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Accounting Questions

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

TURNOVER OF INVENTORY

Question: I should like to know the approved method of measuring turnover. Is it recommended that the inventory at the end of the period, or the inventory at the beginning of a given period, be used in dividing that amount into the cost of sales to see how many times the inventory has been turned?

Answer No. 1: Theoretically, it is the inventory at the beginning of a given period which constitutes the divisor to be applied to the cost of sales. The reason for this is not difficult to comprehend, since the turnover period means the time it will require to dispose of the inventory on hand; manifestly that can only concern the inventory on hand at the beginning of such period. For example, a merchant has a stock of $1,000 of certain goods on January 1st, which he disposes of (without further acquisition of any of such goods) by April 1st. His turnover period—that is, the time it took for him to dispose of those goods—was three months; expressed on an accrual basis, that stock would show a four-times turnover (assuming it to continue, on a like basis, through the year).

In actual practice, it has become generally customary to state the turnover as "number of times per year"; accordingly, when so expressed, it is necessary to take into account the relative change in the inventories. For practical purposes, inventories at the beginning and end of a year are not infrequently averaged, and this average used as the divisor. While this may not be exact, it does give cognizance to the changing inventory situation, and so affords a fair basis, unless other factors vitiate such average. If, for example, inventories have pro-

nounced seasonal peaks, a monthly average would certainly be a more reliable divisor.

Answer No. 2: It is my opinion that the best method of measuring turnover of inventories would be to use the average inventory of a given period and that, if the information is not available in order to accurately determine such an average inventory, then it would be preferable to use the inventory at the end of the period. The cost of sales into which the average inventory or closing inventory is divided in order to measure the turnover should not contain any items of expense which have been included in determining the cost of the inventory.

LEASED-DEPARTMENT SALES

Question: (1) Should leased-department sales be included with own sales?

(2) Should commissions earned from sales in leased departments be reflected in "other income" or used to reduce the cost of sales and, consequently, expand the gross profit?

(3) Should purchase discounts be used to reduce the cost of sales or reflected in "other income"?

Answer No. 1: (1) The leased-department sales are not ordinarily included with the sales of the lessor.

(2) Regarding commissions earned from sales in leased departments, we know of one instance in which the commissions are not reflected in "other income" and are not used to reduce the cost of sales, but are applied as a reduction of the rental expense. In this particular case, the operator of the store is a tenant himself and considers the commissions earned from the leased departments to be a reduction of the rental expense applied against his own operations.

(3) With reference to purchase discounts, there is a question as to whether these discounts are really cash discounts or are in effect trade discounts. Those we have in mind range from 8 to 10 percent and are used to reduce the cost of sales, because they are considered to be trade discounts.

The information offered in the foregoing paragraphs is based on the accounting practices of one of our clients, operating a chain of about 75 stores dealing in ladies' ready-to-wear apparel.

Answer No. 2: Questions one and two are similar in character and both are controversial. It would appear that no general rule can be laid down; that the method of handling sales of leased departments and commissions earned from such sales depends upon the terms of specific leases and upon other conditions prevailing at each store. In general, we prefer to exclude the sales of such departments from the regular store

sales and to reflect the commissions therefrom, if important in relation to the income account, as other operating income. In the financial statements, this income would be added to gross profit on sales before making deductions for operating expenses. If the commissions are unimportant in relation to the income account, the total thereof may be shown as other income after operating expenses have been deducted.

In stores where sales of leased departments are made principally on credit for which the store assumes the credit risk, it may be desirable to include the sales of such leased department with the regular sales of the store in order not to distort the relation between sales, receivables and bad-debt losses. If leased-department sales are included with regular sales, it, of course, should be so indicated in the financial statements.

There is a difference of opinion as to the treatment in the financial statement of purchase discounts, although it is generally agreed that trade discounts should be used to reduce the cost of sales. Regular cash discount may be shown either as a reduction in cost of sales or as other income. It is believed, however, that it is more frequently looked upon as financial income, and as such, classified as other income in the profit-and-loss statement.

COMPUTATION OF WORKING CAPITAL

Question: A client with a diversified and rapidly growing business has a thorough system of financial control whereby the rate of return is carefully considered on existing and projected products.

A dispute as to the method of computing the working capital employed has arisen between the operating and the financial management. The industrial manager claims that in calculating the working capital required, if a certain product is to be manufactured, accounts receivable should be counted at the delivered cost rather than the sales price. The financial management might agree to this plan if the estimated profits were reduced by the profits in the accounts receivable.

I should appreciate an opinion on this rather technical question. Would the inclusion of a charge to operations to create a bad-debt reserve change the opinion?

Answer No. 1: The usual business practice in computing working capital is to include accounts receivable at face value and to calculate the rate of return on this basis. From a purely theoretical standpoint, in computing minimum working-capital requirements, accounts receivable should, perhaps, be reduced by the element of net profit after all manufacturing, selling, administrative and other expenses, and it has even been suggested that, in calculating the rate of return, the net profits should be taken at their estimated present value. However, we would be

inclined to doubt whether the system of financial control of your correspondent's client is so highly developed as to enable him to reduce the elements of estimate in calculations of this kind to a point where the theoretical considerations raised in the question assume any practical significance.

Answer No. 2: It seems to us that the industrial manager is in error. While, of course, the amount of the accounts receivable is comprised of the cost of manufacturing and delivering the product sold, plus profit, the amount of capital employed (as distinct from the cash expenditures in production and delivery of a particular product) consists in part of accounts receivable, as in ordinary circumstances it is actually converted into cash within a short period.

If the accounts were actually collected and the cash deposited in the bank or if the proceeds were utilized for the purchase of raw materials, we believe the industrial manager would not maintain that only the original cost of the product, the sale of which provided the wherewithal, should be considered in computing the working capital and that the profit, now represented by either additional cash or raw materials, should be deducted.

Answering specifically the second part of the question, our opinion would not be changed by the inclusion of a charge to operations to create a bad-debt reserve properly established.