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The Adequacy of Reserves

IN the not so far distant past it was usual to hear representations being made frequently that accountants are not qualified to pass on the adequacy of reserves. Those who took this position were fond of pointing to the matter of depreciation, calling attention to the fact that the measurement of depreciation largely is a matter of guess work, the responsibility for which accountants are not justified in assuming. It has been pointed out repeatedly that accountants are not appraisers; that it is not within their province to pass judgment on valuations; and that their work as auditors should be confined to the verification of data recorded on the books by employes of the client in accordance with instructions from officers and directors. If this line of reasoning had been pursued much further and had come to be commonly accepted, it would have been difficult to have determined just what value the services of certified public accountants might have to clients. The restrictions on their functions were gradually approaching a point where there was little left for them to do but check figures.

Included in this list of restrictions was the matter of reserves. Accountants of the old school were wont to dwell on the idea that once the directors of a corporation had made an appropriation for depreciation, the reserve thereby created was not subject to question in this respect, and any accountant who would presume to investigate the adequacy of the reserve was overstepping the bounds of his jurisdiction.

This idea has not met with popular approval on the part of progressive accountants who are up and coming, so to speak. Granting that "fools rush in where angels fear to tread" and at times all forward-looking accountants are guilty of this mistake, the consensus of sound opinion seems to be that public accountants not only have a right but a duty to investigate matters like depreciation and reserves covering this factor of operations, for the

purpose of passing judgment thereon and rendering an opinion to clients based on the conclusions reached in the premises.

This investigation, if properly conducted, frequently is productive of interesting and valuable results. The basic factors, such as cost of the property and the elapsed period of its service, generally speaking, are easy of determination. Its probable life is somewhat more difficult, but, little by little, experience is affording an accumulation of data which makes the establishment of depreciation rates fairly satisfactory. Numerous writers have furnished tables, based on experience, covering a great variety of property. Appraisal companies, while collecting such data primarily for private use, have contributed something now and then to the fund of information. The Treasury Department has added a substantial amount. It is possible now, in a great many cases, to compute a fair measure of depreciation and therefrom to check the provisions for such factor.

Another item which has been the subject of considerable controversy is the reserve for doubtful accounts. In the past some have been of the opinion that it was not within the province of the accountant to question the adequacy of a reserve for doubtful accounts or to pass judgment thereon. It was held to be sufficient if the mathematical accuracy of the account was verified, that is to say, the results of the computations were determined to be correct or incorrect in accordance with the bases used. If a mistake was discovered in the course of this procedure and not corrected before the accountant's report was rendered, of course, it would have to be mentioned in the comments of the report. No thought, apparently, was given to the fact that a certified balance sheet, to be of any value, should reflect the true financial condition and that one of the items entering into such condition is the net value of the accounts receivable. If the accounts receivable account con-

tains items of substantial size which are uncollectible beyond any question, obviously the accounts receivable are overvalued for balance sheet purposes. If the accounts receivable item contains accounts of doubtful collectibility, its value as an asset is impaired to an extent which is measured by the doubt surrounding the collection of the accounts.

There are two ways, of course, of giving expression to the doubtful element involved in the accounts receivable. One is to separate the total into two parts, showing on the asset side two amounts: one representing the accounts which are considered collectible; the other representing the accounts which are regarded as doubtful. The other means of expression is found in the use of a reserve for doubtful accounts. Previously, there was considerable discussion as to whether this reserve should be deducted from the assets or shown broad. Common sense gradually has influenced accountants generally in the direction of deducting the reserve from the assets, so that the final amount appearing on the asset side of the balance sheet opposite accounts receivable represents the value which it is expected will be realized.

The adequacy of a reserve for doubtful accounts receivable is a matter of judgment, which need not necessarily require constant contact with the detail accounts, personal acquaintance with the customers, and a knowledge of their financial standing.

Cash collected is the best evidence obtainable that an account was good at a given date in the past. The longer an account remains uncollected, the greater the probability that it will prove uncollectible. Notwithstanding the uniform optimism of credit managers and their assurance that all accounts of every description ultimately will be collected, every concern in business sustains some losses on credit sales. Past experience, other things being equal, usually is a very fair indication of what the future will bring forth. While it is true that various factors may affect the situation, the ex-

perience over a period of, say, five years, allowing for extraordinary economic changes, usually will afford a satisfactory basis for judging present conditions.

There has been too much of a tendency in the past on the part of accountants to review the list of customers' balances with the credit man and accept his judgment as to the adequacy of the reserve. This procedure, in the very nature of things, is unsound, because the judgment of the credit man always is modified by false hopes. Investigation of the accounts themselves, plus the experience of the past, is a much better basis for judgment. There is no reason, other than the amount of time and expense involved, why accountants should not determine for themselves, by investigation of the actual accounts and consideration of experience data, what should be the amount in the reserve for doubtful receivables. Recoveries, of course, must be taken into consideration. The age of the balances is another factor. Obviously, any accounts definitely known to be uncollectible, whether large or of medium size, first should be written off and gotten out of the way.

The scientific method of determining the adequacy of a reserve for doubtful accounts generally is conceded to be based on charge sales. These sales, measuring as they do the amount of original charges, should constitute the base on which subsequent losses are computed. The use of this method, however, calls for the determination, regardless of the year in which items were written off, of the year in which the accounts were charged originally. Any recoveries likewise must be related back, not to the year in which the items were written off, but to the year in which they were charged to accounts receivable.

Postponing for the moment discussion of objections from a practical auditing point of view, the theory may be carried through for the analytical value which it has as an aid to clear thinking concerning

the whole subject of adequacy. After charge sales and net write-offs by years for five years prior to the current year under consideration have been determined, the ratio of net write-offs to charge sales for the related years should be computed. This ratio is the experience index which may be taken to indicate what the concern may expect to lose through uncollectible accounts in connection with the charge sales for the current year.

A review of the individual accounts should serve to bring out the accounts representing charges in years prior to the current year which are doubtful of collection. The aggregate of these accounts fixes one element of the reserve. To this should be added an amount found by applying to the charge sales for the current year, the experience ratio developed from the average charge sales and average yearly write-offs, taken over a period of, say, five years preceding the current year. The sum of the two amounts, one covering charges to accounts receivable in prior years, the other covering charges to accounts receivable made in the current year with the estimated losses which may arise later, indicates what the amount of the reserve should be in order to meet the test of adequacy.

The conclusion naturally must be tempered by two things. Any accounts which originated and have been charged off during the current year do not require any reserve to be set up against them. Further, any doubtful accounts of unusual size which render the experience ratio ineffectual must be taken into consideration. Consequently, the amount of the reserve applicable to the current year should be adjusted by deducting from the original charges to accounts receivable, before applying the experience ratio, the original charges for any accounts charged and written off within the current year, together with the original charges for any accounts of unusual size set up within the current year and determined to be doubtful. While this adjusts the base to which

the experience ratio is to be applied, the amount resulting must be increased by adding the extraordinary losses.

A fallacy in reserves for receivables frequently is found in the fact that some of the balances representing current charges at the balance sheet date ultimately will prove uncollectible. This fact often escapes notice, the tendency being to consider a reserve necessary only for accounts which are so long past due as to cast doubt on their collectibility. The application of the experience ratio corrects this oversight.

Time and expense usually preclude the use of the scientific method in auditing practice. Seldom is there time or permission in the matter of cost to analyze the write-offs and recoveries to the point of determining the year or period in which the charges corresponding to sales were made. It becomes necessary, therefore, to find a substitute method which is approximately accurate and satisfactory for practical purposes.

In attempting to do this the natural inclination is to advert to accounts receivable balances at the ends of years or periods, and consider the write-offs and recoveries in the respective years following. Theoretically, this is not particularly sound for the reason that doubtful balances usually are carried over one or two years before being written off, and recoveries usually are credited in the years when they occur rather than in the years in which the original charges were made. Further, the amount of net write-offs for a given year usually includes some charges which originated and have been charged off during the same year, and therefore were not included in the balance sheet at the end of the preceding year. For practical purposes, however, a method comprehending end of year balances and following net write-offs affords a fairly satisfactory substitute basis for testing adequacy.

In making use of this method, the aggregate of accounts receivable balances at

the end of each year for five consecutive years preceding the current year under review should be ascertained. Next, the net write-offs for five consecutive years, including the current year under review, should be determined. Using the aggregate of these two sets of figures, the ratio of net write-offs to receivable balances should be computed. This ratio when applied to the receivable balances at the end of the current year under review will produce an amount which will indicate how much the concern may expect to lose on the accounts receivable at the balance sheet date.

The error in this formula is found in the fact that the amounts written off from year to year may have been carried in accounts receivable over two or more balance sheet dates, and consequently there may have been a duplication in the base figure. The practical effect of this duplication, even if it is a fact, probably is almost nil. In compensation for this theoretical error there is the fact that the method covers automatically, if somewhat roughly, the certain, although not accurately ascertainable, losses which rest in the charges made toward the close of the current year and not past due at the balance sheet date.

The amount resulting from the application of the experience ratio, as determined under this method, to the accounts receivable balances at the balance sheet date indicates roughly how much should be in the reserve to make it adequate. The amount obviously should be increased for any extraordinary losses on accounts in the list at the balance sheet date, not comprehended in the experience

ratio which has been applied to the receivables. Thus, a reserve of \$75,000 at December 31, 1925, may be regarded as adequate to cover ordinary losses based on past experience. However, if included in the accounts receivable at December 31, 1925, there is an account of \$200,000 known to be uncollectible in full because the affairs of the customer are in liquidation, the reserve obviously is inadequate. It should be increased in an amount equal to the face of the account, less the estimated realization and any amount which has been specifically reserved against the account.

The adequacy of reserves for doubtful accounts receivable is not a matter which need be left to the judgment and opinions of credit men and other company officials without question. There is something involved besides familiarity with a customer's financial affairs and opinion concerning his ability and willingness to pay or the hope of success in collecting an account. Careful investigation and consideration of individual accounts, coupled with the company's experience, in relation to existing general conditions and any special circumstances place the accountant in a position where his judgment intelligently formed is about as good as that of any one else who may be concerned. It should be apparent, therefore, that the accountant has little excuse for relying on the judgment and opinions of credit men and others as to the adequacy of reserves for doubtful accounts receivable, unless by reason of restrictions imposed by clients he is prevented from making the investigation which he should make in order to exercise intelligent judgment of his own.

Questions Concerning Current Position

A BALANCE sheet, in order most effectively to serve the many purposes for which it may be used, must be composed of items which are properly valued, clearly described, and intelligently arranged.

This assertion, by dint of much repetition, may seem to have become a mere

platitude. Yet thereby hang all the law and the prophets, as it were, covering the preparation of this important financial statement.

The necessity for proper valuation of the various items is obvious. Essential misstatement of the value of an asset or the