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Aging versus ratios

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cally and attempt to charge operations with depreciation based on up-to-the-minute replacement costs; their main argument is that once appreciated value is set up on the books, however, it should be recognized in computing depreciation charges. An additional argument sometimes urged is that by using the variation of this method described above, it is possible to accumulate out of earnings, by periodic charges to depreciation, a reserve towards replacing fixed assets at some time in the future at prices higher than original cost. It is contended that it is not only entirely legitimate, but also sound business practice, to accumulate such a reserve out of earnings.

Those in favor of the second method answer the charge that it would result in inflation of inventories by saying that the inventories in reality are not inflated if the appreciated value of the fixed assets is sound; that in almost any event the amount of so-called inflation is negligible and could be provided for by creating a reserve against it, if desired.

The net result of following the first method is simply to reverse gradually the entry setting up the appreciation. It does not affect the operating accounts or the earned surplus.

If the second method were followed, the operating expense would be stated at a larger amount than if the first method were used. However, this excess would be offset by an income credit made to take up as income, and thus to transfer to earned surplus, a part of the surplus arising from appreciation. The net effect on the earned surplus account of following the second method then would be the same as that resulting from the use of the first method, with one exception: there would be a slight discrepancy between the two because of the small amount of appreciation included in the inventories, as described above, resulting from the use of the second method. This assumes, of course, that no matter which method the concern used in handling depreciation of appreciation, it would sell its products at the same price in either case.

Whichever method is followed, it seems obvious that in utilizing cost data for purposes of fixing selling prices of a concern's products, there should be taken into account an allowance for depreciation based on the current cost of replacing the concern's fixed property, if such is higher than the actual cost of the property. This course tends to place a business which has acquired its plant at some time in the past at low cost, more nearly on a level with a business which just recently has erected its plant at higher prices. It tends to give the older concern a slightly higher rate of return on its investment, which may be either a reward for the foresight of its management in acquiring its plant during a period of low prices, or a piece of plain good fortune that prices have risen and a competing concern now is forced to pay more for its property. This assumes, of course, that the higher depreciation charges which the newer concern must meet are not offset by economies resulting from the fact that its plant is composed of more up-to-date equipment, which are not available to the older concern because it has to operate with antiquated machinery.

Aging Versus Ratios

THE interest of recent years in ratios has called forth considerable discussion. How much has been based on theory and how much on practical facts, of course, is difficult to determine. One ratio suggested, namely, that showing the relation of receivables to merchandise, has been rather consistently rejected by practical accountants because to them its conception appears illogical.

The ratio of receivables to sales has been more favorably received since, when used on a comparative basis, it will show the trend with respect to the amount of

capital invested in accounts receivable in relation to the volume of sales.

The months' sales in the accounts receivable balance also has enjoyed some use, because it goes further than the receivables to sales ratio in indicating how the receivables appear in relation to the credit term, and, when compared with prior periods, whether the receivables as a whole are becoming stronger or weaker as an asset.

Neither of these methods shows more than a very general condition on which exceedingly little reliance may be placed. Neither will supply enough information to justify specific conclusions, or do more than indicate in some cases the need for further investigation. At the same time the results may not be relied upon to determine conclusively whether or not further investigation is required.

Both of these methods have been thought at times to bear some relation to "aging," which may be defined as a systematic classification of accounts receivable, according to the months or periods in which the uncollected charges were made. For example, for some time it has been assumed that a tendency, as shown by the ratio of receivables to sales, or by the months' sales in receivables, in the direction of increasing receivables investment in relation to the volume of sales, was an indication of the need for aging. This was predicated on the theory that the older an account becomes, the greater is the likelihood of its resulting in a loss, and therefore the necessity of determining specifically the age of the individual accounts.

A recent short study of the matter indicates that there is not sufficient relation between ratios and months' sales and aging to justify reliance on the two former methods to the extent of governing the aging procedure. Ratios of receivables to sales for three successive years (1923, 1924, and 1925) show 22%, 16%, and 18%, respectively. This establishes the fact that as between 1924 and 1925, an increasing amount of capital is becoming invested in accounts receivable and indicates that the company is losing the improvement in the condition of the receivables as between 1924 and 1923, which, of course, is an unfavorable tendency.

The current condition of the accounts as determined by aging, however, tells a different story. In the years corresponding to the foregoing ratios, the relations of current accounts to total accounts receivable were represented by 85%, 80%, and 85%, respectively. In other words, while the investment in accounts receivable in 1925 was increasing both in amount and in relation to the volume of sales, the condition of the accounts was improving. The amount invested in current accounts was becoming larger; the amount in old accounts, smaller.

Studying the two sets of percentages alone, one immediately concludes that the sales must have increased in volume disproportionately during the latter part of the year. Such was not the case. Sales by months showed neither vertical nor horizontal fluctuations of an abnormal nature during the latter half of the year. There was no change in the credit terms. But the result was equivalent thereto. In 1925 the volume of sales on ninety-day terms increased out of proportion to those on thirty- and sixty-day terms.

While this one study, perhaps, is not conclusive as to the lack of reliance which may be placed upon ratios, it demonstrates beyond question, apparently, that nothing will quite take the place of aging. Again, ratios will not determine conclusively whether or not aging is necessary. The other methods will show tendencies and equivalents in terms of sales. They do not take into consideration the actual condition of the accounts. Aging shows the actual condition at a given date, which is a better index to the probability of loss through uncollectible accounts.

Aging is a valuable aid in judging the asset value of accounts receivable. Also, it brings to the surface old accounts in which fraud may be concealed.

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