Journal of Accountancy

Volume 70 | Issue 1 Article 12

7-1940

Accounting Questions: Verification of Notes in Small-Loan Business; Gain or Loss on Foreign Exchange

American Institute of Accountants. Bureau of Information

ACCOUNTING QUESTIONS

[The questions and answers which appear in this department 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 Institute who are practising accountants and are published here for general information. The executive committee of the Institute, 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.—EDITOR.]

VERIFICATION OF NOTES IN SMALL-LOAN BUSINESS

Question

I have a client engaged in the small-loan business and in discussing the audit for the ensuing fiscal year one or two questions have been raised relative to the method and the extent of verification of notes receivable and of notes payable. I would like to submit these questions for presentation to several accounting firms, particularly those that have large clients engaged in small-loan business.

The following are the questions:

1. Method and extent of verification of notes receivable
   (a) Is it considered necessary to verify notes receivable by direct communication with the debtors, or
   (b) Is it considered a reliable test verification to compare the pass books presented with payments at the window with the ledger card?
   (c) In the verification by direct correspondence with the debtors what constitutes a satisfactory test, assuming that the method of internal control is sufficiently extensive and reliable?
   (d) To what extent or what percentage of the accounts should be tested if the method of comparing the pass books with the ledger cards is used?

2. Verification of notes payable.

In this instance there are two or three hundred creditors on notes payable who have loaned their savings to the company based upon their belief in the integrity of the management. These creditors are individuals, unfamiliar in most cases with business practices and auditing procedure, and it is possible a letter requesting confirmation of the amount owing would raise doubts in the minds of these individuals as to the safety of their investment. Based upon the above statement of conditions:

(a) Is it necessary or desirable to request confirmation of the balances from the creditors and, if so, how extensive should it be to be considered satisfactory by accountants generally?
(b) To what extent do bankers or credit grantors consider it essential that such notes payable be verified and by what method?

The small-loan business is peculiar in that the customers are generally in the lower income groups and are not highly educated and are not familiar with business practices. Generally, I believe that the response to requests for confirmations of balances on either notes receivable or notes payable is meager and there is a question as to the reliability of a test with such response. There seems to be a general impression that requirements of bankers and credit grantors relating to verification of such items are not as comprehensive with respect to small-loan and finance companies as with other enterprises.

Answer No. 1

Question 1: With respect to examination of borrowers' loan balances we consider it necessary to include a test examination of the accounts by direct communication with the debtors. The extent of such test should depend upon the accountant's judgment after careful review of the company's internal audit procedure. As loans receivable are the principal asset on the balance-sheets of personal finance companies, it seems advisable that not less than 10 per cent and perhaps as much as 20 per cent of the loan accounts should be covered by the accountants' confirmation procedure regardless of how efficient the company's internal control appears. It may be advisable to select dates other than balance-sheet date for confirmation test.

In our opinion, comparison of information shown on pass books presented during the engagement with information shown on the ledger cards does not alone constitute an adequate test examination, as a sufficient cross section of the borrowers' accounts probably would not be covered in this manner. In other words, this procedure may be limited for the most part to verification of accounts with borrowers who are conforming to terms of their contracts.

Question 2: In connection with examination of notes payable to individuals, we believe it desirable to make at the least a test of such liabilities by direct communication with the creditors. Regardless of the creditors' familiarity with business practice and auditing procedure, we feel that the confirmation letters could be worded in such a manner as to indicate the actual purpose for which the letters are intended. As to the extent of the confirmation test, this matter should depend largely upon the accountant's judgment. Assuming the company acts as its own note registrar and the note liability to individuals is relatively large as compared with total liabilities, it would appear desirable under ordinary circumstances to cover the entire note liability as at the balance-sheet date by affirmative type confirmation letters. However, if other methods exist by which the accountant may satisfy himself as to the substantial accuracy of the note liability, we believe that the confirmation procedure could be correspondingly reduced to a test basis.

We hesitate to volunteer an opinion as to what various bankers and credit grantors would consider essential in connection with the accountant's examination of notes payable to individuals. If there is a question in the accountant's mind as to the adequacy of the audit procedure, it may be advisable to secure permission of the client to discuss the matter with representatives of the leading banks.

GAIN OR LOSS ON FOREIGN EXCHANGE

Question

This is with reference to the subject discussed in Accounting Research Bulletin No. 4.

Please advise what your attitude would be in the following situation: A domestic corporation imports most of its merchandise from Europe, the liabilities being covered by drafts payable in foreign exchange. Because of the extraordinary drop in such exchange, the corporation has realized gains upon payment of the drafts. The question arises whether these gains should be shown as a separate item on the profit-and-loss statement, or whether it would be allowable or advisable to show them as a deduction from merchandise purchases, inasmuch as they arose directly in connection therewith.

Answer No. 1

We think there is little room for doubt about the proper treatment of foreign exchange purchases. We believe the customary and sound practice is to treat the merchandise cost as being the exchange equivalent at the time the purchases are made and to take the exchange loss or profit on payment of the drafts as a separate profit or loss on exchange in the income account.

Answer No. 2

In our opinion, it is preferable to apply such profits in reduction of the cost of the merchandise purchases rather than as a direct credit to profit and loss, for the reason that some part of such reductions of the purchase price of the goods probably would apply to goods on hand at an inventory date, and therefore should be treated as reductions of the inventory values.

Answer No. 3

Ordinarily, the liability for the European purchase is recorded at the exchange rate prevailing at the date of purchase; the difference between such liability and the amount paid in liquidation thereof would be included in other income under the caption, "Gain on exchange." Under this treatment it is assumed that the amount is not appreciable.

Where, however, by reason of extraordinary conditions the resulting gain or loss is appreciable, thus probably affecting the inventory value of the article and/or the selling price thereof, we should adjust the cost of sales, showing the gain or loss on exchange as a separate item.