4-1958

# Credit Department and the Independent Accountants

Lee Ella Costello

# THE CREDIT DEPARTMENT AND THE INDEPENDENT ACCOUNTANT

By LEE ELLA COSTELLO, C.P.A., Houston Chapter, A.S.W.A.

The independent auditor's primary object for being in your office is to be helpful and to render a summary of your business that will be useful to management in dealing with merchandise resources, banks and other creditors. The credit department is not generally thrown into as much immediate contact with the independent accountant as the various sections of the accounting department, unless, as in the case in many small businesses, the accounts receivable department and the credit department are one and the same. However, no segment of a business institution can be more helpful to or can receive more help from the independent accountant than the credit department.

First, consider the businessman who sells direct to the consumer. Credit is extended to customers in every walk and station of life, and often the best customers are homemakers on limited budgets. This may be the statement of a heretic, but there are actually times when a confirmation request sent to certain classes of customers, does damage to a client's business. There are good customers who pay promptly and who become disturbed by a reminder that a bill has not been paid. Many, many people do not know the difference between a confirmation request, and a "did you forget us" reminder, even though most auditors are careful to print on their statement in large letters "THIS IS NOT A DEMAND FOR PAYMENT."

Generally accepted auditing principles demand that accounts receivable be verified in a manner independent of the client's records, but, as a heretic, I declare that, in my opinion, there are times when many customers should not be written directly. There are various procedures which can be followed by the auditor to satisfy himself that the accounts receivable are valid and adequately protected by allowance for uncollectibles, but where in an organization is there a better source of help than in the credit department? Information in the credit department is generally confidential but is usually made available to the auditor. The sales department certainly has no dossier on each individual customer, but it never ceases to amaze me how much "credit" knows about me and my neighbors. The credit department can give the independent accountant a reliable opinion as to the dependability of a customer in arrears; it is here where we confer on accounts that seem doubtful on the face of the ledger; and it is here where we sometimes change our minds when we find a comparatively new balance which we would ordinarily not think of charging to a reserve.

Businessmen are finding the burden of administrative expense getting heavier and heavier. Costs must be cut where possible, and more and more we are turning to client personnel for the preparation of detail used in our reports. If credit and accounts receivable are manned as one department, then the aging and prediction of accounts can be done by the department, saving hours and often days of high-priced work by the auditor's staff. If the two departments are separate, then the accounts receivable department does the listing, balancing and aging, passing its completed work to credit where any unusual circumstance surrounding an account is noted. This job completed, the auditor merely has to make adequate test checks for accuracy and go into conference with department heads for discussion of bad debts and other aspects of the accounts.

Further amplifying my heretical statement regarding the verification of accounts receivable, I assert that the independent accountant cannot shirk his responsibility in his certification of any material item on the balance sheet—and this includes notes and accounts receivable. The accountant can be of great assistance by requesting a reply to his confirmation statement sent to the delinquent customer. One credit man told me he knew of no better collection medium than a letter from his auditor. The accountant always careful to indicate that he is not a collector, often sends out the second, third or even fourth request for a confirmation of a balance due—and this third or fourth letter is frequently just the spur needed to inspire the d. l. q. to enclose a check with his scathing reply.

Certified public accountants are, in response to the demands of business, gradually expanding their services and often are able to serve as management consultants. This area is wide and covers many facets of industry, and the accountant who is a specialist in the field of internal control can, by co-operating with the head of the credit department, render his client an invaluable service. Here are a "baker's dozen" of the areas where he might offer suggestions—and where he might learn something useful to himself:

1. Determination of outstanding volume for various lengths of time through aging of accounts.
2. Comparison of credit sales with total volume.
3. Comparison of the ratio of receivables to the current ratio.
4. The study and evaluation of the treatment of credit memoranda.
5. The effectiveness of the system of writing off bad accounts.
6. Review of the procedure used in granting credit.
   (Here, in particular, the accountant is going to be interested in how often the credit department is by-passed and how much freedom management allows credit in opening accounts.)
7. Special handling of employees' accounts.
8. Safeguards in procedures used in billing and collections.
   (Is there adequate control in posting, billing, collections, deposits and cash flow? You readily see the connection between credit and accounting in these functions on account of the responsibility of the credit department for action in delinquent accounts.)
9. Coordination between the sales department and the credit department as to credit policies and selling terms.
10. Comparison of the client's credit losses with averages in the industry.
11. Comparison of collection costs with collections.
12. Insurance that all personnel and machines are utilized to the maximum.
13. To establish that credit reporting agencies are doing their jobs and that their reports are up to date—and that the use of them is efficient and economical.

There has been considerable recent discussion and research in the direction of such management services which can properly be rendered by the CPA. Many services are so closely tied to the accounting and auditing functions with which the CPA is directly involved that the independent accountant is the logical person to study the problems and offer solutions.

Proper analysis of the credit department, using actual figures, can determine whether the manager is himself in tune with the rest of the business or is actually restricting the available business of the company through policies employed in granting credit to customers. It is not necessarily good to be able to brag that annual credit losses have been one-half of 1%, when, with a slightly more lenient, yet firm, credit policy, the balance might swing up to 2%, with an offsetting increase in sales and good accounts.

Never to have a loss can be a very poor barometer. On the other hand, slack methods and over leniency are indicated when bad debt write-offs are material. The barometer in this instance is often high collection costs, and sizeable charge-offs always reflect "sloppy" methods. Paying a full time collector who does not bring in a profit from the collection of doubtful accounts is dead wood. If you break even on such collections, all you are proving is that some of your uncollectibles are collectible.

Throughout my career in public accounting, I have noted from client to client that the credit department with a firm, fast collection policy, implemented in such a manner as not to drive customers into the arms of competitors, is the one which turns in the best performance at the end of the year. In times like today, when credit is readily available and most of us have established such ratings that we can purchase almost anything "on the cuff", the joint responsibility of the credit department and the independent accountant increases appallingly—the credit department to maintain an equitable credit policy and the accountant to declare in his report that the net receivables as shown are, in his opinion, currently collectible. Either one can do a better job with the friendship and help of the other.

Co-operation between the auditor and the credit department will pay off. You may well wonder, if your job is in retail, why the auditor should "snoop" into your business. You may well say, "I don't handle any money, and, if I did, I wouldn't steal it. I report to management every single time I have a delinquent account to contend with. My boss knows exactly the condition of my accounts."

My answer to your first argument is that the independent accountant is already pretty sure you are not a thief. Although in our training we are taught that we must search for safeguards against fraud, it is most gratifying that cases of thievery of funds or merchandise are few and far between. To me, this is a lesson in the basic decency of people—particularly those people who are capable of rendering judgement and are willing to accept important responsibility.

The second argument is answered by telling you we know you report the condition of your accounts to management, and, if management had no other use for the information than to "prod" collections, then the independent accountant would by-pass the credit department entirely—and you would be saved perhaps considerable annoyance.

However, management must use his accounts receivable for other purposes than just augmenting sales and harassing the credit department. Generally speaking, accounts receivable are a major portion of assets currently convertible into cash. If accounts are in a current condition, financial management can often regard them as they consider cash in the bank.

If the auditor and the credit department have worked hand in hand to insure that there is no material qualification in the certification of accounts receivable, then the credit rating of the retailer will not be curtailed. This account lies in direct relation to accounts payable—large non-current accounts receivable spawn large non-current accounts payable.

Now there lies the "hitch" and the proof of the "pudding". When a retailer extends credit with a smile on his face, then he must extract credit from the manufacturer and the wholesaler—with or without a smile. If you extend credit and your accounts receivable are maintained on an even keel — and your indenpendent accountant can so certify—then the fault lies with management and not the credit department when accounts payable are delinquent or even when the department is unable to take full advantage of anticipation and cash discounts.

As a rule, those in management are fairly sure of employees—particularly key men and women—and, therefore, we, the auditors, are not employed primarily to test your honesty and performance. Statements issued by certified public accountants are submitted to merchandise resources, banks and other creditors in applications for new or continued credit. Many banks and factories require at least one statement per year, regardless of the size and generally known financial responsibility of the customer. These statements are required to be prepared by fair and impartial people entirely unconnected with a particular business. It is often the case that the statement prepared by the auditor is eactly the same as that prepared by the controller. However, it is presumed that the controller is not unbiased, and the impact of reliability is stamped upon the report certified by an independent accountant. The business public, especially the credit department, knows the obligation under which the independent accountant practices. Our ethics demand that we certify a fair and reasonable net worth, with attendant balance sheet and profit and less ratios, only after an objective examination of the financial position of the client.

The most important ratio in the evaluation of a credit risk is the current—current assets over current liabilities. If the audit report contains the unqualified certification, either actual or implied, that the accounts receivable are worth dollar for dollar, that all the liabilities are listed in their proper places in the balance sheet, and if the current ratio is satisfactory, then you can be pretty sure there will be no COD shipments.

Consider the three main items comprising current assets: Cash is cash—it is there or it isn't; merchandise is tangible—it can be seen, felt, often tasted, some times heard and occasionally smelled; but accounts receivable you see and then you don't see. You deal with the unpredictable human element. You must be able to "have the feel" of the dependability of a debtor, you must study human nature, you must "have a heart" and yet be heartless. You have to consider the position of the sales department, you have to consider the condition of the notes at the bank, you have to see that collections stay ahead of disbursements.

If your employer did not extend credit, he would not have hired you, and, if your employer did not need credit, he would not hire me. Therefore, even though it has been said that the twain shall never meet, you and I, or our counterparts, twain though we be, must meet everyday on a common ground and merge our talents for the betterment of business and business practices.