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Accounting Questions: Financing Charges of Automobile Finance Companies; Customers' Deposits on Special Orders

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ACCOUNTING QUESTIONS

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FINANCING CHARGES OF AUTOMOBILE FINANCE COMPANIES

Question

We are engaged in making an examination of an automobile finance company wherein the contracts are written for 12-, 18-, and 24-month periods. The company and its attorneys insist that the financing charge is earned when the contract is executed by both parties.

The accountant whom I am replacing claims that the company earns its cost of operation, namely, 40 per cent of its charges, when the contract is executed and the remaining 60 per cent, or gross profit, is distributable over the life of the contract. I believe that the entire revenue should be spread over the life of the contract and that expenses are charged to operations at the time incurred.

Answer No. 1

The inquiry does not state whether or not the contracts in question bear interest other than that which is included in the face of the contract. However, since such contracts do not customarily bear interest in addition to that which is included in the face thereof, we are assuming that there is no such interest charge.

Such being the case, it seems obvious to us that the excess of the face of the various contracts over the cost thereof to the company or the gross profit on such contracts consists of two parts, (1) reimbursement for the cost of obtaining such contracts and (2) the interest on the investment in the contracts.

All finance companies with which we are familiar obtain the funds for acquiring and carrying the automobile contracts financed to a large extent from borrowings in one form or another. These obligations of the company bear interest at current rates and such interest is a part of the cost of operations of the finance company and is, of course, absorbed in operating expenses over the period for which the borrowed money is used.

To the extent that the carrying charge does represent interest, that interest can be earned only by the passage of time and should be taken in income as earned in the same manner in which the related interest expense is charged to operations. It seems entirely illogical and inconsistent to take into income immediately the interest on instalment receivables and yet spread the interest on the money borrowed to carry such receivables over the term of the obligation.

The question as to the proper portion of the carrying charges which could be taken into income immediately to offset acquisition costs cannot be answered without definite knowledge of the surrounding specific facts. This requires knowledge as to the amount of the carrying charges in relation to the face of the contracts, the volume of business of the particular finance company, and the ratio of acquisition costs to the total financing income of the specific company.

Suffice it to say, it is our opinion that the finance company is justified in taking into income immediately that proportion of the carrying charge which bears a proper relation to the acquisition costs. This would probably be a figure somewhat less than 40 per cent but somewhat more than 20 per cent, depending as stated previously, on the experience of the specific company in question.

Answer No. 2

In my opinion the answer to the question would depend upon the contract under which the financing charges are made. If 40 per cent of the total charge or if any other per cent of the total charge is an amount payable irrevocably to the finance company—in the nature of a specific fee for taking the financial risk, for making an investigation, for insurance expense, or for some other service completed at or before the closing of the contract—then it would seem that that percentage of the charge is earned as soon as the contract has been executed. The balance would apparently be earned, on an accrual basis, ratably over the life of the contract, with appropriate weighting for the amount of money not repaid to the finance company during each month or other accounting period.

On the other hand, if a proper interpretation of the contract leads to the conclusion that the finance company earns the entire financing charge as it accrues in proportion to the amount of money loaned and the time during which it is outstanding, then it would seem proper to apportion the entire amount in accordance with these two factors.

CUSTOMERS' DEPOSITS ON SPECIAL ORDERS

Question

The question has been brought up by a local agency as to the proper classification in the balance-sheet of deposits received from customers on special orders. The company builds furniture pieces according to the requirements of its customers and receives deposits before undertaking the work. The job may be in process or not started at the balance-sheet date.

Will you kindly advise us whether these deposits are properly stated under the heading of deferred credits or accrued liabilities.

Answer No. 1

It seems to us that these deposits ought to be treated as current liabilities. The only justification for not treating them thus, but carrying them as deferred credits, would be that the execution of the orders would involve substantially no reduction of current assets; and it seems that that could not apply to this situation. The time might come when an order has been almost entirely completed, and the cost has been expended or provided for among the trade liabilities, under which conditions the profit to be realized on the order might properly be considered a deferred credit, but until such time the deposits on orders should be carried as a current liability, designated as deposits by, or advance collections from, customers.

We cannot see that there is any question of "accrued liabilities" involved.

Answer No. 2

We are of the opinion that the advance deposits received from customers should be included as part of the current liabilities and designated, for example, as "customers' deposits on contracts." As work progresses on these contracts the company may, if it chooses to do so, take up as deferred credits to income a pro-rata share of profits on uncompleted jobs. On the other hand, should the cost of jobs in process indicate a known or potential loss, provision should be made therefor in the account.