million were on deposit with certain governmental agencies in accordance with statutory insurance requirements. At December 31, 19XX, the marketable equity securities portfolio had gross unrealized gains of $XXX million and gross unrealized losses of $XXX million. Sales of marketable equity securities resulted in net realized gains or $XXX and $XXX million in 19XX and 19XX, respectively.

(4) DEBT

Debt at December 31 consisted of the following (thousands of dollars):

	19XX	19XX
Senior Debt:		
Thrift accounts and certificates	$ 32,105	$ 10,804
Commercial paper	83,600	65,638
X% to XX notes due 19XX-19XX	21,761	16,766
X% notes due 19XX-19XX	12,090	9,314
XX% notes due December 1, 19XX	9,671	7,452
Variable interest rate notes due 19XX	4,837	3,726
Total senior debt	164,064	113,700
Senior subordinated debt:		
X% notes due September 1, 19XX	40,000	40,000
X% notes due March 15, 19XX	34,572	34,572
X% notes due November 15, 19XX-19XX	9,632	0
Total senior subordinated notes	84,204	74,572
Junior subordinated notes:		
X% notes due May 1, 19XX	25,000	30,523
X% notes due March 15, 19XX-19XX	5,400	5,523
Total junior subordinated notes	30,400	30,523
Total subordinated debt	114,604	105,095
Total debt	$278,668	$218,795

Thrift accounts and certificates represent deposits in those states in which the Company's finance subsidiaries are authorized to accept savings funds from the public. Thrift accounts generally are withdrawable on 30 days' notice and thrift certificates generally mature within six months from date of issuance. In practice, withdrawals and redemptions are permitted upon demand, though early withdrawal of thrift certificates is subject to an interest penalty. The weighted average interest rate of thrift accounts and certificates outstanding at December 31, 19XX and 19XX was X% and X.X%, respectively, and the average interest rate during 19XX and 19XX was X.X% and X.X%, respectively.

Commercial paper is supported by revolving credit agreements with banks consisting of $XXX,XXX expiring June 30, 19XX and $XXX,XXX expiring September 30, 19XX. The banks' obligations under the support agreements require, among other conditions, that the Company remain in compliance with convenants of its loan agreements agreements. Annual commitment fees required by these support agreements totaled $XX,XXX in 19XX. Weighted average interest rates at December 31, 19XX and 19XX were X.X% and X.X%, respectively.

Fees related to bank lines of credit range from 4% to 2% annually and annual average compensating balance requirements range from 5% to 10% of the related bank lines of credit. Annual fees paid totalled $XXX and $XXX million in 19XX and 19XX, respectively, and compensating balances averaged approximately $XXX and $XXX million in 19XX and 19XX, respectively. The average compensating balances required for bank lines of credit and revolving credit arrangements in effect at December 31, 19XX and 19XX were approximately $X,XXX,XXX and $X,XXX,XXX, respectively. Inasmuch as compensating balances are maintained on an average basis over a yearly period, those required and maintained bear no direct relationship to the bank balances at December 31, 19XX and 19XX.

Maturities at December 31, 19XX were as follows (thousands of dollars):

	19XX	19XX	19XX	19XX	19XX	Thereafter	Total
Senior debt							
Senior subordinated debt							
Junior subordinated debt							
Total	$	$	$	$	$	$	$

The loan agreements under which certain of the senior and subordinated debt were issued contain, among other provisions, restrictions on the payment of dividends, purchase of common stock and requirements as to the maintenance of certain financial ratios and other financial conditions. Under the most restrictive of the dividend payment and common stock reacquisition provisions, approximately $X,XXX,XXX of consolidated retained earnings was available for such purposes at December 31, 19XX. Requirements for maintenance of certain financial ratios and other financial conditions have the effect of requiring maintenance of consolidated stockholders' equity at certain minimum amounts; at December 31, 19XX, consolidated equity exceeded the amount required by approximately $X,XXX,XXX.

*   *   *   *   *

NOTE: See appropriate FASB and AICPA pronouncements for additional guidance in presenting other information required by generally accepted accounting principles, such as for segment data, lease commitments, employee benefit plans, and income taxes.