1964

Principles of credit extention : a case analysis

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PRINCIPLES OF CREDIT EXTENSION:

A CASE ANALYSIS

By

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A Thesis
Presented in partial fulfillment
of the requirements for the
Master of Science
in
Business Administration
at the
Graduate School
of the
University of Richmond
May 1, 1964

PREFACE

GOAL OF THESIS

Accounts receivable are one of a company's most important assets. These receivables must be converted into cash if the production and sales activities of a company are to continue on a successful basis. The goal of the thesis is to show how a firm footing is established for accounts receivable.

PLAN OF ATTACK

The subject matter has been broken down into five chapters and each chapter presented in its logical sequence.

Chapter one discusses the basis for extending credit. There must be a basis for credit thinking to lead into the subject. Discussing and defining the basis for credit is a logical starting point towards sound credit thinking.

Chapter two identifies and discusses the four characteristics of credit. These characteristics are measured to find out the degree of risk involved in extending credit to a particular applicant.

Chapter three shows how the credit strength of the applicant is measured by an analysis of the financial statements.

Chapter four examines the sources of credit information which gives deeper insight into the applicant's capabilities beyond that revealed by the statements.

The next step is finding a way for safely selling the weak accounts. Chapter five explores the methods available for extending credit to the marginal accounts.

BASIS FOR THESIS

The thesis is based primarily on the writer's five years experience in the credit field with Reynolds Metals Company. During these years the writer has given many hours of thought to the following questions:

1. When should credit be extended and when should credit be refused?

2. Why did a situation work out successfully while a similar situation worked out conversely?

3. How can a particular bad situation be prevented from recurring?

4. How can an unacceptable credit risk be made acceptable?

The cases around which the thesis is built have been taken as they occurred from the credit files of Reynolds Metals Company. Only the names have been concealed and this was necessary due to the confidential nature of the information.

The writer feels that the thesis can contribute some valuable information toward a better understanding of "credit" by making available the invaluable experiences that have been encountered at Reynolds Metals Company and the subject of "credit" as the writer has found it to be.

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CHAPTER I

THE BASIS FOR CREDIT

A sound credit foundation must be built under a business if the business is to survive and prosper just as the foundation for any building must be carefully laid if that building is to stand through the years. This foundation is prepared at the outset when the orders are received and the credit decisions made.

A sound collection policy is a helpful supplement to a sound credit policy but can accomplish very little if credit is extended to accounts which do not have the assets with which to pay or which will not pay.

WHEN CREDIT IS EXTENDED

A sound credit policy does not occur by chance but only through an aggressive and well organized credit procedure in which all orders are carefully screened and through which every penny of credit extended is justified.

There is no formula or secret method to tell when to approve or disapprove an order. There are however, certain basic principles that can be followed. These principles applied with sound thinking and good judgment will result in a good credit selection process.

Credit should never be extended without financial information to support it. Credit might be left to chance and 90% of the accounts might still be collected but not many companies can afford a 10% bad debt loss. Even if all of the accounts are collected the time and expense in collecting them will in most instances more than offset any profits realized.

The basis for credit will vary from company to company depending on the degree of risk each individual company is willing to take and the amount of time they are willing to wait for payment. These two factors are in turn decided by the following:

1. Profit margin. The greater the profit margin the greater the risk a company may be inclined to accept and the longer they can afford to carry an account.

2. Working capital position of seller. The seller needs funds with which to operate, and must turn the receivables over rapidly enough to provide the funds

to pay their bills. The seller can sometimes expedite payment if working capital is tight by allowing cash discounts for prepayment of accounts or may have to restrict sales to companies that can pay within a certain period.

3. Going terms in the industry. The seller will not as a rule, be able to establish payment terms which are shorter in duration than those of competition, unless some other concession or advantage such as a reduced price or a superior product or service is being offered.

PAYMENT TERMS AND THE PROBLEMS THEY PRESENT

The basic selling terms under which Reynolds Metals Company operates are net thirty days and Reynolds Metals Company bases its credit policies around trying to obtain payment within a thirty day period. A large volume of business would be lost; however, if customers were limited to those who pay within thirty days. Reynolds Metals Company's sales people could not compete with such strong rivals as Alcoa and Kaiser with a rigid thirty day payment restriction on their sales efforts. This problem of extended terms is not restricted to the aluminum industry, but is encountered frequently by all industries.

The problem now arises as to how additional time can be extended to some customers while their competitors pay within net thirty day terms. It is not fair to sell competitors A and B the same product, in the same quantities, at the same price and expect A to pay in thirty days while B is getting 120 days in which to pay. A would more than likely place his business elsewhere if this were done and the seller would be vulnerable to prosecution under the Robinson Patman Act for such an unfair policy.

There are two ways in which a company can work with the B's who need 120 days and at the same time be fair to the A's who pay in thirty days:

1. Have Mr. B pay interest for the ninety days financing he requires. The legal rate of interest is six percent per annum in most states.

2. Charge Mr. B a higher price which includes a differential for the additional ninety days financing required by him.

As long as competition exists there will be some situations where a company cannot get either a higher price or interest. These situations should be kept to a minimum and the additional time allowed only when there is firm proof that competitors are going along on this basis, where a substantial sales volume is at stake, and where the overall financial condition of the company requiring the additional time is sound.

DISADVANTAGES TO SELLER OF EXTENDED TERMS

There are three distinct disadvantages to extended terms:

1. Working capital is a costly commodity. Reynolds Metals Company is fortunate in being able to obtain its working capital for around five per cent. Other companies pay up to eighteen per cent depending on their financial strength and banking connections.

2. Extended terms cut down potential sales volume with marginal accounts. Take, for example, an account whose financial strength permits only a $5,000.00 credit limit. If the company can be kept on a thirty day basis the account has a yearly sales potential of $60,000.00. By increasing the terms to ninety days the sales potential is cut to $20,000.00. The credit man is responsible for

educating salesmen on the disadvantage of extended terms, since salesmen are often inclined to offer extra payment terms to marginal accounts in hopes of increasing business. In the long-run, these salesmen are actually decreasing business.

3. Extended terms increase the risk. Thirty days can be the difference between getting paid and not getting paid. Adverse conditions develop rapidly in our business world of today and the longer payment is deferred the greater the risk that the customer will fall into an adverse situation and be unable to pay.

CHAPTER II

THE FACTORS IN EVALUATING THE CREDIT RISK

There are four distinct characteristics that must be analyzed to evaluate the credit risk. These are commonly referred to as the Four C's of credit and are character, capacity, capital and conditions.

CHARACTER

The dictionary defines character as moral qualities, ethical standards and principles. Character is an intangible factor but one that can be evaluated accurately as experience is gained with an account.

Guideline to Character Some of the guidelines that assist us in measuring the character factor are:

1. Commitments. Those who are insincere and unreliable, who consistantly make commitments which are never kept, quickly come to the fore. Conversely those who can be relied on to give a straight promise and to do all possible to perform on this promise can be recognized.

In using commitments as a basis for evaluating character, the credit man's thinking should be tempered if the customer is placed in a difficult position by an unwise credit decision or forced to make a commitment that cannot be kept.

Fortunately the American businessman by nature is normally very conscientious of any commitments made and takes pride in being a man of his word. The unreliable are the exception rather than the rule and clearly stand out. Commitments are the most reliable guideline to the character factor.

2. The intensity with which a customer recognizes the obligation to pay. The majority of Reynolds Metals Company's sales are to customers who have the ability to pay within selling terms and will do so. In today's extremely competitive market place, however, Reynolds often finds itself forced to deal with customers who cannot or will not pay when due. These accounts fall into two categories.

a. Mr. Have Not - Who lacks the working capital necessary to pay when due but will do everything possible to pay in a satisfactory manner. The desire to pay is present but the ability to pay is lacking.

b. Mr. Will Not - Watch Mr. Will Not closely. Mr. Will Not believes that it is the responsibility of the creditors to finance his operation. Mr. Will Not continuously takes any available cash out of the business and continues to live off creditors from year to year in lieu of retaining a reasonable amount of earnings in the company to enable the company to improve its working capital position and pay obligations.

One of the most striking cases involving a Will Not is that of Reynolds Metals Company Vs. Company A.

Company A started in operation approximately 15 years ago with a net worth of $10,000.00. Company A was under very capable management and in the course of 15 years the net worth was built to over $1,000,000.00. In addition the two owners made personal fortunes from Company A and used the company as a springboard to a host of other corporations.

The owners worked on the philosophy that there was no obligation to pay the old accounts until something was required in return. Company A would run up a large account and then stop buying from Reynolds Metals Company. About five or six months later Company A would call and ask what was required on the old account to ship an additional $200,000.00 or so worth of metal to them.

Reynolds Metals Company worked with Company A on this basis for years as did competitors. There were continuously long overdue invoices open on the books.

Early in 1962 one of the unions won bargaining rights over Company A's employees after a ten year battle. The company couldn't reach agreement with the union on the initial contract, sold all the inventory, pulled all of the money out of the operation and left Reynolds Metals Company holding the bag for over $700,000.00.

The character factor was lacking; however, Reynolds and competitors extended credit to Company A because of the high sales volume potential.

3. Truthfullness. The character of a company's management can be appraised by the truthfullness of the information given to creditors. Company B lost substantial money over a several year period. Along with this

the owner had taken $81,000.00 out of the business to purchase a new home. As a result Company B was running 30 days to nine months slow with suppliers. The credit man involved found out from Company B's principal supplier that the company owed them over $300,000.00 dating back nine months and new shipments were being made strictly on a dollar for dollar basis.

Company B's treasurer said that all suppliers were being paid within selling terms and that Reynolds Metals Company's invoices would be paid accordingly. This was an indication of the lack of character and this along with the poor financial condition of the business made it impossible for the credit man to extend any open credit to Company B.

4. Fairness of adjustment claims. An account that makes unfair adjustment claims is just as much a thief as someone who sneaks into the creditors warehouse at night and attempts to make off with the assets. The adjustment thief is as void of the character factor as the other type of thief.

Company C received a shipment of aluminum sheet on which the protective tarpaulin had ripped. Company C refused to accept this shipment subject to inspection and told the carrier to either release the material at scrap value or take it back.

The material appeared to be in good condition and had been wrapped in plastic for additional protection. It was apparent that Company C was attempting to buy good metal at scrap price. The salesman was vigorously defending the account but was forced to admit that the customer was trying to make a "little" money at the carriers expense. Company C has been a consistant adjustment problem and their demands have been very costly.

Joe Scudero, an ex-halfback for the Washington Redskins who now sells Reynolds Aluminum, used this football phrase to describe one of his accounts, "They're nickle and diming us to death with adjustments." These nickles and dimes are the profits. If the profits must be given away in adjustments the sale is of no value. Also the account that will cheat on adjustments will just as quickly cheat on paying obligations.

5. Favors. The average American is instilled with a sense of fair play and feels a sense of obligation towards others for the favors they so kindly do for him. Character is lacking if a thank you is not given for a favor.

This trait of the American way of life carries over to business dealings where usually most customers are appreciative of anything done to help them. There is the type of customer to whom a favor is just a stepping stone to another favor. Customers who will take advantage of a favor in this manner are certainly lacking in moral qualities.

Company D had a fire several years ago which destroyed most of its inventory. Reynolds Metals Company rushed through some additional material for Company D and had the material in Company D's hands within a week to enable the company to meet some essential orders.

The President of this company, several years later, was still appreciative for what Reynolds Metals Company had done for him those earlier years.

Reynolds Metals Company has sold Company D a great deal of metal since the fire and is still getting a major portion of the company's business despite the fact that Company D could occasionally get some of the material at a cheaper price elsewhere.

Company E which was owned by a very successful and wealthy labor lawyer as a sideline venture was in serious financial difficulty. Over a period of several years the Reynolds Metals Company credit representative did numerous favors for Company E in an effort to help the company get back on its feet.

The owner made this remark to the credit representative following a creditors meeting, "What can you do for us this week?" This remark showed how much the owner of Company E appreciated help.

At a later date an additional $25,000.00 credit was extended to this company following a phone conversation with the lawyer in which he agreed to personally see that the invoices would be paid when due. Reynolds Metals Company ended up writing off a portion of this $25,000.00 in addition to the old account.

6. Bankruptcies, suits and criminal offenses. The major portion of bankruptcies are honest and usually due to a shortage in the capital, condition or capacity factors; however, quite frequently the character factor enters into the cause.

There is the type individual who is only in a business for what can be gotten out of it. When the going gets rough this individual gets his money out of the operation, quickly steps aside and lets the creditors work out the problems.

Mr. F told one of the Reynolds credit men that handling the problems of a business entitled him to a minimum of $25,000.00 a year salary. Mr. F would not consider touching the problems for less. Mr. F grossed a minimum of $125,000.00 for leading two companies into bankruptcy. Mr. F is personally wealthy but this fact provides little consolation to the many creditors who have been left with the bad debt losses.

Those with a long history of suits and criminal offenses should be carefully investigated and watched. The information below which was taken from a credit report shows an example of a Company G whose management has a record of past crimes and business failures. The management of Company G was clearly void of the character factor. Reynolds Metals Company extended credit to the company and wrote off as a bad debt $18,000 on the first sale of $25,000.

CREDIT COMPANY
CREDIT REPORTS
July 15, 1959

"BUSINESS HISTORY: Our records of Mr. G go back to the fall of 1936 in R area when subject first entered business there as G's Electrical Appliances. The business was unsuccessful and creditors closed it down for non-payment of trade obligations. Subject then was unemployed for a time and next engaged in a venture that finally resulted in his indictment by a Federal Grand Jury for withholding taxes on alcohol and it is indicated that Mr. G served time in a Federal Penitentiary for this offense. Numerous judgments stand against subject between 1939 and 1942.
NOTE: Mr. G has been regarded as a promoter in the past several years and has left actual building and development

work to subcontractors. Mr. G's business has suffered over the years due to his slow pay and non-pay tactics.

FINANCES: A banking connection reports having several checking accounts past one year, all ranging low to moderate four figures. The bank has made unsecured loans to Mr. G as an individual up to low five figure amounts, and also to various and sundry of his firms up to low six figure amounts. Currently a low six figure aggregate amount is outstanding (business-wise) and the bank has placed Mr. G on a reduction basis to pay out and when the loan is paid this bank will no longer deal with the firms or individual, indicating slow pay and deemed to be pressed for working capital. The bank feels that Mr. G has a personal net worth of some low six figures.

A second banking institution, also having open accounts dealing from 1953, had in past asked Mr. G to leave their bank for unsatisfactory dealings, however Mr. G returned to the bank in the past two to three years and most of dealings have been around X O Builders Corporation. The bank knows Mr. G as a promoter only, usually subcontracting actual work to subcontractors.

Business loan experience has been on the unsatisfactory side, being slow, and business seems extended and pressed for working capital. Despite this however, both the G brothers have accumulated substantial net worth and a joint statement as of October 1958 (Mr. G and Mr. G's brother) shows some nine corporations to be worth some $1,300,000 and with home equities, and realty and investments in domestic corporations the bank puts combined net worth at $1,500,000.

Mr. G has a home worth some $125,000 subject to undetermined mortgage. Mr. G lives in style befitting a $35,000 per year income, has late model Cadillac cars, ample domestic help. The home sets upon one acre of ground.

Local trade bureau records show that over a period of years from 1951 up through August 1958, there are numerous trade clearance statements entered into records here, in varying amounts, and from "no good--non pay" through suit threatened and small claim court and common law suits to slow, unsatisfactory and closed out as uncollectable. Over twenty five such accounts listed. Also out of state trade bureau records show similar items prior to coming to the present area. Agencies advise dealing with caution."

The writer received a $10,000.00 order from Company H last September and at the time Dun and Bradstreet listed nine open suits and judgments. At the same time the owner of Company H was making payments on a new Cadillac and a new Lincoln. The man is leading a pretty good life at the expense of his creditors. Mr. H's personal code of ethics considers driving two expensive cars of more importance than paying obligations and Mr. H is not deserving of the priviledge of credit.

The following statement which the writer read over five years ago has always remained in the back of his mind, "Never deal with a rascal under the impression you can prevent him from cheating you. The risk in such cases is greater than the profit."[1] This statement was made by Hugh McCullough, first comptroller of the currency

1 Albert F. Chapin, Credit and Collections, Principles and Practice (6th ed.; New York: McGraw Hill Book Company, Inc., 1953), p. 172

back in 1864 and the writer has found it to be almost 100% true today. While keeping this in mind, do not overlook the positive side of character.

Character alone will not insure payment but its presence will go a long way towards payment. In most instances where character is present the credit man will be able to find a reasonable basis for selling an account.

Credit is based on man's trust in his fellow man. If our fellow man is void of the moral qualities, ethical standards and principles which are character they are undeserving of the valuable asset of credit.

CAPACITY

Capacity is the ability that a company has to operate successfully. The need for capacity has greatly increased in the past twenty years, and is becoming more and more important as competition becomes more intense and better and cheaper ways are found of doing the job.

GUIDELINES TO CAPACITY

Below are some of the guidelines available to help judge a credit applicant's capacity:

1. Past record - The best guide to a company's capacity is its past accomplishments. A company that has operated for a period of years including periods of feast as well as famine, consistantly earned a nice profit, maintained a sound financial structure and paid obligations promptly, unquestionably has capacity.

The difficult credit decisions; however, are not made on accounts with the clear cut record of progress and the sound financial condition.

When a company's past record does not give a clear cut picture of its ability, a credit man must get to know the company more intimately to know what it can do. The credit man must find out what the people behind the company know, think, plan, and what their company can do. The management of the marginal accounts is usually in the hands of from one to three people and once these people are known the company is known.

2. Knowledge of the industry - Management must know what is going on in an industry pricewise, productwise, and otherwise. Management must keep on top of their industry; know competitors, competing products, new

production methods, weak spots in the market, and future opportunities.

Decisions cannot be any better than the knowledge behind them. Dynamic and rapid changes are being continuously made. A company must be aware of these changes to meet them and keep pace with the times.

3. Goals of management - The goals of a company must be sound, realistic, and obtainable. To succeed a company must have a good product, sell it at a profit, and produce at a rate commensurate with sales.

If a company's plans seem to conflict with current conditions and good judgment that company should be watched closely. A company should not normally be increasing production at a time when their finished goods inventories are extremely high; at the end of the selling season, or when sales are off. Neither can a company which is operating at a loss hope to increase prices above what the market is bringing to get back on a profitable basis.

When a company's basic goals are not sound the capacity factor is lacking and creditors must be very cautions in selling them.

4. Financial thinking - Management should have a good idea as to how much money will be needed to operate and from where this money is coming. Money does not grow on trees as the incapable and the promoters would lead one to believe.

A company must have sufficient funds to pay employees, taxes and suppliers if that company is to stay solvent. This requires good sound financial planning especially for the accounts with very limited amounts of working capital.

Mr. I came to the writer with a $10,000.00 order for a new company. The information below which Mr. I gave the writer gives a lead on how weak the financial thinking behind the new company was.

A. The company was being set up with an initial investment of $50,000.00. Mr. I did not have the capital yet but hoped to have it in two to three weeks if everything went right. The money was to come from several other individuals who were interested in backing the company.

B. Mr. I did not know what the starting payroll would be but would hire people as needed and hoped to eventually employ eight to ten people or more.

C. The company would need $180,000.00 inventory when the business gets in high gear.

D. The overhead would be very low and the company would not require a large volume of business to operate at a profit.

The writer would have been very unwise to extend $10,000.00 credit to Mr. I with his business set up on such vague plans. Mr. I had no clear ideas on what the company was hoping to accomplish. The company was starting operations with $50,000.00 capital that was not available and was already thinking in terms of $180,000.00 inventory which the company could not afford even if the $50,000.00 were available.

5. Manufacturing Facilities - The highly competitive conditions that exist in the aluminum industry and for that matter in all other industries at this time

do not leave much margin for outdated inefficient production methods or facilities.

Over the past ten years Reynolds Metals Company has invested an average of $59,000,000.00 per year in capital assets to keep up with the times.[2] Reynolds has developed a new process for rolling sheet which is radically different and much cheaper from anything heretofore developed; just one of the many changes which are continuously taking place. More efficient equipment and processes are being developed for all companies large and small and in all industries.

HOW ACCURATELY CAN CAPACITY BE JUDGED

A credit man should be able to judge what a customer can do after having worked with the customer over a period of several years. However, even then the capacity factor sometimes remains a mystery. Quite frequently a company sells new accounts when the capacity factor is very cloudy. How a person will react under extreme

2 1962 Annual Report of Reynolds Metals Co., Richmond, Va.: (Reynolds Metals Co., 1963), p. 16

pressure is a constant uncertainty. Many do not have the capability to come up with the right decision when faced with an adverse situation and all too quickly will pull up stakes and let the bankruptcy courts and the creditors work out the problems.

IMPORTANCE OF CAPACITY

Capacity is rated by most credit men as the most important of the four C's of credit. Yet quite frequently important credit decisions must be made with very little idea as to how much capacity a credit applicant has. Credit decisions must be supported in such instances with an overabundance of one of the other factors usually Capital.

CAPITAL

THE PURPOSE CAPITAL SERVES

Capital is the repayment insurance cushion that a credit man has as a final resort. Capital can make up for serious weaknesses in capacity and conditions for a temporary period of time and can by itself be sufficient to support credit at a particular time if the customer has character.

Capital can also be of very vital importance to the company itself. Many companies, large and small, on occasions run into adverse periods. The capital cushion can provide a company with the added time needed to work out of these situations and restore operations to a profitable level.

THE CAPITAL CUSHION IN ACTION

Here are some practical examples of the capital cushion in action during adverse periods showing its value to the credit man and to the customer.

COMPANY J1

DATE	NET WORTH
6-30-56	$859,226.00
6-30-57	768,780.00
6-30-58	536,747.00

1958 thru 1961 financial statements declined.

Company J1 produced screen wire primarily for porch screens. Over the years the company's production facilities were not kept up and at the time of the decline the equipment of Company J1 was all obsolete. Company J1 went bankrupt in March 1961. Reynolds Metals Company extended $30,000.00 credit to company J1. This company's capital enabled them to stay alive for five years during which Reynolds could have bowed out of the picture. Unfortunately Reynolds Metals Company did not despite customer's refusal to provide financial statements and despite the apparent downward trend. Cost to Reynolds Metals Company--$23,481.19. The capital cushion gave creditors a four year period in which to find out what was going on.

COMPANY J2

DATE	NET WORTH
12-31-55	$724,631.00
12-31-56	633,579.00
12-31-57	554,350.00
12-31-59	360,197.00

Company J2 was a brewery that had operated since early 1900. The company's facilities became old and the company was unable to meet the intense competition that faced them in the 1950's and went bankrupt in May 1961. The capital cushion gave Company J2 five and one half years to reverse the trend, however, the company was unable to restore operations to a profitable basis.

COMPANY J3

DATE	NET WORTH
10-31-52	$1,210,000.00
10-31-56	710,000.00
10-31-57	502,000.00
10-31-58	419,000.00
10-31-59	477,000.00
10-31-60	428,000.00
10-31-61	386,000.00
10-31-62	388,000.00
10-31-63	407,000.00

Company J3, which was started in 1927, moved into a new plant and warehouse in 1952. The plant and warehouse cost $820,000.00. Company J3 served as a distributor for steel and aluminum products and, in addition, manufactured metal trim. The new quarters were too expensive for Company J3 and at the same time the metal trim business became unprofitable. The new quarters were sold in 1957, and the metal trim production was discontinued. It took this company nine years and $824,000 to return to a profitable basis. Thanks to a very substantial cushion of net worth Company J3 was able to work out of their difficulties, and are operating once again on a profitable basis.

The above examples show that substantial companies do not as a rule go broke overnight. In cases J1 and J2 the cushion was not able to save the companies. It did give the creditors involved five years to find out the problems behind the decline of these two companies, obtain payment of what was due, and bow out of the credit picture. Company J3 was able to survive a nine year period of substantial losses thanks to a $1,200,000.00 cushion of net worth.

A credit man must get to the root of the problem and make sure that the company involved has the resources and know how to overcome the problems before extending credit to companies which are incurring steady or substantial losses.

INCREASING CAPITAL

There is no substitute for character or capacity. Creditors must adapt to conditions as an individual company cannot do much to change them. Creditors can, however, increase the capital behind a company or transaction by adding the financial strength of outside parties through subordinations and guarantees, by shifting the payment responsibility to others through payment assignments, joint check arrangements and by insuring payment through letters of credit and payment bonds. The thesis shall cover these devices in greater detail in the section on special arrangements for selling the extremely marginal accounts.

HOW MUCH CAPITAL

There is no set numerical figure as to how much capital a company should have to support credit. Each case speaks for itself and the credit man after reviewing all of the facts must answer this question, "Is the capital adequate to reasonably insure payment within a given period?"

The less a credit man knows of a company's capacity and character, the more capital the credit man must usually insist on to support a credit transaction. Credit men are for that reason usually very cautious in selling a new account and insist on a little extra cushion. After the company is known a little better the possibilities of working with them are unlimited and the writer has seen many cases where credit has been safely extended to companies far in excess of their net worth.

CONDITIONS

SEASONAL CONDITIONS

One of the most important factors in sound credit planning is the development of a good sense of timing in extending credit to the marginal accounts. This timing is based on the fact that, in almost all industries, the bulk of the sales are made during a particular season. These seasons follow the same pattern year after year and can be accurately predicted.

The weather causes the seasonal pattern in some industries such as the construction industry. Other industries build their business around a special time of the year, such as Christmas.

Creditors stand the best chance of being paid promptly when credit is extended at the beginning of the selling season, or while the selling season is in full swing. Caution must be exercised on orders placed for shipment towards the end of the selling season. If the marginal customers are caught with inventories high at that point financing will be required through their off season. This often means that the creditors will not get paid until activity picks up again the following season.

Here are a few of the highly seasonal industries that the writer has worked with in the Central Region of the United States.

CONSTRUCTION INDUSTRY

Sales Season Sales hit a peak in the early spring when the freezing weather is ended. Activity usually starts to pick up good around March or April and is in high gear by June, with sales holding up good throughout the summer months and tapering off a little from September to early November.

Off Season The construction industry is for the most part paralyzed when the intense cold weather arrives and reaches a low point around January or February.

Inventories Inventories should be at the highest level during the period March through June and should taper off somewhat during late summer. Inventories should reach the low point sometime between November and January.

ALUMINUM CHRISTMAS TREE INDUSTRY

Sales Season The manufacturers selling season is almost exclusively August through October but there will be some replenishment orders during November.

Off Season The Christmas tree manufacturers have made or lost their fortunes by the end of November and sales will be inactive until August rolls around again the following year.

Inventories Inventories should be at the highest peak in July and August and should be reduced to a very low level by the end of November.

IRRIGATION INDUSTRY

<u>Sales Season</u> Sales for irrigation pipe distributors start moving around March and reach the highest peak in June. Irrigation pipe as a rule moves good throughout the summer, and starts falling off a little during August and September.

<u>Off Season</u> Sales fall off quite a bit in October and when the cold weather arrives are at a standstill. A rainy season at any time will cause the irrigation business to fall off drastically.

<u>Inventories</u> Inventories must be at the highest peak around March to be available when the season breaks and should be reduced to a low level by the end of October.

The above emphasis placed on selling seasons should not give the impression that marginal accounts are not to be sold during the off season. A company could not retain its marginal accounts very long if this were the policy.

The key to whether credit should be extended at a particular time is this, "Does a customer's inventories appear to be in proportion to sales at a particular time and can the customer turn the inventory over and pay creditors in a satisfactory manner?"

The seasonal patterns should be kept in the back of the mind since the seasons play a very important role in credit planning and must be weighed along with the other factors in making credit decisions.

GENERAL CONDITIONS

Each credit man should be aware of the general conditions in an industry. These conditions contribute much to the ability of the extremely marginal accounts to survive. There have been certain basic trends over the past two decades that must be taken into consideration.

A drastic change has taken place in the last twenty years. Shortages were prevalent during World War II and the post war period thereafter. Almost all anyone needed to make a business prosper was something to sell.

Take, for example, the aluminum industry. The industry had to allocate the short aluminum supply judiciously. The problem was not selling aluminum but producing aluminum to sell. Deep scars exist today from that era with some customers who feel the aluminum supply was not distributed in a fair manner.

The aluminum industry has very rapidly passed from that era of want to an era of plenty. The day when anyone could hang out a sign and prosper has now passed. The battle for every dollar of sales is intense with profits limited. The following section takes a look at general conditions prevalent in the aluminum industry today.

SALES AND CONSUMPTION

The aluminum industry has been breaking through into new markets and increasing sales volume at an almost unbelievable pace. The consumption of aluminum in the United States has increased steadily over the past ten years. Consumption of aluminum in the United States reached a record high of 2,550,000 tons in 1962.[3]

3 Ibid., p.2

PRODUCTION

The production of aluminum has more than tripled since the 1947 to 1949 base period. During this same period Federal Reserve Index Figures indicate that the production of steel has increased by 78%.[4]

PRICING

The price of aluminum has been going steadily downward for the past three years despite the steady increase in sales and consumption. The price of 99% Virgin aluminum ingot at New York dropped to 22.54 cents per pound in December 1962. This is the lowest basic price primary aluminum has carried since December 1954.[5]

4 "Aluminum Industry Basic Data Book" (Economic Research Department, Reynolds Metals Company, New York, September 1962) p. A6

5 Norbert J. Lancer (ed.), Metal Statistics 1963 (56th ed; New York: American Metal Market) p. 555

The following statistics show how the price decline is affecting Reynolds Metals Company:[6]

Year	1957	1958	1959
Net Sales and other revenue*	$451,661	$450,975	$498,624
Net Income before tax	73,386	71,634	74,735
Ratio of income before tax to revenue	16.2%	15.9%	15.0%
	1960	1961	1962
	$448,003	$486,212	$542,392
	37,419	33,475	38,050
	8.4%	6.9%	7.0%

*Thousands of dollars

COMPETITION

The aluminum industry is currently involved in a terrific competitive struggle for sales. Alcoa, Reynolds Metals Company, and Kaiser are leading the way. Harvey Aluminum Company, Anaconda Aluminum Corporation, and Ormet Corporation are also in the thick of the fight.

Foreign competition is also becoming more of a factor to reckon with. Imports of aluminum products for

6 1962 Annual Report of Reynolds Metals Company (Richmond: Reynolds Metals Company, 1963), p. 2.

the year 1962 exceeded exports by 120,000 short tons. Compare this with 1958 when exports exceeded imports by 212,000 short tons and the impact of foreign competition is seen.[7]

The competition has reached a very unhealthy state in which prices and selling terms are being sold instead of aluminum. This competition is being met by all and the end result is that most of the companies in the industry are still getting a proportionate share of the aluminum business only at a depressed price.

A credit man must have an idea as to the general conditions existing in an industry to evaluate the opportunities available to customers and the pitfalls standing in the customers path. The increased sales opportunities, decreasing prices and intense competition outlined above are being felt by all size companies in all sectors of the aluminum industry. The large companies are fighting for a reasonable profit and many of the smaller companies are fighting for their lives.

7 Lancer, Op. Cit., p. 549

CHAPTER III

FINANCIAL STATEMENT ANALYSIS

Having looked at the principal factors in credit analysis, the writer now looks at the application of the factors in practical situations. A credit man starts with a completely unknown credit applicant and identifies the capital or financial strength, the character or moral strength and the capacity or ability. The initial step in the identification process is usually the evaluation of the capital factor.

OBTAINING FINANCIAL STATEMENTS

It is now common practice for credit applicants to make available to creditors detailed financial statements to support credit requirements. Many credit applicants make this information available through Dun and Bradstreet and other credit agencies, while others will give statements directly to the creditors on request.

Credit men still run into a number of situations where it is extremely difficult and sometimes impossible to obtain this important information. The financially sound as well as the weak sometimes will not release financial statements. The reasons for this vary.

Some credit applicants feel that their financial affairs are strictly their business and that creditors have no right to this information. It is maintained that obligations are paid satisfactorily and that this should entitle them to any amount of open credit.

A financial statement may obtain information which could place a company at a serious disadvantage if it were to get into the hands of competitors.

The amount of credit involved may not be considered sufficient to warrant the release of financial figures.

The credit man's approach may offend the credit applicant, or there may be some clash in personalities to cause a customer to refuse financial figures.

The credit applicant may be weak financially and know that the statement will not support the amount of credit in question. The weak have usually been through the credit mill on other occasions and have the most convincing arguments on why financial statements should not be required.

APPROACHES FOR OBTAINING FINANCIAL STATEMENTS

A job of top salesmanship is sometimes required to obtain financial statements. The stakes are often high as this information may be the difference between selling a substantial volume to a particular account and not being able to sell the account.

The approaches to obtaining financial statements are as many as a credit man's imagination can improvise. The writer has found three basic ideas to be most effective in persuading customers into releasing this important information:

1. The credit man is most anxious to approve the order in question or the credit line which a customer requires. To do this the customer's help is needed in furnishing financial statements.

2. It is management policy which requires this most important information and not a personal whim of the credit man. The blame for this financial statement requirement is placed on our management; but this policy of management is a sound one and requires no excuses should the credit applicants take exception to it.

3. The financial statement is to be used solely to support credit and will be kept strictly confidential.

<u>OTHER THOUGHTS ON OBTAINING FINANCIAL STATEMENTS</u>

A credit man must sell his personality to his customers. Once a credit man is on a good first name basis with a particular account the account is usually more receptive to requests for financial information.

One of the Reynolds Metals Company credit men had dealt with Company K for a period of time and was unable to obtain a financial statement from them. The credit man noticed that the treasurer of this company chewed tobacco quite vigorously, and on a visit told the treasurer that he would swap a package of good Virginia chewing tobacco for a financial statement. The credit man mailed the chewing tobacco and received a financial statement in the return mail.

The first name approach does not work in all cases. There is the type of individual who respects only strength. The only way financial figures can be obtained from him is to place business on an either or basis; no figures, no credit. Salesmen can be helpful in most of these cases as they are generally on a first name basis with these accounts and can pave the way for financial figures when the initial sale is negotiated.

SITUATION WHERE FINANCIAL FIGURES CAN NOT BE OBTAINED

Despite all the skill and diplomacy a credit man may use, situations arise where financial figures cannot be obtained. Sometimes the banks and other sources of credit information will give sufficient information to support credit on a particular company. There is also the chance of selling the prospective customer on a cash basis where supporting credit information is not available.

CONFIDENTIAL INFORMATION AND THE CREDIT MAN'S RESPONSIBILITIES

Credit men have a moral obligation to zealously guard confidential credit information not only from other companies but from other people in their own company.

There is no quicker way of spreading information around the industry than to make it available to salesmen. The writer has encountered several situations while working with Reynolds Metals Company in which sales management and production management people have requested confidential information from the credit department to enable them to evaluate the profitability of a particular company's operations. These people have no right to information which was given to support credit and it was tactfully refused them.

VALUE OF FINANCIAL STATEMENTS

Financial statements show a company's capital or financial strength at a given date. Financial statements are often the only tangible information available on the initial sale to a company and enable the credit man to separate the strong from the weak and to follow the progress or regress that a company is making. Statements give us a history of what a company has done. This history helps creditors to determine what a company can do in the future and whether it is a good credit risk.

The financial statement analysis section of the thesis will cover those points of special interest to those reviewing a statement for the purpose of supporting credit. It is assumed that those in management and credit, to whom the thesis should be of interest, already have a working knowledge of accounting principles.

RELIABILITY OF FINANCIAL STATEMENTS

Financial statements are only as reliable as the people preparing them. Their accuracy depends on the accuracy of those preparing them.. The character and capacity of the people preparing financial statements must therefore be weighed to determine how much reliance can be placed in these statements.

Company G submitted the following figures to Reynolds Metals Company along with their initial order in the amount of $25,000.00:

Company G
Balance Sheet
October 30, 1959

Cash on hand	$ 1,500	Owing affiliate	$ 16,822
Cash in bank	5,000	Current mortgage	20,800
Inventory	107,000		
Total Current Assets	$113,500	Total Current Liabilities	$ 37,622
Fixtures and equipment	75,000	Mortgage on real estate	82,378
Real estate and bldg.	110,000	Capital Stock	150,000
Other assets	1,500	Surplus--Paid in	30,000
Total Assests	$300,000	Total Liabilities & Worth	$300,000

The credit man commented as follows in the transmittal letter with which statement arrived: "Attached you will find subject's financial statement. We note that land and buildings are carried at $110,000. Apparently this is the same property that was carried at $86,007.83 by the previous owners on May 31, 1958. We received unverified information that Mr. G has pulled some very questionable deals in the past."

Twenty five thousand dollars would normally be a very conservative credit limit for a company with a statement as good as Company G's; however, the figures meant nothing in the above instance as the principals were dishonest. The assets were purchased from a bankrupt company for a very small sum, and valued in excess of the original book value.

Dishonesty is not the only cause of unreliable figures. Company L which at one time was a very substantial company got into financial difficulty and several small checks given Reynolds Metals Company for long overdue invoices were returned unpaid by the bank stamped "not sufficient funds." A local factoring company which was heavily involved called on Company L and found their accounting records in a state of worthless confusion. The bank account had not been reconciled for six months and Company L had to close the checking account and open another one to determine their cash position. The condition of the company's accounting records and the worthlessness of any financial statements released during this period is apparent.

AUDITED FINANCIAL STATEMENTS

Audited financial statements should be insisted on where a substantial amount of credit is required by a company whose honesty or ability to prepare accurate figures is questionable or unknown.

Audited financial statements are not fool proof. Company M was bankrupt some years back due to fradulantly overstated inventories. The inventory shortage did not show up on an audited statement and it was later found that the auditors had not inventoried a warehouse supposedly filled with materials which was actually filled with empty boxes.

Certified public accountants do have fairly rigid standards which they follow in audit work and would be foolish to jeopardize their future for any one company which might wish them to certify false or misleading figures. The accounting firm mentioned in the previous paragraph was ruined by the careless work and examples like this are almost non existent.

Audit figures should include all footnotes and the auditors opinion to be meaningful. Auditors cannot force a company to publish figures in accordance with generally accepted accounting principals; however, the auditors in the opinion will mention variations. The footnotes will explain other items on which there may be a question as to their proper accounting treatment.

The scope of the auditors work will range anywhere from filling out financial statement forms with information supplied by clients to fully verifying all details. The auditors cannot be held responsible for the inventories or receivables if a customer does not hire them to take inventory or verify receivables. The auditors opinion tells us the scope of the audit work. Auditors accept full responsibility for a financial statement endorsed with the following opinion:

> We have examined the balance sheet of the XYZ Company as of....date..., and the related statements of profit and loss and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the XYZ Company at....date..., and the results of its operations for the year then ended

in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[8]

PROPERLY CLASSIFYING BALANCE SHEET ITEMS

The first step in the analysis of a balance sheet is to remove any inflated values or "water" and to reclassify balance sheet items in accordance with the part each plays in paying liabilities.

Credit men look at some balance sheet items in a different light than accountants. Credit men are a little more conservative than the average accountant and credit thinking is tempered more by the actual saleable value of an asset. In addition to these honest differences of opinion, credit men must also contend with those who will improperly classify balance sheet items and inflate them to make the financial condition appear stronger than it actually is.

This preliminary job of classifying and organizing figures for analysis and comparison is the

8 Thomas W. Byrnes, K. Lanneau Baker, and Aubrey C. Smith, Auditing, (New York: The Ronald Press Company, 1948), p. 531.

most time consuming and tedious part of balance sheet analysis. It is also one of the most important as figures are useless unless accurately valued and in meaningful form.

For credit evaluation purposes, only those assets available to pay current obligations should be classified as current assets. Cash, receivables, and inventory are the only items which are generally shown as current assets. Government securities may be classified as current assets if available (not pledged) to be converted into cash if need be to meet current bills. Prepaid expenses are often classified as current assets. These items are of no value in paying liabilities and should be reclassified as other assets.

Intangible assets such as patents, copyrights, leasehold improvements, trademarks, goodwill and organization expenses are seldom of any value other than to a company which possesses them and depends on them for a livelihood. There may be exceptions where an intangible asset would have resale value. However, these exceptions are so rare that intangible items are usually deleted from the balance sheet.

Balance sheets are sometimes prepared with fixed assets inflated to include appraised values. Accounting Research Bulletin number 5 issued in 1940 covers this practice as follows:

"Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impractical and inexpedient."[9]

Experience shows that when a company gets into financial difficulty and is forced to sell its fixed assets, the company is in most instances lucky to get fifty cents on each dollar of book value, based on cost less depreciation. The buildings and equipment are usually such as to be good for only limited purposes and in most cases it is an almost impossible task to dispose of these assets.

Company A, mentioned on pages nine and ten, had a beautiful plant valued at $705,513. Reynolds Metals Company is now renting this plant for use as a warehouse. Company J1 carried its fixed assets at $280,000. But

9 H. A. Finney, and Herbert Miller, Principles of Accounting, Intermediate, (4th ed.; New York: Prentice Hall Inc., 1952), p. 485.

FINANCIAL STATEMENT

of

____

____

ISSUED IN CONFIDENCE

to

____

____

DATE..

CREDIT is CONFIDENCE established by COMPLETE INFORMATION and maintained by CONTINUED COOPERATION.

EXHIBIT 1
FORM FORWARDED TO CUSTOMER
FOR OBTAINING FINANCIAL FIGURES

TO ____________________________________
Credit Department

GENTLEMEN:
For the purpose of forming a basis for credit with you we make the following financial statement for your confidential information:

Name ____________________ State if Partnership or Corporation ____________________

(Street and Number) (Town) (State)

Full names and ages of members composing firm or officers if corporation:

KIND OF BUSINESS:

ASSETS	DOLLARS	CENTS	LIABILITIES	DOLLARS	CENTS
Cash—On hand and in the Bank			**Accounts Payable** (Suppliers only)		
Accounts Receivable, (good) customers only			**Notes and Trade Acceptances Payable** (Suppliers only)		
Notes and Trade Acceptances, (good) customers only			**Bank Loans** (not including real estate mortgage)		
Merchandise — Finished			**Loans from Officers.** Is this indebtedness subordinated to that of trade creditors? Yes ☐ No ☐		
Merchandise — In Process			**Loans from Others.** (Explain on reverse side)		
Merchandise — Raw Materials and Supplies			**Accruals** — Wages, Insurance, Rent, etc.		
Other Quick Assets			**Accruals** — City, State, Federal Taxes		
			Other Quick Liabilities		
TOTAL QUICK ASSETS			**TOTAL QUICK LIABILITIES**		
Machinery, Fixtures and Equipment — Present value			**Liens or Chattel Mortgages on Merchandise, Machinery, Fixtures and Equipment**		
Land and Buildings (If not owned, monthly rental is, $________)			**Owing on Land and Buildings**		
Investments in Controlled or Allied Concerns			**Debts Secured by Mortgage on Real Property**		
Due from Controlled or Allied Concerns			**Other Liabilities**		
Due from Officers, Stockholders, Employees and others not customers					
Deferred Charges			**TOTAL LIABILITIES**		
Other Assets			**NET WORTH** — Capital Stock		
			NET WORTH — Surplus and Undivided Profits		
TOTAL ASSETS			**TOTAL**		

INSURANCE
- On Merchandise $ ________ On Buildings $ ________
- On Machinery, Furniture and Equipment $ ________ For Employers' Liability $ ________
- Amount of Life Insurance for Benefit of Business ________
- Is any Insurance Assigned? ________ Are your employees Bonded? ________

Date business began ________ Capital at beginning ________

Annual Sales $ ________ Expenses $ ________ Amount of Receivables pledged for loans or sold $ ________

Any contingent liabilities through endorsements, etc.? ________

Merchandise in transit (not included in Assets or Liabilities) $ ________ Merchandise contracted for (not included in Assets or Liabilities) $ ________

The above is a full and correct statement of my (our) financial condition as of ________ 19 ____

Signed ________

Address ________

By ________

(Title) ________

Form R-718

(List References On Other Side)

EXHIBIT 1
FORM FORWARDED TO CUSTOMER
FOR OBTAINING FINANCIAL FIGURES

the factory was obsolete and had very little resale value. Company J2 had fixed assets valued at $128,000. There are not many people in the market for a brewery.

Unrealized increases in fixed assets due to appraisal are often hidden unexplained in the surplus or net worth accounts. A credit man should insist on a breakdown of the worth and surplus accounts so that these inflated values can be detected.

ANALYZING THE STATEMENT

WORKING CAPITAL

A slow pay record is a tip off of a weakness in a company's working capital. This alerts the credit man to take a close look at the current assets and liabilities of a company.

There is no magic amount of working capital that a company must have to make itself acceptable for open credit. Some companies with a large working capital tie their money up in slow moving assets and are unable to pay bills promptly. Others pay bills promptly by sound financial planning despite what looks like an impossible working capital position.

Company N, whose working capital is shown below, bought $85,000 worth of aluminum during the first seven months of 1963. Company N paid for the aluminum promptly on net thirty day terms, despite what looks like an impossible working capital condition.

Company N
Working Capital
December 31, 1962

Accounts Receivables	$129,177	Bank Overdraft	$ 10,507
Notes Receivable	7,922	Accounts Payable	149,956
Merchandise	233,315	Notes Payable	187,403
		Accrued Expenses	87,105
Total Current Assets	$370,414	Total Current Liabilities	$434,971

The writer mentioned above that there is no magic amount of working capital to tell when to approve credit. There is a situation that represents the maximum extent to which creditors should go in extending credit. This is where the money which comes from the inventory sold will go to pay creditors invoices. A company does not want the proceeds from its material to bail competitors out of a difficult situation and leave them in the competitors place.

FINANCIAL HISTORY

FIRM OR INDIVIDUAL

GUARANTEED: ☐ ______

OUTSIDE WORTH: ______

SUBORDINATION: ☐ ______

	ASSETS					
CURRENT	Cash					
	Accounts Receivable (net)					
	Notes Receivable					
	Inventory					
	Total CURRENT Assets					
FIXED	Land					
	Buildings (net)					
	Machinery and Equipment (net)					
	Furniture and Fixtures (net)					
OTHER	Bonds and Stocks					
	Cash value Life Insurance					
	Investments					
	TOTAL					
	LIABILITIES					
CURRENT	Accounts Payable					
	Notes Payable - Bank					
	Notes Payable - Other					
	Taxes - Federal Income					
	Taxes - All Other					
	Total CURRENT Liabilities					
FIXED	Bonds or Mortgages (Due)					
	Reserve for Depreciation					
	Other Reserves					
NET WORTH	Capital Stock - Preferred - Par $					
	Capital Stock - Common - Par $					
	Surplus - Capital					
	Surplus - Earned					
	TOTAL					
	Current Assets					
	Current Liabilities					
	Working Capital					
	Net Worth					
	Sales					
	Net Profit					
	Current Assets to Current Liabilities					
	Sales to Receivables					
	Total Debt to Net Worth					
	Fixed Assets to Net Worth					
	Sales to Inventory					
	Net Profit to Sales					
	Reynolds Sales Volume					

FORM R-339 (REV.4-59)

CASH

Once a company's production, sales and other efforts are converted into cash their value is insured. As desirable as cash is, creditors must be cautious in dealing with accounts of questionable character and capacity where a large part of the assets are centered in cash. Cash can be very readily taken out of a business by those of weak character. Those who lack ability can deplete cash rapidly, and are likewise tempted to take the liquid cash out of the business when a bad situation develops.

There are many old line companies that pride themselves in maintaining a large bank account. A credit man should find out the why, wherefore, and intentions when approached for credit by a new company with a top heavy cash position, or where a company suddenly builds up a large bank account.

RECEIVABLES

A company is no sounder than its receivables. A sale and the production efforts put forth to make the material for the sale are worthless unless the resulting receivables can be collected.

Creditors should know who their marginal accounts are selling. The credit man should obtain a listing of receivables, or at least review the trial balance or accounts receivable ledger so that it is known exactly who a customer is selling, where the customer is an extremely marginal credit risk.

Company O wanted to place a $90,000 extrusion order with Reynolds Metals Company in October 1962. The company admitted having financial problems and when a financial statement was requested gave one which linked the cash, receivables and inventory under one figure. The writer obtained a detailed statement and a listing of receivables and found that $110,000 of receivables which totaled $143,000 were owing from related companies. These companies, related through stock ownership, were all in poor financial condition and $131,000 owing from these companies had already been written off to bad debts. One week after this order was rejected Company O filed a bankruptcy petition.

Reynolds Metals Company extended $13,000 credit to Company P in March 1961. The president of the company told the Reynolds Metals Company credit representative that Company P had an agreement to furnish storm windows to sixty two branches of W. T. Grant Company and was negotiating to furnish an additional one hundred of their branch stores with aluminum windows and doors. Company P was also supplying a large volume of windows to Federated Department Stores, Cincinnati, Ohio, May Department Stores Company, St. Louis, Missouri, and John Wanamakers in Philadelphia, Pennsylvania. All of these companies are very sound financially and it appeared as though Company P was selling sound companies.

Yet in a statement which was provided the receivables were up to $280,504 versus net worth of $134,888. The company was running ninety days slow with suppliers. Company P went bankrupt in July 1961 and it was found out at that time that the windows were actually being distributed through several companies owned by a brother-in-law of a brother of the owner of Company P. The distributing companies from whom Company P was looking for payment were found to have a deficit consolidated net worth of $940,000.

INVENTORY

Inventories like receivables throw up a warning flag where there is a weakness. This warning flag is a slow inventory turnover which will in turn cause the company to develop a slow payment record.

A slow inventory turnover can be caused by overbuying or by the presence of worthless merchandise in stock. There is not much that can be done once the capital is tied up in worthless stock; however, creditors can discourage customers from overbuying.

Those with a limited amount of capital cannot afford to overbuy, yet frequently let salesmen talk them into buying 30,000 pounds of aluminum when one thousand pounds are needed to save $300.00 on the price. The glitter of the $300.00 which is saved obscures what has been done until the company finds itself in a cash bind and unable to pay obligations.

A credit man should see that his company does not oversell the marginal accounts. One of the most frequent questions that should be asked the marginal customers is, "Does your company have the orders on which to use this material?" The marginal customers appreciate creditors keeping a watch out for their interest once it is impressed on them that creditors have the customers interest at heart; that creditors are out to sell their products but not at the customers expense.

The accuracy of a company's inventory is important to the financial analyst as the balance sheet figures are no more accurate than the inventory. Where the inventory is overstated the worth of a company is overstated along with the working capital.

Taking inventory is a tedious and time consuming job. It usually requires that operations be shut down. Many accounts may prefer to take an educated guess at the inventory figure and let it go at that. A credit man should insist, however, that the extremely marginal accounts have an audit at least once a year in which the inventory is thoroughly checked.

FIXED ASSETS

Overinvestment in fixed assets has sounded the death knoll for many a company. Many others are able to survive but the cash position is restricted to such a degree that the company becomes a continuous credit problem and is unable to make any progress.

Many times, those who have been successful with a good small or moderately sized business decide to build the new factory, buy the new modern equipment with the increased production capacity and go for the large volume, big time market.

Too late these people find that their sales volume is not adequate to profitably utilize this equipment and will not cover the additional overhead expense. The decline starts and before long the company is in serious financial difficulty.

Company Q has one of the nicest new paint lines one of the Reynolds Metals Company credit representatives has ever seen. The company's plant was enlarged at considerable expense to make room for the paint line. Company Q has not been able as of this date to develop a sufficient amount of business to cover the overhead expense resulting from this paint line and Company Q is fighting for its life.

Company R had a nice moderately sized operation going with a medium six figure net worth. The company built a beautiful new extrusion plant in Mississippi. There was a gala grand opening ceremony with many dignataries. The plant flopped from the start as there was not a sufficient market for its products. Company R went bankrupt owing us over $500,000.

On the other extreme the writer had the privilege of visiting with one of our leading accounts in the Louisville area this past summer. Company S is built around equipment classified as obsolete which was purchased very reasonably from Reynolds Metals Company. This operation was started in October 1954 with an initial investment of $12,000. The last figures received on this company, which were as of December 31, 1961, showed a net worth of $510,000. The company paid quarterly income taxes of $110,000 in January 1962 and just prior to the December 31, 1961 figures the principals had taken $40,000 out of the business in dividends. Company S has purchased in excess of three million dollars from Reynolds Metals Company over the past two years and has not missed paying one invoice on the due date. Company S could have complicated its financial picture along the way with a newer building and brand new equipment but chose to stick with what was available which was adequate to do the job.

RECEIVABLES AND INVENTORY TURNOVER

The receivables and inventory turnover give a lead as to how sound these assets are. The turnover figures enable us to estimate approximately how long a credit applicant will require to convert the assets into cash. This in turn tells approximately how long a company needs to pay its current liabilities.

A few words of caution before reviewing the actual computation of the receivable and inventory turnover. Inventory, receivables and sales figures must be obtained for the particular season being analyzed, if the business is a seasonal one, if the turnover figures are to be meaningful. A credit man also has to temper his thinking with the behavior of the firm in the season to immediately follow the balance sheet date.

Credit men use the sales figure in computing the inventory turnover, because the cost of goods sold figure, which would give the actual inventory turnover is frequently not available. The sales figure contains profits but very seldom are the profits sufficient to change the turnover answer significantly.

The formulas used to compute the turnover are as follows:

A. Sales divided by Receivables (or Inventory) = Turnover

B. Days Sales divided by Turnover = Average Days Turnover

The examples below assume the following working capital figures to be applicable:

Company Example
Working Capital
September 30, 1963

Cash	$ 10,000	Accounts Payable	$100,000
Receivables	90,000		
Inventory	40,000		
Current Assets	$140,000	Current Liabilities	$100,000

Example A--Steady non seasonal type business with sales for year end September 30, 1963 of $360,000.

$360,000 (Sales) - $90,000 (Receivables) = 4 Turnover
365 days (Days Sales) - 4 (Turnover) = 91-1/4 Days
Turnover Period

$360,000 (Sales) - $40,000 (Inventory) = 9 Turnover
365 days (Days Sales) - 9 (Turnover) = 40-5/9 Days
Turnover Period

The company will have to collect all of the receivables to have sufficient cash to pay current liabilities. It is taking the company approximately ninety days to turn over its receivables and creditors should not expect them to pay any sooner than ninety days unless special arrangements have been made to tie down payment over a shorter period.

Example B--Highly seasonal business during selling season when sales are averaging $60,000 per month.

$60,000 (Sales) - $90,000 (Receivables) = .67 Turnover
30 Days (Days Sales) - .67 (Turnover) = 45 Days
Turnover Period

$60,000 (Sales) - $40,000 (Inventory) = 1.5 Turnover
30 Days (Days Sales) - 1.5 (Turnover) = 20 Days
Turnover Period

This company is turning its receivables in forty-five days and should be able to pay bills in close to forty-five days.

Example C--Highly seasonal business during off season when sales are averaging $15,000 per month.

$15,000 (Sales) - $90,000 (Receivables) = .17 Turnover
30 Days (Days Sales) - .17 (Turnover) = 176 Days
Turnover Period

$15,000 (Sales) - $40,000 (Inventory) = .375 Turnover
30 Days (Days Sales) - .375 (Turnover) = 80 Days
Turnover Period

This company appears to be in serious financial difficulty. It is taking them six months to turn over receivables and eighty days to turn over inventory. The turnover rate is extremely slow and creditors should proceed with utmost caution.

PROFITABILITY

A company operates to earn a profit for its owners. A company that has no profit potential has no future. Conversely a company that has a good profit potential has a good future.

There are three elements that must be present for a company to earn a profit:

1. A good product
2. Large enough sales volume
3. A selling price that covers all expenses and leaves a profit

One of the three elements above is lacking if operations are unprofitable. Credit men must diagnose the missing element and make certain that customers have the ability to overcome the problem and restore operations to a profitable level.

A customer's chances of surviving are only as good as its product. If sales volume is off creditors must keep in close touch to see what kind of order backlog the customer has and what the prospects are for additional business. Where the prices are lower than costs creditors should find out why and see what chance the customer has of increasing prices or decreasing costs.

Most companies are intensely sales volume conscious. Unfortunately many let the glitter of this sales volume obscure the reason business is carried on, "To earn a profit." Creditors frequently run into the following story:

"Things have never looked so good. Our company has just cornered a large share of Sears Roebuck's requirements." These companies quite frequently end up giving the material to Sears Roebuck and other large companies at less than cost and before long are in financial difficulty.

A company that is able to make a good profit can overcome many obstacles. The company can reinvest these profits back in the business and overcome a weakness in working capital. Net worth can be built up to a safe proportion. Also where operations are profitable a company can get suppliers to work with them with confidence until such time as the company is not so dependent on them.

DATE OF FINANCIAL STATEMENT

Financial statements must be up to date to be of any value in judging the financial strength of a company. What constitutes up to date figures varies with the seasonal nature of a business.

Many customers maintain a fairly constant financial condition and their progress can be followed with a year end statement. Other companies are extremely seasonal and it may be necessary to obtain monthly statements to know what their condition is. Company T (see financial statements next page) is an example of how much difference several months can make in a highly seasonal business.

FINANCIAL HISTORY

GUARANTEED: ☐

OUTSIDE WORTH:

FIRM OR INDIVIDUAL **COMPANY T**

SUBORDINATION: ☐

ASSETS	8/31/61	2/28/62	8/31/62	12/31/62	3/31/63
CURRENT					
Cash	32,581	4,637	21,441	1,282	1,614
Accounts Receivable (net)	83,513	54,911	80,310	63,399	63,373
Notes Receivable					
Inventory	64,203	50,242	61,946	48,562	73,680
Total CURRENT Assets	180,297	109,790	163,697	113,243	138,667
FIXED					
Land					
Buildings (net)	24,854	22,147	19,720	17,778	16,467
Machinery and Equipment (net)					
Furniture and Fixtures (net)					
OTHER					
Bonds and Stocks					
Cash value Life Insurance	6,495	6,523	9,618	9,173	9,618
Investments					
TOTAL	211,646	138,460	193,035	140,194	164,752
LIABILITIES					
CURRENT					
Accounts Payable					
Notes Payable - Bank					
Notes Payable - Other					
Taxes - Federal Income					
Taxes - All Other					
Total CURRENT Liabilities	85,901	88,897	70,690	79,622	119,974
FIXED					
Bonds or Mortgages (Due)					
Reserve for Depreciation					
Other Reserves					
Notes Payable Long Term	27,321		28,220		
NET WORTH					
Capital Stock - Preferred - Par $					
Capital Stock - Common - Par $					
Surplus - Capital	98,424	49,563	94,125	60,572	44,778
Surplus - Earned					
TOTAL	211,646	138,460	193,035	140,194	164,752
Current Assets	180 M	110 M	164 M	113 M	165 M
Current Liabilities	86 M	89 M	71 M	80 M	120 M
Working Capital	94 M	21 M	93 M	33 M	45 M
Net Worth	98 M	50 M	94 M	61 M	45 M
Sales	yr. 411 M	6mos 88 M	yr. 371 M	4 mos. 49 M	7mos 97 M
Net Profit	yr. (13M) Loss	6mos (49M) Loss	yr. (4M) Loss	4 mos (34M) Loss	7mos (49M) Loss
Current Assets to Current Liabilities	2.1	1.2	2.3	1.4	1.2
Sales to Receivables	4.9=73 Days	116=113Days	4.6=78Days	.78=154Days	1.5=140Days
Total Debt to Net Worth	1.2	1.8	1.1	1.3	2.7
Fixed Assets to Net Worth	.26	.44	2.1	.30	.35
Sales to Inventory	6.4=56Days	1.8=100Days	6.0=60Days	1.0=170Days	1.3=162Days
Net Profit to Sales	(3%) Loss	(55%) Loss	(1%) Loss	(75%) Loss	(50%) Loss
Reynolds Sales Volume					

FORM R-339 (REV.4-59)

The figures for the fiscal years ending August 31, 1961 and August 31, 1962 would indicate that Company T is a well balanced company. Cash and receivables alone exceed total debt. The current assets exceed the current liabilities by over two to one. Net worth is just about equal to total debt. A small loss is indicated for both the years but the strong balance sheet would appear to more than offset this.

The interim figures indicate quite a contrast. The loss of $49,000 for the six months ended February 28, 1962 is equal to fifty percent of net worth. The losses of $34,000 for the four months ending December 31, 1962 and $49,000 for the seven months ending March 31, 1963 represent thirty six percent and fifty two percent of the worth for the fiscal year ending August 31, 1962. The debt jumps to over twice the worth in the interim periods and reaches a high of 2.7 to 1 as of March 31, 1963.

The Reynolds Metals Company credit representative was aware of the risk involved in this case.

Company T's sales did not materialize as usual during the spring and summer of 1963, and the company is currently trying to work out a payment extension arrangement with creditors, which will enable Company T to survive until the 1964 selling season comes around. Company T's chances of surviving are slim at this writing.

LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements are a very important part of the overall picture that represents the credit applicant. These statements give a pretty good idea of the type of financial situation with which creditors are faced.

One should not forget, however, that statements are only a part of the overall picture. A credit man should not discard any company as a prospect for open credit on the basis of a financial statement alone. Statements merely tell when a credit man must use his ingenuity to find a basis for safely selling a company whose financial strength is limited.

Company U's financial statement below would indicate that the company has little if any credit potential.

Company U
Balance Sheet
March 31, 1963

Current Assets		
Cash	$ 19,934	
Accounts Receivable	117,207	
Inventory	71,863	
Total Current Assets		$209,004
Fixed Assets		194,351
Prepaid Expenses		5,290
Total Assets		$408,645
Current Liabilities		
Accounts Payable	$255,531	
Bank Loan Secured	75,000	
Accrued Payroll Taxes	3,391	
Accrued Expenses	18,961	
Total Current Liabilities		$352,883
Notes Payable Stockholders--Long Term		$130,000

Net Worth		
Class A Stock	$ 45,000	
Class B Stock	1,450	
		$ 46,450
Surplus Deficit April 1, 1962	$-149,976	
Add profit for year end March 31, 1963	29,288	
Surplus Deficit March 31, 1963		$-120,688
Net Worth Deficit		$- 74,238
Total Liabilities and Net Worth		$ 408,645

Reynolds Metals Company sold this company over $900,000 worth of aluminum last year. The total sales to Company U over the past three years are $1,800,000. This kind of account does not come along very frequently and Reynolds Metals Company could have very easily thrown a lot of good business away by saying "no" to open credit on the basis of the above balance sheet.

CHAPTER IV

SOURCES OF CREDIT INFORMATION

BANKS

One of the first things a credit man should do is to make the acquaintance of the bankers in his area as the bankers are an invaluable source of credit information. The time and money invested in meeting the bankers, and taking them out to lunch occasionally, will be repaid many, many times with worthwhile credit information.

Bankers usually have several advantages over the credit man in keeping on top of a company's financial condition. Bankers are usually located in the same geographic area as the accounts; know them well personally; and are in a position to obtain more frequent and greater detailed financial statements than the credit man.

The average banker as a rule is more conservative in his credit thinking than the average credit man.

The bankers' viewpoint on an account is valuable to have in appraising a credit applicant's financial condition.

OBTAINING GOOD CREDIT INFORMATION FROM BANKERS

Two basic factors are necessary before the banker generally will give out worthwhile information:

1. The banker must know the credit man or his company and feel that the credit man can be relied on to keep the information confidential and to use it properly.

2. The credit involved must be worthwhile. A credit man should not waste his time or ruin his banking connection by contacting the banker for information on trivial orders. A form letter addressed to the bank will obtain sufficient information to support small orders.

When the credit man approaches a banker for credit information, the case should be stated clearly. The banker should be told the amount of credit in question, and any particular questions brought up that the credit man may have on the credit applicant's financial responsibility.

To obtain information from a prospective customer's bank, where a personal contact is not available, the credit man should emphasize that his company wants to work with the bank's client, and is anxious to give prompt credit approval to their initial order. To do this information is needed from the bank on the credit applicant's financial responsibility. The credit man should emphasize that the bank's client requested that the bank be contacted for the information and that the information given will play an important part in the credit decision.

Bankers will exchange information freely with other bankers. A credit man should have his bank contact the credit applicant's bank when worthwhile information cannot be obtained direct from the bank.

OTHER SUPPLIERS

Other suppliers are another important source of credit information. A credit man must get to know the credit representatives with competitors and those with other companies that have occasion to sell the same accounts as his company to obtain good credit information from them.

GROUND RULES TO CONFIDENCE

It is necessary that certain ground rules be set up with other credit men if complete credit information is to be exchanged with confidence. These ground rules should cover the following points and should be firmly agreed to by all parties concerned:

1. Use of information. Credit information should only be used for credit purposes. It must not be used to tip off sales personnel to a lucrative account which has been overlooked or to a competitor who is trying to sell one of the company's good accounts.

2. Confidential nature of information. All information exchanged should be kept strictly confidential. Each credit man is responsible to see that any information received is kept away from everyone other than the people in credit who are involved in making the credit decisions.

CREDIT INFORMATION THAT CAN BE RELEASED

Credit information that gets into the wrong hands can be costly. Many a lucrative account has been lost due to information carelessly used by those to whom it was given as a favor. For this reason creditors must be extremely cautious in giving out credit information.

Credit men who have an order or are selling a particular account are entitled to the experience of other companies with that account. The information given should not go far beyond ledger experience; however, unless the inquirer is known and can be trusted to use this information properly.

A credit man can go a little farther with those inquirers who the ground rules have been set up with. A credit man can generally tell his opinion on a particular account, any security his company possesses, and any special arrangements made to tie down payment.

There are certain things a credit man should not disclose. Financial statements which customers give in confidence must be kept that way. Each credit man should go to the credit applicant direct for this kind of information. On occasion creditors may accept security with the understanding that the security will be kept confidential. Creditors are committed not to disclose the security, in such situations, even at the risk of misleading other creditors.

It is to the advantage of all credit men, that credit information be kept accurate and reliable. Credit decisions are no better than the information on which the decisions are based. Each credit man must do his part to see that this information is kept on a high level.

CREDIT AGENCIES

A credit man should obtain a good credit agency to supplement the other sources of credit information. The city of Chicago has over ninety different credit agencies and associations.[10] These credit agencies are for the most part tailored to a particular industry or particular type of account.

10 Yellow Pages, Chicago Classified Telephone Directory 1963 (The Reuben H. Donnelley Telephone Directory Company), pp. 518-519.

Dun and Bradstreet, Inc. is the most widely used of the commercial credit agencies. It covers all industries and is world-wide in its coverage. Everyone interested in credit should be familiar with the Dun and Bradstreet, Inc. Agency because of its wide coverage and usage.

DUN AND BRADSTREET, INC.

COST

Dun and Bradstreet sells their reference book service and their report service in a package. The basic rate varies from $740 to $1,100 depending on which geographic area the service is desired. This basic rate entitles the subscriber to six reference books and one hundred report subscriptions over a year.

Additional reports cost $270 for 100 reports when paid in advance and included in the contract and $320 for 100 reports whn paid and contracted for within eight months of the original contract commencement date.[11]

11 Dun and Bradstreet, Inc. Reference Book, March 1964 (Dun and Bradstreet, Inc.), p. XII.

DUN AND BRADSTREET REFERENCE BOOK

When a subscriber opens the Dun and Bradstreet Reference Book and looks up the listing of a concern with which a company contemplates business transactions, among other things the correct name, the line of business, the year the concern started, if within the past ten years is learned.

The subscriber then turns to the rating which is the heart of the reference book. A rating consists of two elements, namely, estimated financial strength and composite credit appraisal. The composite credit appraisal is an estimate of the company's overall condition.[12]

Below is an example of how a company would appear in the Dun and Bradstreet, Inc. Reference Book and of the information the book would give on the company.

17 42 Company Example.....P1ST6...H3½

12 Hayden Kuehn, Key to Ratings (Dun and Bradstreet, Inc.) p. 1.

EXHIBIT 4

KEY TO DUN AND BRADSTREET, INC. RATINGS[13]

Estimated Financial Strength					Composite Credit Appraisal			
					High	Good	Fair	Limited
A_A	Over		$1,000,000	- -	A1	1	1½	2
A+	Over		750,000	- -	A1	1	1½	2
A	$500,000	to	750,000	- -	A1	1	1½	2
B+	300,000	to	500,000	- -	1	1½	2	2½
B	200,000	to	300,000	- -	1	1½	2	2½
C+	125,000	to	200,000	- -	1	1½	2	2½
C	75,000	to	125,000	- -	1½	2	2½	3
D+	50,000	to	75,000	- -	1½	2	2½	3
D	35,000	to	50,000	- -	1½	2	2½	3
E	20,000	to	35,000	- -	2	2½	3	3½
F	10,000	to	20,000	- -	2½	3	3½	4
G	5,000	to	10,000	- -	3	3½	4	4½
H	3,000	to	5,000	- -	3	3½	4	4½
J	2,000	to	3,000	- -	3	3½	4	4½
K	1,000	to	2,000	- -	3	3½	4	4½
L	Up	to	1,000	- -	3½	4	4½	5

13 Chapin, *op. cit.*, p. 209.

EXHIBIT 4 (Continued)

KEY TO DUN AND BRADSTREET, INC. RATINGS[13]

CLASSIFICATION AS TO BOTH ESTIMATED
FINANCIAL STRENGTH AND CREDIT APPRAISAL

	FINANCIAL STRENGTH BRACKET	EXPLANATION
1	$125,000 to $1,000,000 and Over	(When only the numeral 1, (2,3, or 4) appears, it (is an indication that (the estimated financial (strength, while not (definitely classified, (is presumed to be with- (in the range of the ($) (figures in the corres- (ponding bracket and (that a condition is (believed to exist (which warrants credit (in keeping with that (assumption.
2	20,000 to 125,000	
3	2,000 to 20,000	
4	Up to 2,000	

NOT CLASSIFIED OR ABSENCE OF RATING

The absence of a rating, whether as to estimated financial strength or as to credit appraisal, and whether expressed by the hyphen (-), the dash (--), or by the (x) sales listing (see below), or by the omission of any symbol, is not to be construed as unfavorable but signifies circumstances difficult to classify within condensed rating symbols and should suggest to the subscriber the advisability of obtaining additional information.

13 Chapin, op. cit., p. 209.

Company Example is in the plastering and lathing business (17-42). The business was started in 1956 (6). Its net worth is estimated at $3,000 to $5,000 (H) and the overall condition of the business is rated as good (3½). The index in the front of the reference book explains the meaning of the code symbols used.

DUN AND BRADSTREET, INC. CREDIT REPORTS

IDENTIFIES THE FINANCIALLY SOUND

Many of the companies which are financially strong give a great deal of information to Dun and Bradstreet, Inc. including periodic balance sheet and profit and loss statements. One of the main values of the agency service is that it separates these strong companies, from the marginal ones and gives sufficient information to support the credit which the strong companies require. This enables the credit man to concentrate his efforts on the marginal accounts.

GIVES INFORMATION ON THE MARGINAL ACCOUNTS

The Dun and Bradstreet report does not replace a good sound credit investigation by the credit man, where a marginal account is involved, but is a helpful supplement to the other sources of credit information.

There are two basic types of information available in these reports: factual information collected by the analyst and the judgments and opinions the analyst forms in interpreting the information. The credit man is interested primarily in the factual information and uses the factual information along with the other information obtained to form an opinion. Below is the factual information often found in Dun and Bradstreet reports:

Financial statements. Balance sheet and profit and loss statements and other relative financial information are published by the agency on all companies who will release this information.

Suits, judgments, lien notices and notices of secured transactions. Frequently Dun and Bradstreet, Inc. is the only place where this information will be found.

Trade clearances. Dun and Bradstreet knows the accounts a company is buying from by the reports ordered and has available trade clearance information from many suppliers whom creditors are not aware the credit applicant is purchasing from.

Operations. Dun and Bradstreet, Inc. tells the type of operation a company is engaged in, number of employees, sales area serviced and describes the company's facilities.

History. The report gives a brief history of the company and its officers or owner. It tells when the company was started and the past business affiliations of the officers or owners. Bankruptcies, fires, criminal records and other such events which could reflect on the moral and financial responsibility of the principals are mentioned.

PUTTING THE CREDIT PICTURE TOGETHER

Each of the sources of credit information just discussed supplies a piece of the puzzle. When the pieces of the puzzle are all fit togethar, a good picture is usually given of the credit applicant.

The two cases below are representative of the credit problems encountered at Reynolds Metals Company and the information available through the various sources of credit information to help resolve the problems.

These cases are now history and the outcome has been presented to show how the initial impression which the preliminary information gives, ties in with the actual outcome of the cases.

CASE I

BACKGROUND INFORMATION

Company V was a relatively new company. The management of the company was made up of employees from another company which had just gone bankrupt. A $6,000 credit line would be required to service Company V's requirements.

CREDIT INFORMATION OBTAINED FROM BANK

Company V has been a customer of the bank since April, 1961, and maintains a low four figure checking account which has always been handled satisfactorily.

The bank has a $15,000 credit line available for Company V of which $5,200 is being used at the present time. Ten thousand dollars of the available credit is secured by receivables and $5,000 is unsecured.

The company has not made much in the way of profit to date. However, the principals are experienced in their field and working very hard to make the business a success. The officers do not hesitate to put on their working clothes and go out in the plant and have been working Saturdays and Sundays. The bank feels this company is good for $6,000 unsecured credit.

CREDIT INFORMATION OBTAINED FROM SUPPLIERS

Supplier A has been selling Company V for one year, terms net thirty days, high recent credit $4,000, owes 0, payments all prompt.

Supplier B has been selling Company V for over one year, terms net thirty days, high credit $4,000, owing $4,000, payments prompt. The four people behind the company are working very hard to make a success of Company V. The company is presently earning a profit and paying bills promptly. The officers do not hesitate to go to the bank for money when it is needed to pay suppliers. Supplier B feels Company V will present no problems to creditors.

Supplier C has been selling Company V continuously for over one year, terms net thirty days, high credit $1,500, owing $600, payments meticulously prompt.

FINANCIAL STATEMENT OF COMPANY V--See page 92.

SUMMARY OF INFORMATION IN CREDIT AGENCY REPORT

Company V was founded in 1961 and manufacturers aluminum grating which is used for decorative purposes. Sales are to contractors and to the building trades on monthly terms. There are two employees.

The officers of Company V formerly worked for a company which went bankrupt just prior to the time Company V was founded. The officers did not have an interest in the bankrupt company.

Company V is new and appears to be making progress.

ANALYSIS OF CREDIT INFORMATION

Company V's working capital along with available

EXHIBIT 5

BALANCE SHEET
COMPANY V
DECEMBER 31, 1962

Assets		Liabilities	
Cash	$ 3,213.41	Accounts Payable	$20,897.89
Accounts Receivable	29,483.04	Notes Due 3/1/63	5,000.00
Inventory		Taxes Payable	1,336.81
In Process	10,000.00	Other Accrued	
Raw Materials	5,300.00	Expenses	2,742.42
		Due Officers	11,200.00
Total Current Assets	$47,996.45	Total Current Liabilities	$41,177.12
Machinery	18,012.58	Capital Stock	22,000.00
Prepaid Expenses	803.29	Earned Surplus	4,485.20
Deposits - Security	850.00		
	$67,662.32		$67,662.32

Sales from 11/1/62 to 12/31/62 $174,186.82

Net Profit before taxes $ 8,635.45

bank support gives the company sufficient available funds to pay $6,000 credit line on net thirty day terms. The principals appear to be conscientious and working hard to make a go of the company.

CREDIT DECISION

Reynolds Metals Company extended an unsecured credit line of $6,000 to Company V.

OUTCOME

Reynolds Metals Company has sold $25,000 worth of aluminum to Company V through September 30, 1963 and all invoices have been paid when due. In January 1964, the company started ordering an additional item from Reynolds Metals Company and the credit line has been increased to $10,000. Company V is now earning a nice profit and could turn into a very good account for Reynolds Metals Company.

CASE II

BACKGROUND INFORMATION

Company O approached Reynolds Metals Company for a $200,000 credit line. Company O had been in business for years and was a very substantial company at one time but had been going downhill for the past several years. Company O admitted having financial problems but said these problems could be overcome if Reynolds Metals Company would give them a $200,000 credit line and six months in which to pay, for a temporary period.

<u>CREDIT INFORMATION OBTAINED FROM BANKS</u>

Bank A has dealt with Company O for years. Company O has several checking accounts with the bank. The regular account ranges from a minus balance to a five figure balance. There are quite a number of overdraft notices in the file and the account is currently overdrawn. The other account is an employees profit sharing account which is small at present.

Financial statements that the bank has on Mr. O, the major stockholder of Company O, indicate that Mr. O is quite wealthy and that a creditor would be adequately covered on a $200,000 credit line if Mr. O's personal guarantee could be obtained.

Bank B has a $350,000 credit line available to Company O and the company has currently borrowed up to that amount. The credit line is secured by discounted notes, accounts receivable and inventory. Company O maintains a five figure checking account with the bank.

Company O has suffered losses for the past few years. These losses have been caused by keen competition which has cut prices to an unprofitable level. The company has not yet turned the corner profitwise but the bank feels confident operations will eventually be restored to a profitable level.

Bank B advises that Mr. O's wealth is all tied up in companies such as Company O and that a personal guarantee would be of questionable value.

CREDIT INFORMATION OBTAINED FROM SUPPLIERS

Supplier A advises that Company O owes them $64,000 with the invoices going back as far as seven months. Supplier A is presently making no headway in obtaining payment.

Supplier B has discontinued Company O's credit until the account is paid in full. Company O has owed them up to $100,000 in the past but Supplier B would not say what was owing them at present.

Supplier C had extended credit as high as $60,000 to Company O. Twenty-five thousand dollars of this amount has been paid but Supplier C has shut off Company O's credit due to slow payment.

FINANCIAL STATEMENT OF COMPANY O--See page 97.

SUMMARY OF INFORMATION IN CREDIT AGENCY REPORT

Company O was founded in 1916 and manufacturers and installs store fronts and metal mouldings. The company has two hundred employees and yearly sales are approximately five million dollars.

The company is under experienced management and the owners appear to have substantial personal wealth and a clear past record.

The last figures made available to the credit agency indicate that Company O was losing money at the rate of $300,000 per year. No figures have been released for the past two years.

EXHIBIT 6

COMPANY O
BALANCE SHEET
FOR SIX MONTHS ENDED FEB. 28, 1962

Assets

Cash, Notes and Accounts Receivable	$ 662,566
Inventory - Net after Reserves	620,327
Prepaid Expenses	23,730
Total Current Assets	$ 1,306,623
Investments - Net after Reserves	42,032
Non-Current Notes (60,000.00 due in 1963)	85,000
Fixed Assets - Net after Reserves	273,820
Deferred Expenses	139,994
Total Assets	$ 1,847,469

Liabilities and Net Worth

Real Estate Mortgage Note - Current maturities	$ 31,107
Notes Receivable - Discounted at Bank	197,329
Notes Payable - Trade and Others	56,500
Accounts Payable	481,804
Accrued Expenses and Taxes	79,341
Total Current Liabilities	$ 846,081
Real Estate Mortgage Note - Due after one year	243,826
Notes Payable - Stockholder - Due Dec. 1, 1963	65,000
Capital Stock and Surplus	692,562
Total Liabilities and Net Worth	$ 1,847,469
Net Working Capital	$ 460,542
Current Ratio	1.54
Tangible Net Worth	$ 692,562

Management admits that operations remain unprofitable with sales off. A trade clearance indicates that payments are averaging around ninety days slow. One account is eight months past due and one supplier is demanding cash in advance.

ANALYSIS OF CREDIT INFORMATION

The unprofitable trend of Company O's operations is increasing rather than reversing itself. The balance sheet of August 31, 1962 shows a net worth of $480,000. However, the balance sheet is inflated with many worthless assets (see page 59). Company O's credit is being cut off by their major suppliers and the company is using all of the credit available to them at the bank.

CREDIT DECISION

Credit was refused Company O.

OUTCOME

Company O went bankrupt two weeks later.

CHAPTER V

EXTENDING CREDIT

The credit applicant has at this point been identified and the credit man has a good idea as to the credit applicant's weaknesses and strong points and the risks involved in extending credit to him. The credit applicant falls into one of three categories.

The extremely strong account. A credit man need not waste time on the accounts which clearly have the resources with which to pay and will pay promptly. These companies may be placed on an automatic credit approval list which can be distributed to the sales service personnel and used as authority to process all orders received.

The second type of account is strong enough for its ordinary requirements but bears watching a little more closely. This account does not present much of a credit problem, but creditors do want to keep track of the orders processed to make certain that the orders received are reasonable in amount. Creditors also keep a general watch on the payment performance of these companies.

The third type of account is the marginal account. These accounts range from marginal to extremely marginal. The marginal accounts are not hard to identify. A slow payment record usually exists and financial statements show weaknesses which exist in the financial structure.

The credit problem however is not identifying these accounts but in finding a way to sell them. A company must sell its products to earn a profit. These products are not sold by saying to a prospective customer, "Our company cannot sell your company because the net worth is too limited or the working capital is inadequate." The credit man's job is to find a way to compensate for weaknesses or to work around them.

The remainder of the thesis is devoted to credit problems that arise in dealing with the extremely marginal accounts and to the methods, instruments, and devices that can be used to safely sell them.

A few words of caution before proceeding with the final portion of the thesis. A credit man should be interested in cultivating accounts which have a future sales potential for his company; not in becoming involved in impossible credit situations. No foolproof way has been found that will enable creditors to obtain prompt payment for credit extended to an insolvent account which is unable to earn a profit.

Steps can be taken in many instances that will insure ultimate payment; but ultimate payment is of little consolation several years after the credit is extended when payment is finally received along with the attorney's bill which is for almost as much as the account collected.

GUARANTEES

Company U, whose financial statement is on pages 74 and 75, presented a problem frequently faced by credit men; namely, that of a company which could use a large volume of products and could probably pay for them in a satisfactory manner with careful supervision, but a company without sufficient worth to support the kind of credit needed.

Company U had a deficit net worth of $74,000.00 and a deficit working capital of $44,000.00 as of March 31, 1963. The company was bankrupt on paper and did not have the financial support for the $100,000.00 credit line which was needed from our company.

In their favor, Company U sold a good class of financially sound accounts, which would pay promptly, and Company U could turn its inventory over in less than thirty days. This along with the funds available through the bankers gave Company U the ability to pay within ninety days and Company U was agreeable to accepting notes and paying interest for the time required in excess of net thirty day terms.

The principals who owned Company U had over $1,000,000 in personal wealth exclusive of their investment in Company U and gave Reynolds Metals Company personal guarantees on the account.

Sales of $900,000 a year are good to a customer with a deficit net worth of $74,000.00. This is what Reynolds Metals Company sold Company U in 1963 thanks to the support of the personal guarantee.

WHAT THE GUARANTEE DOES

The guarantee is a document through which a third party assumes responsibility for the payment of a debtor's obligations. The guarantee is a devise widely used by credit men for selling companies whose worth is too limited to support the credit required.

The guarantee, to be of any value, must be workable in form, signed by guarantors whom the law recognizes as being able to guarantee the account, and backed up by sufficient wealth to enable the guarantor to pay should the need arise.

The creditor finds that the guarantee is little more than a worthless piece of paper if any of these three factors are missing and there is nothing more dangerous than extending credit on the support of a worthless piece of paper.

The guarantee properly used is an invaluable instrument. Reynolds Metals Company has used it to safely extend millions of dollars worth of credit to extremely marginal accounts.

FORM

Guarantees must be in writing to be enforeable and should be clear and complete as the courts enforce them strictly in favor of the guarantors.[14]

WHEN GUARANTOR IS OBLIGATED TO PAY

Prospective guarantors will send in letters which it is felt creditors should accept as a guarantee worded as follows: "I guarantee payment of the account of X Company."

The courts will not normally enforce such a guarantee until all legal remedies have been exhausted against the debtor. It is likely that creditors would have to obtain judgment against the debtor, levy against all of the available assets, and have the debtor adjudged

14 Ibid., p. 568.

EXHIBIT 7

GUARANTEE USED BY
REYNOLDS METALS COMPANY FOR
SOLE - CONTINUING ASSURANCE OF
PAYMENT OF ACCOUNT

April 25, 1964

Reynolds Metals Company
Richmond, Virginia

Gentlemen:

In consideration of Reynolds Metals Company's extending credit to ______________________________, of (address, city & state)__________, hereinafter called debtor, for goods that have been or may be sold to debtor from time to time by Reynolds, I agree as follows:

Upon demand I will immediately pay to Reynolds any sum due by debtor to Reynolds and unpaid after the due date thereof.

It is understood that Reynolds may, without consulting me:

> Extend the due date of any indebtedness, or any part thereof owed to it by debtor.
> Accept any promissory note or other evidence of indebtedness from debtor, and renew or extend any such note or other evidence of indebtedness.
> Accept collateral in any form for any such indebtedness.

EXHIBIT 7 (Continued)

GUARANTEE USED BY
REYNOLDS METALS COMPANY FOR
SOLE - CONTINUING ASSURANCE OF
PAYMENT OF ACCOUNT

-2- April 25, 1964

Any such action on the part of Reynolds shall not relieve me of my obligation under this guarantee.

It is further understood that I shall become liable to Reynolds under this guarantee upon receipt of this guarantee by Reynolds, and that Reynolds shall not be obligated to notify me that it has accepted this guarantee. I also waive presentment, protest, and notice of non-payment of any note or other evidence of indebtedness accepted by Reynolds from debtor.

I reserve the right to terminate this agreement thirty days after my communication to Reynolds of written notice of my intention to do so.

Yours very truly

____
(Signature)

Witness:

____________________________ ____________________________
(Address)

bankrupt and its assets liquidated and distributed to creditors before the courts would enforce such a vaguely worded guarantee.

Creditors should be in a position to have recourse against the guarantor immediately when the debt becomes due and is unpaid by the debtor and the guarantee must be worded accordingly.

MAINTAINING FLEXIBILITY FOR WORKING WITH DEBTOR

Creditors need a certain degree of flexibility for working with the marginal accounts. The marginal accounts often require time in excess of selling terms. This means that creditors must reserve the right to allow these accounts to pay a little slow or more preferably set the accounts up on notes or trade acceptances which give the time required.

At times, the amount of credit required may make it necessary to obtain collateral in addition to the guarantee. The right to extend the due date, to accept promissory notes or other evidence of indebtedness, and to accept collateral must be reserved in the guarantee.

TERMINATING THE GUARANTEE

The manner in which the guarantee may be terminated should be set forth in the guarantee. Normally creditors desire at least thirty days notice in order that other arrangements might be explored for working with the debtor or for terminating the relationship with the debtor in an orderly manner.

CLOSING THE REMAINING LOOPHOLES

To insure that the guarantee remains effective there are other miscellaneous questions that should be adequately answered by the forms used:

1. Are the debtor, the account guaranteed and the guarantor clearly identified?
2. Is the consideration which is required to make the guarantee binding identified? The extension of credit to the debtor is sufficient consideration to make the guarantee binding on guarantors.
3. Is the guarantee dated so that there is no question as to when it became effective?

4. Is the guarantee so worded as to answer questions which might arise as to the responsibilities of the creditor to notify guarantor in various situations such as when the account becomes past due, or when the guarantor accepts promissory notes?

Creditors cannot leave any loopholes in a guarantee form which would lead the courts to an interpretation contrary to the creditor's best interest.

WHO MAY GUARANTEE AN ACCOUNT?

Individuals. An individual who can legally contract is free to guarantee any account with the exception of married women who cannot make a contract of guaranty in the absence of enabling statute.[15]

Partnership. A partnership may guarantee in the regular course of business, that is, in furtherance of its own business, and the signature of a partner will

15 *Ibid.*, p. 565.

bind the firm. A partner, however, cannot bind the firm in an accommodation guaranty, though such a guarantee can become binding if signed by all partners.[16]

<u>Corporations</u>. The general rule is that no corporation has power by any form of contract or endorsement to become a guarantor or surety or otherwise lend its credit to another person or corporations. There are exceptions to this rule.

The usual exception is the case in which the corporation which gives the guaranty owns a majority of the capital stock of the corporation whose account is being guaranteed. While a parent corporation can validly guarantee the account of its subsidiary, the reverse is not true; a subsidiary corporation cannot guarantee an account of its parent.

Frequently the stock of each of two corporations will be owned by the same person. This is not sufficient to make the guaranty valid.

16 <u>Ibid</u>., pp. 565-566.

Sometimes a corporation is expressly authorized by charter or statute to make contracts of guaranty. Such a company cannot escape the general rule of law that a corporation cannot guarantee the liability of others, except insofar as it becomes a guarantor in the ordinary course of its business, or unless it receives the proceeds of the paper which it guarantees.[17]

In a few rare instances a guaranty has been sustained upon a showing to the court that the guaranty was actually in furtherance of the business for which the corporation was incorporated. These cases are quite rare, and usually there is no assurance that the guaranty is valid.[18]

In all cases other than that in which a company, holding a majority of the stock in a subsidiary wishes to guarantee the subsidiary account, the credit man should refer the case to legal counsel for an

17 Ernest A. Rovelstad (ed.), Credit Manual of Commercial Laws, 1963 (New York: The National Association of Credit Management, 1962), p. 64.

18 Bernard P. Holland, Attorney, "Memorandum to A. W. Herthel, General Credit Manager, Reynolds Metals Company Sept. 11, 1952".

opinion since a fine legal distinction may be drawn between whether or not any other corporation may guarantee an account in a particular situation.

WORTH BEHIND GUARANTEE

Creditors must know how much worth a prospective guarantor has if a sound credit decision is to be made based on the guarantee. Financial information should be obtained along with the guarantee, and only as much credit extended on the strength of the guarantee as the worth behind it and the credit applicant will support.

Once the guarantor's worth has been determined, that portion of the worth which represents equity in the account being guaranteed must be deducted from the worth to get the true value of the guarantee. All too often the guarantor has all of the wealth tied up in the account being guaranteed, and when the debtor becomes insolvent the guarantor is likewise unable to pay.

The writer has heard it said by other credit men: "While this guarantee does not have much behind it in terms of dollars and cents, it does place the moral responsibility of the guarantor behind the debtor." Bills are paid with dollars and cents and unless the guarantor has the funds with which to support the credit in question, the guarantee is worthless.

SUBORDINATION

The subordination is an instrument by which third parties can subordinate claims held by them against a debtor to the creditors. The subordination is used by creditors principally in cases where a substantial amount of the capital which a company requires to operate is provided through officers' loans.

The subordination in effect locks loans into the operation and enables creditors to look on the loans in the same light as net worth. Should the third parties remove these funds from the business, creditors holding the subordination have recourse against the third parties to the extent of the money removed.

EXHIBIT 8

SUBORDINATION FORM USED
BY REYNOLDS METALS COMPANY

April 25, 1964

Reynolds Metals Company
Richmond, Virginia

Gentlemen:

In consideration of your extending credit to ___________ ___________________________ of (address, city and state), herein called Debtor, I hereby subordinate any and all claims which I now have or may hereafter have against Debtor, to any and all claims which Reynolds Metals Company may now have or shall hereafter have against Debtor.

I agree that if any payments are made to me on account of any claims which I now have or may hereafter have against Debtor, including any dividends or other payments received by me in any bankruptcy or receivership proceedings, or pursuant to an assignment for the benefit of creditors, affecting Debtor:

> I shall pay over to Reynolds Metals Company so much thereof as may be necessary to satisfy the claims of Reynolds Metals Company against Debtor, on the understanding that

EXHIBIT 8 (Continued)

SUBORDINATION FORM USED
BY REYNOLDS METALS COMPANY

-2- April 25, 1964

Reynolds Metals Company will assign to me so much of its claims against Debtor as may be equal to the amount paid by me to Reynolds Metals Company pursuant to this agreement.

Witness the following signature and seal:

_________________________ (SEAL)
(Signature)

The ____(name)____________ hereby agrees to the subordination set forth above.

(Company)

BY_________________________ (SEAL)
(Title)

CASE WHERE SUBORDINATION MAY BE USED

Company W placed $20,000 worth of orders with Reynolds Metals Company in early 1963. Company W depended heavily on officers' loans to finance inventories and receivables.

Balance Sheet
Company W
January 1, 1963

Cash	$ 12,762	Accounts Payable	$ 13,440
Accounts Receivable	47,863	Owing Officers	75,409
Inventory	55,877	Accrued Liabilities	5,184
		Real Estate Mortgage	3,600
Current Assets	$116,502	Current Liabilities	$ 97,633
Fixed Assets	$ 62,702	Real Estate Mortgage	$ 12,128
		Capital Stock	21,800
		Surplus	47,643
	$179,204		$179,204

Company W was maintaining a prompt payment record and could do so as long as the officers' loans, shown as a current liability, were left in the business.

The writer obtained the subordination of the officers of Company W. For all practical purposes, the subordination increased the cushion of worth supporting Company W's order to $145,000 and increased the working capital available for payment of its account from $19,000 to $94,000.

The subordination not only gave Reynolds Metals Company strong support for the $20,000 worth of orders then on the books, but left Reynolds Metals Company in a position to extend even more credit to Company W if some additional orders were to materialize.

PAYMENT ASSIGNMENT

Company Y had a net worth of $97,000 as compared to total liabilities of $849,000. The company's working capital showed a deficit of $7,000 and the payment record showed payments varying from 30 to 150 days slow on accounts ranging up to $20,000. The company was solvent but had been undercapitalized since its inception in 1941 and had always been slow in paying obligations. Company Y had earned a $12,000 profit for the year 1961.

The date was January 15, 1962 when a $300,000 order was received by Reynolds Metals Company from

Company Y. The order was for one-third of the aluminum requirements on a $1,000,000 order Company Y had received from the United States Corps of Engineers for portable aluminum bridges.

Company Y provided the solution to this credit problem. Payments to be received under the contract were assigned to a special account in the bank and an arrangement was set up under the bank's supervision whereby payments could only be distributed from the account to suppliers for the materials which suppliers provided for use on the contract.

The government made 85% progress payments monthly under the contract, and this enabled the customer to pay suppliers on a 45 to 60 day basis. Reynolds Metals Company was paid in a very satisfactory manner.

WHAT PAYMENT ASSIGNMENTS ARE AND WHAT THEY DO

A payment assignment is a method available for working with customers with limited working capital. It enables creditors to insure that payment will be made when a customer is paid.

A payment assignment is stronger than a joint check arrangement and, where the laws of notification and filing are adhered to and consideration is present, an assignment will be upheld even if the debtor were to be adjudged bankrupt. It is valueless though, if the debtor is adjudged bankrupt before the work is performed which is required to create a payment liability on the part of the third party.

The Credit Manual of Commerical Law, which is published annually by the National Association of Credit Management, contains the requirements that each state has for the perfection of an assignment.

JOINT PAYMENT ARRANGEMENT

A joint payment arrangement is one whereby a third party agrees to make a check payable jointly to the debtor from whom he is buying and to the creditor. This type of agreement is used where the third party is financially sound and is buying in some shape or form the material which the creditor is selling to a debtor who is short on working capital.

The creditor is willing to accept payment when debtor is paid but does not want to see the proceeds from the transaction go to pay other creditors who have past due obligations owing from debtor. Also creditors run into those situations where it is apparent that the debtor will be unable to pay for an order until payment is received. If credit is to be extended on that basis, a thorough credit man may want to formalize payment by a joint check arrangement.

There are certain weak points to a joint payment arrangement which a credit man should be aware of in considering its use:

1. The payment experience under a joint payment arrangement can only be as good as the ability of the third party to pay. Creditors should avoid being placed in a position where payment is contingent on third parties unless the third parties can be counted on to pay promptly.

2. The debtor must be able to provide acceptable material for the third party before the third party becomes obligated to pay. There is no added risk in this area when the debtor is reselling the material in the same state that it is bought from creditors. A credit man should be careful where there is any question as to the ability of the debtor to produce acceptable material for the third party.

3. A joint payment arrangement would not place the debtor in a very strong position if debtor were to go bankrupt before the payment were disbursed by the third party and endorsed and mailed by the debtor.

CASE WHERE JOINT PAYMENT ARRANGEMENT USED

Mr. Y is an excellent salesman but Mr. Y's net worth is only $18,000 and Mr. Y is restricted by working capital of only $9,000.

Reynolds Metals Company has accepted Mr. Y as a distributor for its electrical products and over the past several years Mr. Y has done a very good job of selling these products. Mr. Y places orders quite frequently, some of which are as high as $30,000.

There is no way Mr. Y can lose money on these orders as Reynolds Metals Company sets the ultimate selling price and Mr. Y gets a discount from the selling price when Reynolds Metals Company bills him. The writer looks out for Mr. Y's interests from a credit standpoint and would not permit an order unless the customer were financially sound and able to pay promptly. Mr. Y is merely a middleman and resells the material in the same state that he buys it from Reynolds Metals Company.

This is an ideal situation for using a joint payment arrangement and the writer has very successfully handled many orders for Mr. Y on this basis. The joint payment arrangement shifts the payment responsibility onto Mr. Y's customers who must pay him before Mr. Y would be able to pay. Reynolds Metals Company knows at all times where Mr. Y is selling its material and can make certain that only those accounts are sold which can pay in a satisfactory manner.

PAYMENT BONDS

Every state of the union, as well as the Federal Government, now requires contractors on certain public works to funish a bond for the protection of labor and materialmen. Many private jobs are covered by payment bonds. The payment bonds are also usually accompanied by a performance bond which is important to insure that the job will be completed to the point where the payment bond will become effective.

Payment bonds are for the protection of creditors. Creditors are thus entitled to a copy of the bonds and should insist on a copy as a prerequisite to the extension of credit to a marginal account.

Just recently Reynolds Metals Company received a $30,000 order for cable on a particular job from Company Z. Company Z is the general contractor and has a net worth of only $35,000. It is involved in the job to the extent of $200,000.

The bonding company initially refused the writer a copy of the bond under the guise that it was a standard form bond and creditors had no need for it. The writer discussed this case with the attorney for Reynolds Metals Company, who advises that there is no such thing as a standard bond, and that creditors must have a copy of the bond to know what protection the bond affords them.

Reynolds Metals Company has two legal suits pending against company Z's bonding company at the present time. In both cases the bonds contained a clause whereby creditors had to file notice of non-payment with the bonding company within 90 days of the date that the materials were shipped. Reynolds Metals Company had a copy of the bond, complied with the notification clause, and has a strong case to present to the courts.

It is most important that creditors obtain a copy of bonds so that it is known exactly what protection the bonds afford and what steps creditors must take to obtain payment from the bonding company. Also creditors should never extend credit solely on the basis of a bond. These bonds are difficult to collect on and the writer's company has had to file suit on numerous occasions and obtain judgment before payment could be obtained. This is an expensive procedure and the time and expense is generally more than the profits in the sale.

EXAMPLE OF WHAT THE BOND CONTRIBUTES TO THE CREDIT PICTURE

In May 1963 the writer received a $20,000 order for electrical cable to be used on a rural electric cooperative job. The cooperative was very sound financially and had funds from a government loan available to pay for the job.

The credit applicant, Company AA which was the general contractor, had successfully completed three similar jobs in 1962 with the contracts involved ranging from $111,000 to $296,000 and appeared capable of doing the work required.

The questionable factor was Company AA's net worth which was only $40,000. This does not give much of a cushion for a $120,000 job and if for any reason the company were to run into difficulties, insolvency could result.

The payment bond gave the cushion which the net worth did not provide and the writer accepted the order which was paid satisfactorily.

CASH ARRANGEMENTS

A credit man should take a positive approach in dealing with customers whose financial strength is too limited for open credit and should sell these companies on the idea of purchasing on a cash basis.

A credit man should strive to show the unacceptable credit risks their financial weakness and how it makes it necessary for sale to be on a cash arrangement. The cash arrangement will be for a temporary period only until debtor can get the company back on the right track financially and correct the weakness which exits.

Some very good accounts have been developed out of an early relationship which started on a cash basis. Not one penny of business should be turned away for credit reasons before an effort has been made to work out arrangements on a cash basis.

MANUFACTURING PROTECTION

Whenever a customer's financial condition is so weak that open credit cannot be extended, creditors should get a sufficient cash payment with the order to cover any unrecoverable costs a company might incur in producing the order and shipping the material. Also creditors want the customer to have an economic interest in the goods to make sure that the customer accepts delivery promptly when the goods are ready.

The deposit should cover the cost of the goods less scrap value where the goods must be of special make and cannot be readily sold elsewhere. Cash with order requirements can be relaxed where the materials are standard and easily saleable elsewhere; but if the order is large in amount creditors want a substantial down payment to give the customer an interest in the goods.

TYPES OF CASH ARRANGEMENTS

CASH ON DELIVERY

Cash on delivery or C. O. D. terms are generally used for smaller orders. The carrier picks up a certified or cashiers check from the debtor when the merchandise is delivered.

PRO FORMA

The seller issues a pro forma invoice when the material is ready. This invoice lets the customer know that the material is ready and tells how much additional cash is needed to ship the material.

The pro forma arrangement is used when the material must be produced and it cannot be determined what the exact quantity produced will be. The order can be placed in production with an initial payment for manufacturing protection and the customer need not tie up the rest of the money until the material is ready for shipment.

SIGHT DRAFT ORDER NOTIFY BILL OF LADING

The order notify bill of lading is a negotiable instrument and when it is used the carrier will only release shipment to the party which holds a properly endorsed bill of lading.

FORM R-576-2

REYNOLDS METALS COMPANY

REYNOLDS METALS BUILDING
RICHMOND 18, VIRGINIA

TO ______________________________ ISSUED AT ______________________

______________________________ DATE ______________________ 19 ____

____

Gentlemen:

We enclose for collection the draft and documents described as follows:

DRAFT NO. __________ DATE OF DRAFT __________ TENOR __________ AMOUNT __________

BILL OF LADING NO. __________ INVOICE NO. __________ DRAWEE ______________________

ADDRESS ______________________

PLEASE HANDLE IN ACCORDANCE WITH THE FOLLOWING INSTRUCTIONS

1. DELIVER DOCUMENTS AGAINST PAYMENT
2. MAKE PAYMENT TO . . . . } REYNOLDS METALS COMPANY P.O. BOX
3. ADVISE NON-PAYMENT BY WIRE COLLECT TO }
   ATTENTION: CREDIT MANAGER,
   Who is authorized to make reductions, extensions, free delivery, waiving of protest, etc.
4. DO NOT PROTEST
5. ALL CHARGES ARE FOR DRAWEES ACCOUNT

OTHER INSTRUCTIONS:

REYNOLDS METALS COMPANY

BY ______________________________

. . . .

CUSTOMER'S DRAFT

NO. ______________

$ __________ ISSUED AT ______________________ DATE ______________ 19 ____

____ PAY TO THE

ORDER OF REYNOLDS METALS COMPANY ______________________________

____ $\frac{}{100}$ DOLLARS

____

Value received and charge to account of:

TO ______________________ REYNOLDS METALS COMPANY

______________________ BY ______________________

129.

The sight draft is forwarded to the customer's bank along with the order notify bill of lading. The bank presents the sight draft to the customer and when the sight draft is paid gives customer the order notify bill of lading. The bill of lading then enables the customer to obtain delivery of the goods from the carrier.

The sight draft and the bill of lading must arrive at destination ahead of the shipment so that the customer has time to pay the draft and pick up the bill of lading before the carrier arrives at the destination. This arrangement cannot be used for local deliveries but is for situations where the materials are shipped for some distance.

The arrangement enables the customer to receive the material more quickly than under the pro forma arrangement as shipment can be made when the material is ready. It also brings the customer's bank into the picture and a company would be reluctant to refuse a sight draft of which it's bank was aware.

CASH WITH ORDER

Creditors can obtain 100% cash with the order when the materials ordered are carried in stock and can be shipped out immediately. This is the safest and cleanest way of handling a cash arrangement and enables creditors to make immediate shipment.

WHAT CASH CAN DO

The writer approved a $2,000 order for Company BB in 1962. Mr. BB, president of the company, promised to pay for this order within thirty days but did not keep the promise and the account was forty five days past due when payment was finally received. Reynolds Metals Company's experience was better than some of Company BB's, other suppliers and two accounts were placed for collection about this time.

The writer told Mr. BB that the writer could not extend open credit to Company BB but would like to work with the company on a fifty percent cash with order balance pro forma arrangement. This would be for a temporary period only until Mr. BB could get the company back on a sound financial footing.

Mr. BB went to the bankers and arranged for a $15,000 credit line. The company purchased over $20,000 worth of aluminum from Reynolds Metals Company in 1963. This represented the company's entire aluminum requirements.

The cash arrangement was a blessing for both companies. It forced Mr. BB to arrange the financing which Company BB needed and to watch the company's purchases more closely. It enabled Reynolds Metals Company to obtain payment promptly and the writer's personal relationship with Mr. BB was better than when open credit was extended and Mr. BB had to be dunned for payment.

Company BB handled the fifty percent cash balance pro forma arrangement cleanly and the writer just recently opened up a $3,000 credit line for the company. The first $2,500 in billings under this arrangement have been paid promptly. The credit line will be increased at a later date if Company BB's financial statements continue to reflect improvement and if the company continues to pay bills promptly. The company is small at the present time and their requirements limited but no one knows what the future might hold.

Company CC is a distributor of our Reynolds Wrap products. Reynolds Metals Company began having quite a collection problem with the company in late 1962. Company CC was running sixty to ninety days slow in paying invoices and a check received on a past due invoice as inducement to release a new shipment was returned unpaid due to "not-sufficient funds."

The account was placed on a certified check with order basis and Company CC purchased $7,000 worth of Reynolds Wrap in 1963 on this basis. Reynolds Metals Company sold the company more material than in 1962 and the relationship with Company CC is sounder than it was when open credit was extended.

PROMISSORY NOTES AND TRADE ACCEPTANCES

Notes and trade acceptances are credit instruments used for working with those customers who need or demand time in excess of selling terms in which to make payment. These instruments accomplish the same major results when used for credit purposes, but are completely different instruments.

The following advantages are effected by both trade acceptances and notes:

1. Payment is kept on a definite basis. One of the main problems in dealing with the slow pay accounts is that of reaching and maintaining a definite payment understanding at all times. There should be a firm agreement as to when payment will be made when it cannot be made within selling terms. Promissory notes and trade acceptances are the instruments by which a definite payment understanding can be formalized as both are firm promises to pay a sum certain in money at a definite future date.

2. Customer's bank may be brought into the collection picture. Debtors, especially those who have a slow payment reputation, are liable to procrastinate in making payment direct to suppliers. However debtors are much more unlikely to risk ruining their reputation with the bankers by dishonoring such a firm payment commitment, as a trade acceptance or note. Creditors

should insist that both of these instruments be made payable at the customer's bank to encourage prompt payment.

3. Interest may be collected for the time required in excess of payment terms. Both instruments are tailor made for the collection of interest.

4. Both instruments are a firm acknowledgment of debt. The courts look on them as presumptive evidence of the existence of debt. The burden of responsibility then falls on the debtor to prove that the obligation is not owing rather than on creditors to prove that the debt exists. Notes and trade acceptances place creditors in a much stronger position if court proceedings are necessary to obtain payment.

5. Promissory notes and trade acceptances are both negotiable instruments and can be easily endorsed and discounted at the bank should creditors desire to convert these instruments into cash before maturity.

TRADE ACCEPTANCE

The Federal Reserve Board has defined a trade acceptance as a "draft or bill of exchange drawn by the seller on the purchaser of goods sold and accepted by such purchaser."[19]

The trade acceptance is not supposed to be used as a collection instrument. It is not intended that the instrument be substituted for a past due book account; but rather that the trade acceptance be used in situations where the payment date is agreed to before the material is shipped.

Trade acceptances should only be used when the customer requesting the payment extension is financially sound and can be counted on to pay the trade acceptance when due. The instruments should never be used in cases which are liable to end up in a collection problem.

PROMISSORY NOTES

A promissory note is an unconditional promise, in writing, signed by the maker, to pay at a

19 Chapin, op. cit., p. 63.

TRADE ACCEPTANCE

FORM APPROVED BY THE AMERICAN ACCEPTANCE COUNCIL

(CITY OF DRAWER) (DATE) 19 No.

On (DATE OF MATURITY) Pay to the order of Ourselves

Dollars ($)

The transaction which gives rise to this instrument is the Purchase of Goods by the Acceptor from the Drawer. The Drawee may accept this Bill payable at any Bank, Banker or Trust Company in the United States which such drawee may designate.

To (NAME OF DRAWEE)

(STREET ADDRESS)

(CITY OF DRAWEE)

ACCEPTED

DATE

PAYABLE AT (NAME OF BANK)

LOCATION OF BANK

(SIGNATURE OF ACCEPTOR)

BY

(SIGNATURE OF DRAWER)

By

R 395

EXHIBIT 10

TRADE ACCEPTANCE

$__________ Richmond, Virginia__________ 19____

__________ after date for value received

__________ promise to pay to the order of __________

__________ DOLLARS

with interest at the rate of _____ per cent per annum from __________ until paid.

Negotiable and payable at __________

Each maker and endorser hereof hereby waives demand, protest, presentation and notice of dishonor and the benefits of Homestead Exemption as to this note, and agrees to pay all collection expenses, including 15% attorney's fee, should it or any part of it not be paid when due, and to remain bound for the payment hereof notwithstanding any extension of the time of payment hereof or any part hereof.

This is # _____ of a series of _____ notes made by and payable to the parties hereof. Each maker and endorser agrees that immediately upon the non-payment when due of any part of this or any other note in this series, all notes in this series will become due and payable.

____

____

Due __________ Address __________

Form R-229 (Rev. 5-55)

EXHIBIT 11

PROMISSORY NOTE

fixed or determinable future time, a sum certain in dollars to order or to bearer.[20]

The promissory note is a much stronger instrument than the trade acceptance and should be used where the possibility exists that the account could turn into a collection problem.

WHAT NOTES AND TRADE ACCEPTANCES CAN DO

Company DD is one of the leaders in a particular industry. The company produces a very fine product. Company DD's net worth is in the millions of dollars. The company, however, has overtraded for years on the worth and as a result has an extremely slow payment record.

Dun and Bradstreet reports over the past several years show payments running consistantly from 60 to 120 days slow. A recent credit check that Reynolds Metals Company credit representative made showed other suppliers being paid as follows:

20 *Ibid.*, p. 49.

Supplier Number One. Sold for several years, terms net tenth proximo, high recent credit over $100,000. Company DD's account is over ninety days past due and new orders would have to be on a cash basis.

Supplier Number Two. Sold for years, terms net tenth proximo, but gives Company DD an additional sixty days. High recent credit $246,000, owes $246,000, past due $157,000. The oldest invoice is ninety days past due. Supplier number two needs money to ship more material.

Supplier Number Three. Sold for years, terms net thirty days, high recent credit $56,000, owes $37,000, past due $37,000. Supplier Number Three is trying to get three dollars on the old account for each one dollar of new orders shipped; but could only get $7,000 for the current month.

In October 1956, when Company DD first started to run slow with Reynolds Metals Company the credit man handling the account told Company DD that Reynolds Metals Company would work with Company DD for an additional thirty days over and above the net thirty days selling terms; but that Company DD would have to pay six percent per annum interest and sign trade acceptances to formalize the arrangement.

Reynolds Metals Company sold the company over $300,000 worth of aluminum in 1963 and since the agreement was put into effect have sold them well over $1,000,000. Every trade acceptance to date has been paid when due.

A few other suppliers followed Reynolds Metals Company in setting the account up on notes and trade acceptances and the results have been as follows:

Supplier Number Four. Sold years, terms net sixty day note, high recent credit over $200,000, owing $150,000. Notes have always been paid promptly.

Supplier Number Five. Sold years, terms net sixty day note, high recent credit $50,000, owing $45,000. Pays notes when due. Used to sell on open account and at that time account was paid from thirty to ninety days slow.

The prompt manner in which the notes and trade acceptances are being paid is no accident. An official of the company told the Reynolds credit man that the payroll, finance companies, and notes are being paid in that priority. Company DD is paying other suppliers as best they can out of the balance.

The easy way out is to ship a company and worry about obtaining payment later. The credit man did not take the easy way out and was almost physically thrown out of Company DD when the interest and trade acceptances were initially proposed. The credit man followed up on the original visit several more times and kept insisting on the trade acceptances and interest and finally C ompany DD agreed to work with Reynolds Metals Company on this basis.

The results have certainly been gratifying. Payment has been kept on a definite basis at all times, interest has been received for the additional time taken by customer, and most important of all Reynolds Metals Company has been able to keep the credit pipeline wide open to Company DD.

A few words of caution on the <u>use</u> of notes and trade acceptances. These instruments can only be paid at maturity when there is sufficient cash available to pay them. Company EE is an extremely marginal account and a very close watch is being kept on them to make certain that Company EE is headed in the right direction and will have sufficient cash coming in to pay our trade acceptances.

LETTER OF CREDIT

A letter of credit is an instrument by which the credit of the bank can be substituted for the credit of a debtor.

A letter of credit was obtained to support the credit requirements of Mr. EE who desired to purchase scrap from Reynolds Metals Company. There was not sufficient information available to support the $10,000 credit line which Mr. EE required so Mr. EE obtained the letter of credit.

Creditors must be careful where the letter of credit has an expiration date. There must be sufficient time for the material to be produced, shipped and come

No.______________ ______________

NATIONAL BOULEVARD BANK

OF CHICAGO

400 NORTH MICHIGAN AVENUE

CHICAGO, ILLINOIS U. S. A.

GENTLEMEN:

WE HEREBY AUTHORIZE YOU TO DRAW AT______________SIGHT ON THE ______________FOR ANY SUM OR SUMS NOT EXCEEDING IN ALL______________

FOR ACCOUNT OF______________

WE HEREBY AGREE WITH DRAWERS, ENDORSERS AND BONA FIDE HOLDERS OF DRAFTS NEGOTIATED UNDER AND IN COMPLIANCE WITH THE TERMS OF THIS CREDIT THAT THE SAME SHALL BE DULY HONORED UPON PRESENTATION AT THE COUNTER OF______________EACH AMOUNT DRAWN MUST BE ENDORSED ON THE REVERSE HEREOF BY THE NEGOTIATING BANK.

INSURANCE______________

DRAFTS UNDER THIS CREDIT MUST BEAR UPON THEIR FACE THE WORDS:
"DRAWN UNDER NATIONAL BOULEVARD BANK OF CHICAGO
CREDIT No.______________ DATED______________"

RESPECTFULLY YOURS,

NATIONAL BOULEVARD BANK OF CHICAGO

______________ SAMPLE

ASS'T CASHIER VICE-PRESIDENT

144.

due before the letter of credit expires or creditors will lose the protection before they have a right to demand payment from the bank.

FIELD WAREHOUSING

Company FF has been one of Reynolds Metals Company's good irrigation product distributors over the years. When the writer first came in contact with the company in 1958, Company FF was insolvent and Reynolds Metals Company was working with Company FF under a field warehousing arrangement under which a $25,000 credit line was being extended.

The field warehousing arrangement enabled Reynolds Metals Company to keep Company FF alive and give the company a chance to work out of a bad situation in which Reynolds was caught to the extent of $75,000.

The inventory was in the field warehouse, for Company FF to use when orders were obtained. The $25,000 additional credit line, combined with the readily available inventory supplied the company's normal requirements. Occasionally Company FF would receive a large order on a good job. The $25,000 limit was temporarily raised to enable Company FF to handle jobs in which the company could make money, receive payment promptly and pay accordingly. The last contact the writer had with the company was in June 1962 and Reynolds Metals Company had sold Company FF over one million dollars between that time and when the company first became insolvent. The credit man did a masterful job of selling out of a bad situation thanks to the help of the field warehouse arrangement.

HOW FIELD WAREHOUSING WORKS

The field warehouse company leases space in the customer's plant or yard. The customer then receives a check in payment of the lease and the lease is duly recorded as required by the laws of the state in which customer's facilities are located. The leased space then becomes a warehouse of the warehouse company.

The leased space is clearly marked by signs and if necessary is enclosed and a lock placed on the door.

The warehouse is placed under the supervision of a bonded warehouseman. The warehouseman is usually an employee of the customer who tends to the warehouse on a part time basis and performs regular duties the rest of the time. The warehouseman is paid by the warehouse company and legally becomes the employee of the warehouse company.

Creditors ship material to the warehouse and the warehousman gives them a warehouse receipt for the materials received. The warehouse receipt is a document of title and the material can only be released by the warehouseman on authorization by suppliers in accordance with the terms of the warehouse receipt. Suppliers can maintain complete control over their inventory at all times and if the customer were to go bankrupt could have the inventory returned or diverted to other customers.

One word of caution on the use of a field warehousing company. Creditors should investigate the field warehouse company closely and make certain that the company is financially responsible, properly bonded and that the warehouse company will accept the responsibility for which payment is made to them.

CHAPTER VI

SUMMARY

Chapter one shows how management establishes the broad policy under which a credit department functions. Management establishes the basic period over which a company is willing to wait for payment and decides when exceptions will be made to the basic payment terms.

The payment terms vary from company to company and from product to product. Management takes into consideration the profit margin, the working capital position of the seller, and the going terms in the industry in establishing the payment terms.

Extended payment terms are costly, reduce the sales potential of marginal accounts, increase the credit risk, are unfair to customers who observe the regular selling terms, and can result in prosecution under the Robinson Patman Act. Extended terms should be used judiciously.

Chapter two identifies the four characteristics which all credit applicants have, shows the importance of these characteristics, and tells how the characteristics can be evaluated. The four characteristics of credit are character, capacity, capital and conditions.

Character alone will not insure payment but will in most instances enable the credit man to find a method of selling an account.

Capacity is considered by most credit men to be the most important of the four characteristics of credit for as long as a company has the ability to operate successfully the company will keep on generating the cash necessary to pay creditors.

Captial is the repayment insurance cushion that a credit man has as a last resort. Capital can give the credit man the time needed to recognize a deteriorating situation and obtain payment before a customer becomes insolvent.

A good sense of timing in working with the seasonal conditions is important to sound credit planning. The marginal accounts' purchases should fit in with sales which are frequently effected by seasonal conditions.

A credit man must be aware of the problems which general conditions present to customers. The writer mentioned the decreasing profit margins in the aluminum industry over the past several years. The decreasing profits are making it difficult for the extremely marginal accounts to survive and make it important that creditors watch the marginal accounts closely.

Chapter three tells how the first phase of the identification process is accomplished. A financial statement is usually obtained with the initial order. The financial statement identifies the credit applicant's capital.

Financial statements are sometimes difficult to obtain and the writer gives the approaches which are effective in persuading credit applicants to release financial statements.

Financial statements are only as reliable as the people preparing them and often inflated to give a false picture of what a company is worth. The worthless values should be deleted from a statement and assets reclassified according to the part each plays in the payment of liabilities.

The following question gives the key as to how much working capital a credit applicant should have: "Is the working capital adequate for the company to pay creditors in a satisfactory manner?" A slow payment record is a warning of a working capital weakness. Slow turning receivables and inventory are a warning sign that these assets may contain many worthless items.

A company is only as good as its ability to earn a profit. The three elements that are necessary for a profit are a good product, a large enough sales volume and a selling price adequate to cover expenses and leave a profit.

Financial statements are an important part of the credit applicant's picture but should never be interpreted as the whole picture. Never disregard a potential customer on the basis of a balance sheet alone.

The credit applicant can be further identified with information available through bankers, other creditors and credit agencies. A credit man can obtain invaluable information from the bankers who know and trust the credit man, when the credit in question is worthwhile. Other credit men are another good source of credit information. Here again the secret to obtaining good information is getting to know the fellow credit men and gaining their confidence.

The service of a good credit agency should also be employed to supplement the other sources of credit information. Dun and Bradstreet is the most widely used of the credit agencies.

The cases on pages 89 through 98 show how an accurate credit picture can be obtained by fitting all of the types of credit information together.

The real test of a credit man is the credit man's ability to find a way to safely sell the extremely marginal accounts. The credit man makes use of guarantees and subordinations to add the financial strength of outside parties to bolster an extremely marginal credit applicant. The payment responsibility can be shifted to other parties through payment assignments, and joint check arrangements and payment can be insured by letters of credit and payment bonds. A customer may be persuaded to purchase on a cash basis where there is not sufficient support for open credit.

It is important that there be a definite payment understanding when credit is extended to an account which cannot or will not pay within the ordinary terms of sales. Promissory notes and trade acceptances are instruments which can be used to formalize the payment understanding when additional time is to be taken by a customer.

The thesis shows how a firm footing is established for accounts receivable by showing how the basic credit goals are set by management, and how the credit applicant is identified and the ability to pay in an acceptable manner is determined. Methods are then shown by which the weak credit risks can be strengthened or otherwise made into acceptable credit risks.

The ways of doing the credit job which have been presented in the thesis have been tried and tested by the writer and other credit men with Reynolds Metals Company and have been proven effective.

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