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By Charles C. Kimball

Even if I had the hardihood to attempt to tell accountants how to prepare a report it would be unnecessary, because the subject has been so well covered in the bulletin prepared by the American Institute of Accountants, *Examination of Financial Statements*. It seems almost superfluous for me to speak of this report, except that it has been my lot every now and then to talk with an accountant who, when I have asked him why he hadn't followed the procedure outlined in the bulletin, would register surprise. I was always uncertain about the surprise—whether it was because a banker knew something about the existence of such a publication or whether the accountant himself was ignorant of it. I have been reluctant to think the latter, but in some instances the surprise has been so well feigned that I have had a suspicion the accountant did not know of the existence of the pamphlet. If there really is any accountant who is not familiar with it I urge him to lose no time in getting a copy on his desk.

This pamphlet, early in the introduction, mentions several groups besides the accountants who are interested in an accounting report. It mentions the management, then stockholders and then "for credit purposes." A little further on it makes the following ambiguous statement: "Statements prepared primarily for the purpose of reporting to stockholders and other investors should not differ greatly from those prepared for bank and commercial credit purposes." I don't know whether it means that stockholders should be given all the information that the bank wants—if that is right, I am wholly in favor of it—or whether it means the banker should not be given any more information than is given to stockholders. I fear it is the latter.

However that may be, the banker's interest should not be the sole reason for an audit. In my opinion the main purpose of an audit should be for the benefit of the client, the management. Now, perhaps the greatest benefit to a client is to allow him to get credit at his bank. If that is the sole aim, however, it is very limited and I do not believe the accounting profession would admit that the value of its work is so restricted.

The main purpose of an audit, I repeat, should be for the benefit of the client himself, and the client will not benefit unless the audit is thorough. It should be a sufficient piece of work not only

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to enable the client to get credit from his bank, not only to enable him to get money, but to save money and to make money. And that implies a comprehensive piece of work. The audit must be sufficiently thorough to show the customer what is wrong with his business or how his business can be improved.

The great objection generally found is the expense of the audit. I think that a good many accountants would like to enlist the aid of the banker in selling the idea of a more complete audit to their clients. The banker undoubtedly can sometimes help. He can frequently induce his customer to have a more complete audit in order to get credit, but I do not believe that you want to place the banker in the position of being your salesman. I think the problem of a more complete report is a problem for the accountancy profession rather than for the banker.

I should like to introduce at this time an idea which perhaps could be used in persuading clients that more complete reports would be helpful, and that is—there is a growing tendency among bankers to use the accountant's report as an index of the ability of the management. One of the things that at the start creates a favorable impression of managerial ability is a complete and thorough report laid on the banker's desk.

I pass now to the question of what the banker wants. We sometimes meet some false ideas among our customers. One is that all the banker wants is to see an accountant's signature at the foot of the balance-sheet. That in the past has led to the certificate that the statement was "in accordance with the books," leaving the matter there, with no indication as to whether or not the books were correct. Now, such a certificate creates a very unfavorable impression on the banker. It does the customer harm because the banker at once suspects him of trying to slip over a slovenly job and it does the accountant harm for being willing to be a party to such a transaction. If you are asked to certify a statement of that sort—I do not believe any of you would, but if you are asked to—you can point out to your customer that he is doing himself more harm than good. The banker will not consider it a satisfactory statement on which to base his judgment for a loan.

There is another sort of statement to which the banker objects, namely, the condensed balance-sheet. This, apparently, is based on the theory that the banker is a busy man, that he hasn't time to read a complete report and that therefore you are doing him a service by putting your package in as small a form as possible. However busy the credit department of a bank may be, it is willing to spend sufficient time to learn all the facts available regarding customers to whom the bank is extending credit. The banker is always gratified, therefore, to receive the full report and not a condensed statement. We realize that the accountant is employed by the customer and not by the banker and that he can not well refuse to certify a condensed report when this represents with substantial correctness the financial position of the business. We ask your coöperation, however, in pointing out to your client that the banker desires the full report and that it makes a better impression to give it to him voluntarily rather than to make it necessary for him to ask for it. Furthermore, we should like to see condensed reports labeled as such, since sometimes we are in doubt as to whether we have the full story or not.

The banker would like a full report and a comprehensive report. Beyond this the banker wants to know from the report and through the certificate what the accountant has done and what responsibility he assumes.

Perhaps you remember that former President Theodore Roosevelt coined the phrase "weasel words," words which are apparently innocent, yet when appearing in a paragraph suck all the strength out of the paragraph. Too often the banker, in all innocence, will read a report and say it is fine. Then something will crop up which is at variance with what the banker thought the certificate said and he will have his attention called to one or two words which form a convenient hole for the accountant to crawl out of. The banker does not want any "weasel" words.

The certificate which appears in this bulletin *Examination of Financial Statements* is one of the few things in the bulletin which does not have our full approval. It seems to be the type of certificate that could be used for almost any kind of a job. It could be used for a first-class job and I should think it could be used for a job that wasn't quite as good. The main definite statement in it seems to be "But we did not make a detailed audit of the transactions," which seems rather a negative thing on which to base one's confidence. There are six notes, however, which are appended, and if the accountant should follow those notes he would meet the banker's wishes one hundred per cent. In fact, if he would sign the certificate and the number one note I believe it would be about all the banker would want.

The first note says, "It is contemplated that before signing a report of the type suggested the accountant will be satisfied that his examination has been adequate and in conformity with the principles outlined in this bulletin." That would be fine.

In discussions at some of our Robert Morris Associates meetings with members of your society we have spent considerable time on the subject of classification of various items: whether an item should be classed in current assets or whether it should be placed below the line, as the saying goes. I am disposed to place less weight on the fact that an item is put by the accountant above or below the line than I am on how he describes it.

Given the description, the banker, in his analysis, can make up his mind whether he wants to treat it as current or deferred, as the case may be.

I wish to say a word on the subject of window dressing. One thing that the banker would like is to have the accountant's comment on any unusual transaction which takes place. One of the most frequent transactions of this sort is the case in which a man is borrowing from his own business. Just before statement date he gets a loan somewhere else, and then after the year-end he borrows from the business again and pays his outside loan. We should like to feel that such a transaction would be noted by the accountant and commented upon in his report.

There is another type of window dressing which sometimes has the coöperation of the accountant. He will usually mention it, though I have known cases in which he did not. That is the practice of holding the books open after statement date in order to take advantage of cash collections and make a better showing. Naturally the customer likes to put his best foot forward. We had a case some years ago in which there was an accountant's certificate attached to the statement. For years this company had shown no notes payable on statement date. Then by chance we learned it was borrowing on statement date from a bank in another city and we were told, "We hold the books open for about two weeks and then our collections allow us to take up these notes." The accountant had at first given no indication of this. In subsequent years, after he had had his attention called to it by the bankers, he certified that the company did hold its books open after statement date. If my own idea of a balance-sheet is right, however—if it is intended to show the condition of the business on a given date—when you have some transactions as of one date and some two or three weeks afterwards, I confess I do not know whether you have a statement of condition or not. I don't think you have. The banker does not like a statement indicating that the books are kept open after statement date.

There is one practice, resulting in the customer's putting his best foot forward, which has the banker's hearty approval, and that is the use of the natural business year. In part, our reasons for approval are the same as the accountant's. In our credit departments we are overwhelmed with work from January to April, and then there is not much analysis of statements after that time. The banker approves thoroughly of the use of the natural business year to spread the work more evenly. Beyond this—I am not sure of my ground here, but I put it forward as a theoretical consideration—I think probably it gives us a better comparison if statements are presented to us at the time of least activity. That is, the comparison from year to year is less likely to be affected by seasonal influences at the low point than it is some time later in the year when the business is more active. That is theoretical but I think there is something in it.

However, on the natural business year the banker has one suggestion that I should like to offer. I am not sure that this comes strictly under accounting, but it would be very helpful, when the statement is made up at the low operating point, if somewhere in the body of the report there should be noted the maximum debt of the corporation during the year. That would be of great service to the grantor of credit in showing him the adequacy of the company's working capital and also indicating the amount of credit which the corporation was likely to require.

I shall now pass to a more detailed consideration of the accountant's report. It is sometimes supposed that when a report is laid on the banker's desk the first thing he does is to turn to the balance-sheet and compare the quick assets and the current liabilities. That used to be the banker's practice but it is no longer so. I have already referred to the fact that the banker increasingly relies on the report as an index of managerial ability, and as such the first thing that the banker turns to is the profit-and-loss statement.

The money-making ability of the management is of primary importance as an index of how good that management is. Also, if the banker has the profit-and-loss statement it gives him a better basis for coöperation with the management, in that it enables him to point out unsatisfactory trends in the business which would probably not be apparent in the balance-sheet until much later.

I have jotted down some of the things which the banker likes to see included in the profit-and-loss statement. He likes to see the gross sales, as well as the net sales. Many profit-and-loss statements that come to us start with the net sales. Often the amount of returns and allowances in a business is significant as to the ability of the management and the quality of the product, and the banker wants to have both figures in order to judge whether returns and allowances are more than a normal amount.

We have spent much time in analyzing the margin of profit lately. It is helpful in showing trends in a business. It is also helpful in giving us some basis for comparing the efficiency of different managements by the amount of gross profit they obtain. The item of gross profit, therefore, is bulking large in our analysis work.

Then we have the selling expenses and the general administrative expenses.

General and administrative expenses are particularly interesting to the banker as showing the amount of executive salaries. We want to know how much money the business is making, and often the business will not show profits but the officers will be drawing large salaries.

We had a wholesale grocer before us the other day with a poor earnings record over a period of years, and yet the management was taking out in salaries enough to enable it to put back each year, over a period of six years, fifty thousand dollars in new capital stock. That information was a valuable aid to us in forming our opinion of what the management could accomplish.

Regarding other income and other charges, the banker would like to see an explanation of any extraordinary income or extraordinary charges which appear. That is, instead of just seeing the figures he would welcome comment in the body of the report calling attention to and explaining unusual items of this sort.

Somewhere in the profit-and-loss statement, or elsewhere in the report, the banker would like to have shown the amount of depreciation for the period. Often we find depreciation included in the cost of the goods manufactured and it is sometimes included in such a way that we can not pick it out readily. The amount of depreciation is an indication of the conservative policy of the management, or the reverse.

Having arrived at the net profit, we want to see what is done with the net profit, and that implies that the report will include a reconciliation of surplus. If there have been any changes in the capital structure we should like to have a reconciliation of the capital account, too.

There is a third reconciliation which is less frequent in accounting reports, but which we see in an increasingly large number, and that is a schedule of the application of funds, showing what is done with the cash which the business takes in. We have been working lately with a manufacturer who in the early years of the depression became over-extended. The management consisted of capable manufacturers and the banks were willing to continue their support. They are being rewarded by the fact that the company is now making a little money. Because they are good manufacturers the management, which has always been liberal in depreciation charges, can not resist the temptation whenever the cash balance increases to make an improvement in the plant and equipment. The result is that in spite of the depreciation and the profits they are now earning, they are not making any progress in building up much-needed working capital. When we have an application-of-funds statement it sets the problem directly before the banker and makes it easier to show the customer what is wrong.

As the American Institute's bulletin correctly states, the banker is "interested primarily in the liquidity of a business enterprise and the character and adequacy of its working capital." Therefore he is interested primarily in the make-up of the items which go into current assets and current liabilities.

Among the current assets on which I should like to comment the first is the item of receivables. The bulletin points out that accounts from officers and employees or subsidiaries and affiliations should not be included in the trade accounts, but should be set up separately. You may consider that they are current assets but they should certainly be described. There is no need for me to comment on that.

There is one thing, however, that the banker always likes to see in connection with the receivables, and that is an ageing. This sometimes appears in the balance-sheet and sometimes in the body of the report, but the ageing of the accounts receivable is a valuable aid in our credit analysis and we feel that it should appear in accountants' reports.

There is another minor thing—and here again I may be talking about something impracticable from the accounting viewpoint. We do not like to see notes and accounts receivable lumped together. That is sometimes done in the condensed reports of which I spoke earlier. It is important for a banker to know to what extent the customer is taking notes, and in most reports the notes and accounts receivable are separated. We are wondering whether that separation couldn't be carried a little further—if it wouldn't be possible to separate the reserve for bad debts into that part of the reserve which applies to the notes receivable and that part which applies to the accounts receivable. Usually the practice is to combine the reserve and deduct it from the total of the notes and the accounts receivable. It would be interesting and helpful to the banker to know how that reserve should be divided.

I am now going to tread upon the dangerous subject of merchandise inventories. I want to make first a preliminary explanation of the banker's viewpoint regarding them. On most of the statements that come to us, the largest item on the asset side, certainly the largest asset among the current assets, is the merchandise account and yet that is the one item which we are asked to take on faith. We may have a splendid piece of work throughout the report with this one exception, and that is probably the thing we must look to for the payment of our loans.

Now, I am familiar with the various arguments against the accountant's assuming responsibility for inventory. I am told that he lacks the technical knowledge to judge the condition of the inventory, he lacks the men to take the inventory, he lacks the knowledge to value the inventory. That would require a skilled appraiser. But making allowances for all these difficulties, it seems to me that the one great improvement we would like to see in accountants' reports is the assumption of more responsibility for inventory quantities and valuations. My technical knowledge of the procedure followed in verifying inventories is probably insufficient for me to attempt to lay down rules as to how this should be done. In general it seems to me that the taking of inventory should be conducted under methods laid down by the accountant and that he might well have a representative on the job to see that these methods were followed. Then at the time of the audit he should make sufficient tests to satisfy himself as to the correctness of quantities and prices. To the lay mind this ideal does not seem to differ greatly from the procedure outlined in the Institute bulletin. The banker's criticism of prevailing practice is mainly that in so many of the reports which come to him the accountant appears to do little more than take the figures of the management, confining his verification to the mechanical work of proving the computations submitted.

On the question of valuation it is highly important that the method of valuation should be stated, and the banker would like to have this stated in such a way that he knows what the valuation is.

We had an interesting case not long ago in which one of our clients brought in a statement by one of the leading accounting firms, with these words on it—that the inventory was valued "not in excess of the lower of cost or market values." It seemed to us that this was a clear case of an inventory valued at cost or market. Our client came in to see us and said, "What did you think of the statement?" We replied, "It looks all right, but we should have liked to see a larger profit." "Well," he said, "you know that inventory is valued all the way through at twenty per cent. below cost and cost at that time was lower than market."

We like conservative valuations but this thought occurs to me —we know accountants would probably speak of any gross overvaluation. Shouldn't they also speak of any gross under-valuation of inventory? It is difficult to sell that idea to your client in these days of heavy taxes, but I wonder whether you are really doing a service to your client in allowing him to avoid taxes in that way. Some of these inspectors are becoming inventory-conscious.

The banker would also like to have the accountant assume some responsibility for calling attention to obsolescent or unsaleable goods. That is something on which the accountant would have to rely largely on what he was told by the management, but I believe there is a responsibility on the part of the accountant to ask the question and try to bring out the facts.

The next item on my list is investments. Often we see this item on statements and frequently it is described simply as either "investments" or "securities." Nothing is said as to what these securities consist of or how they are valued. If those investments are accumulated, as they frequently are, as a secondary cash reserve, it is important to the banker to know how good that reserve is. If they are not readily marketable investments, if they are investments in subsidiary companies, the banker wants to know in what direction his client is branching out.

So, from the banker's viewpoint, I urge you to give a list stating the names of the companies in the investment account, the amount of bonds or the number of shares and the basis of valuation.

In the body of the report the banker would like to see an itemized list of the notes payable. He wishes to find out if anybody else is extending credit and how much they are extending. He often finds, when such a list is given, that the customer is receiving credit from quite unexpected sources. I bring up the subject of notes payable, particularly, however, as I wish to speak briefly on the question of liens when there is collateral for notes payable.

You will say that if there is collateral against notes payable you will comment on it. I think that in most cases collateral on a note will be reported. Omissions of this sort in our experience have usually occurred in conjunction with acceptances under letters of credit. It may be partly due to the fact that this type of transaction is unfamiliar, but in numerous reports which have come to us we have seen acceptances set up with no indication as to whether there was a lien or not. Sometimes when we have called this to the attention of our friends, the accountants, they have said, "Does not the mention of acceptances put you on notice that there is a lien?" There isn't always a lien. Acceptances are frequently created to finance import and export transactions without any pledge of merchandise. This is not the usual procedure, but there are sufficient exceptions to prevent the banker from assuming when he sees acceptances in the balance-sheet that they are secured.

Probably part of the difficulty comes from the fact that it is hard to identify a lien under acceptances on a specific body of merchandise and to meet that situation this phrase has been suggested: "Acceptances under letters of credit against merchandise released under trust receipt." That is a statement of the facts. There is no attempt to identify the collateral but the existence of a lien is indicated and that, according to the Institute bulletin, is something that the accountant has the responsibility to report.

Another item on the liability side is that of reserves. In too many instances reserves are used as sort of a catch-all. A sum may be included in reserves for the reduction of the value of an asset item. There may be a reserve for taxes. There may be a reserve set up in case of an unfavorable decision in a law suit, or it may be simply a segregation of the surplus put there so the surplus won't look too big. By all means give us a separation of the reserve account, so that we shall know when we look at reserves whether we are looking at a liability, real or potential, or part of the surplus.

I have already spoken of the desirability of schedules reconciling changes in the surplus and capital accounts. It would be most helpful to have included in the report an explanation of the changes which have occurred in surplus reserves during the year. A few accountants give such explanations, but the practice is by no means frequent. We hope to see it become general.

Somewhat the same is the question of contingent liabilities. In the old days there was considerable trouble in obtaining any report of contingent liabilities. Such things as notes receivable discounted, one of the most common contingent liabilities, would be omitted from the balance-sheet. I am happy to say that this rarely happens now. The same improvement has taken place in reporting other types of contingent liabilities, such as unsettled law suits, guaranties or accommodation endorsements. Well, perhaps I am too optimistic on that point. Quite recently we had a report prepared by a first-rate accountant for a large corporation which was guaranteeing the obligations of an independent company that was doing some buying for them. The accountant tried to cover the point and asked the management whether or not there were any contingent liabilities of this sort, but I think he asked the question of the assistant treasurer. The transaction didn't show on the books and the assistant treasurer didn't know about it. The company was selling its paper in the open market and the bank that had the guaranty bought the note. Perhaps the moral of this is to stick to your own bank and not sell paper in the open market, but certainly it shows how difficult it sometimes is to catch these contingent liabilities and how careful one must be to detect them.

There is one other item of this general sort on which we find a most surprisingly casual attitude among some accountants. This is the question of dividends in arrears on preferred stock. The

Institute bulletin states definitely that such an item should be reported, but many accountants do not follow these instructions. The bank is interested in the accruals for two reasons. The first is that the existence of a large accumulation of dividends represents a potential drain on future earnings. Then there is the more immediately practical consideration that most preferred-stock indentures include a provision whereby there may be a change of management in case a certain number of dividends are passed. Therefore a large accumulation of dividends may indicate a possible change in management.

A word about consolidated statements. An earlier speaker referred to the recent excellent article in THE JOURNAL OF ACCOUNTANCY on consolidated statements. I can add nothing to that article, but it is desirable from the banker's viewpoint not only to have the consolidated statement, but to have what I suppose you call the consolidating statement, that is, the individual statements of the subsidiaries and the parent company with the intercompany eliminations shown. I should like to go further than this. When statements are not consolidated, when there are wholly owned or largely owned subsidiaries whose figures for one reason or another are not put into the consolidated balance-sheet, (as is quite frequently the case with foreign subsidiaries) the individual statements of those non-consolidated subsidiaries should be carried in an appendix to the report. This is important to the credit grantor because loans to holding companies present special pitfalls. The banker may be extending credit to the parent company, which uses the credit for bolstering the weaker members among its subsidiaries. The consolidated statement looks fine, but the creditors of the stronger subsidiaries have a first claim on the assets of those subsidiaries and by the time the liquidation filters down to the holding company to which the banker is lending there may be very little left for him.

One of the pleasant things in my credit work during the past few years has been the interchange of ideas between bankers and the members of the Massachusetts Society of Certified Public Accountants. We have found the accountants desirous of understanding the banker's viewpoint and of attempting to give the banker what he wanted so far as it lay within their power. I do not think it would be impertinent for me to say that during this period there has been a tremendous improvement in the reports that have come to the banker's desk. Many of the old annoyances, that we used to have, seem to be pretty much a thing of the past and it has been gratifying to note that improvement. And the banker, I think, by these meetings, has obtained a greater appreciation of the accountant's problems. We realize he is limited by his clients' wishes, by the terms of his engagement, that he can not accomplish, perhaps, all that he would like to, and we are firmly convinced of his desire to make just as good a report as he can.

I am sure that this coöperative spirit will bring in the future, as it has in the past, mutual understanding and more comprehensive and comprehensible accountants' reports.