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Essential Features in a Report for Credit Purposes*

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In preparing a report for credit purposes, the accountant should have constantly in mind the fact that he is being relied upon to furnish the data from which the banker or prospective creditor can arrive at a decision as to whether or not it is reasonably certain that the borrower's paper will be met promptly at maturity; or, in case any unexpected and unforeseen contingency arises which temporarily delays payment at maturity, whether or not the final discharge of the obligation can be depended upon. If accountants would keep this idea constantly before them, there would be a noticeable improvement in the statements prepared by them for credit purposes.

In a report for credit purposes, the items on the balance-sheet should, of course, be segregated under appropriate captions, the assets generally coming under the headings "fixed assets," "current assets" and "deferred charges to profit and loss" and the items on the right side generally falling under the headings "capital stock" or "partnership accounts," "bonds" (or other long time obligations), "current liabilities" and "reserves." While other captions appear on the balance-sheets coming before the busy banker for his scrutiny and attention, the foregoing include the items ordinarily found and to which our attention will be confined in this article.

As the banker's principal thought in deciding on the desirability of a loan is the certainty or lack of certainty of its repayment, it

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naturally follows that his attention will be first directed to the current or quick assets and that they will be subjected to a close scrutiny and investigation. The term quick assets includes cash and such other items as can presumably be quickly turned into cash, such as inventories of material and merchandise, bills and accounts receivable, securities owned, etc.

With respect to the inventory, one of the first things the banker will be interested in knowing is whether or not it is the result of a physical count. If a physical inventory was taken, was the method followed such that the results can be depended upon? Or if book records were relied upon in making up the figures, upon what basis have the stock records been kept and how trustworthy are they?

Another important point to be considered is the basis adopted in pricing the various items listed. Are they at cost or market and what is the approximate variation between the two? It is a comparatively easy matter to arrive at the unit cost of various items of raw material and merchandise purchased ready or practically ready for sale, but in the statements of a manufacturing company, there will appear goods in process and finished stock, and here the question immediately arises as to whether or not the concern maintains an adequate system of cost records and, if so, just what items are being included as part of the cost of manufacture.

Has the inventory been inflated by including therein items which cannot fairly be considered part of the cost, or, as is sometimes the case, is there profit included? Has the clerical work in compiling the quantities and in extending and adding the sheets been rechecked? Overstatements or understatements of inventories by substantial amounts frequently result from simple errors in calculation. To illustrate a case in point, a clerk's error in misplacing the decimal point in the unit cost of an item resulted in an overstatement of the inventory by about $140,000.00.

Another matter of very great importance is whether there is obsolete or damaged stock included in the inventory. Changes in style or in the product occur rapidly in certain lines of business and in the statement of such a concern this point should be looked into carefully.

It goes without saying that the report should state if any portion of the stock is subject to a lien or is pledged as security for the payment of any debt, if there are any consigned goods included, and whether or not the liabilities have been taken up for all goods inventoried.

Next in order come the bills receivable. What proportion of them can we reasonably expect will be paid when due? Are there included therein some which are either wholly or partly valueless and which will have to be extended from time to time as they mature and eventually be settled by compromise? Are there any which are past due or have already been renewed one or more times? Are they all notes of trade debtors taken in the ordinary course of business, or do some represent advances or loans to employees, officers or subsidiary concerns, or notes accepted in payment of equipment or fixed assets disposed of, or even of capital stock sold? It is a well-known fact that in certain lines of business the more valuable customers buy only for cash or on open account, settling promptly at maturity, and that notes are taken only from customers who are "slow pay." Dealers in farming implements frequently accept notes payable in instalments over long periods and this, if found to be the case, should be covered fully in the report. A manufacturer of one variety of farming implements, dealing directly with the farmers, accepts in settlement of goods sold the purchasers' notes payable in instalments over periods of from two to four years.

It will readily be seen that all of the foregoing queries have a distinct bearing on the value of the bills receivable as a current asset and unless the points mentioned are carefully inquired into and reported on by the accountant, the value of his report to the banker will be seriously affected.

Practically all the foregoing remarks regarding bills receivable apply also to the item next on the balance-sheet—accounts receivable. These must be carefully scrutinized for bad, doubtful and overdue items and a sufficient reserve must be provided. Prospective allowances in respect of discount, freight, etc., must also be estimated and provided for.

Are there included any personal accounts of officers or employees, any advances to allied or subsidiary companies, or any open accounts of any substantial aggregate in respect of the sale of items outside the concern's regular line of trade? As regards advances to officers or allied concerns, numerous instances can be cited where such accounts are carried along from year to year without any effort being made to collect them. Are there any debits on account of uncompleted contracts on which payment cannot be expected until the contracts are completed, or are any of the accounts in the hands of attorneys for collection?

The geographical distribution of the accounts should also be looked into, as it will readily be seen that if a substantial portion of a firm's debtors were located in one section of the country and business in that section happened to be adversely affected by a crop failure, hurricane or other calamity, the creditor's concern would be in line to suffer a substantial loss on account of bad debts.

Advances to salesmen to cover traveling and other expenses should be shown separately, if they aggregate any substantial amount.

The details of the items comprising the open balances of the various accounts should be looked into, as instances are numerous where the current charges are settled promptly as they fall due, leaving old items in dispute unpaid.

Frequently accounts receivable are sold to discount companies or are hypothecated as security for loans, and in such cases it is highly probable that the best of the accounts has been taken. Do any of the debit balances represent memorandum charges covering consigned merchandise? In the ordinary course, such accounts do not become current assets until the consignee has disposed of the goods. Do one or two accounts make up the greater part of the aggregate outstanding? In this case the failure of one of these large debtors would seriously cripple the applicant from a financial point of view.

From the foregoing it will be seen that there are many questions affecting the value of bills and accounts receivable when considered from the viewpoint of whether or not they are quick or current assets. Next to cash on hand, it is to these two sources that the banker must first look for a repayment of his loan, and it will be seen, therefore, that a thorough inquiry into these two assets is of vital importance in an examination for credit purposes.

Surplus funds of the applicant may have been temporarily invested in securities which can be quickly disposed of and such items should, of course, be included among the current assets. Securities purchased to obtain an interest in or control of other companies and which are of more or less value to the applicant, aside from the interest thereon, should not be classed as current assets. The report should give a list of the securities and state whether carried at market or cost and if at the latter, how it compares with the market value. If market prices are not available, the approximate value should be given, based on the latest available reports of the companies in question.

On seeing the item "cash in bank and on hand" in a balance-sheet with no further comment thereon, the banker is justified in assuming that the funds are available for disbursement as required, and the accountant should satisfy himself regarding this question. Frequently moneys are deposited under a special arrangement whereby they are not to be withdrawn for a stated period, say ninety days, and, furthermore, deposits in banks are frequently tied up by liens filed against the deposits, in which case the amounts may not be available for months.

Was the amount shown as "cash in office" represented by actual currency or cheques at the date of the balance-sheet, or was it principally I. O. U.'s?

The accountant should satisfy himself that the total of the cash in banks and on hand is normal for the particular concern, having in mind the nature of the business conducted and business conditions generally. It frequently occurs that a substantial cash balance is built up in anticipation of heavy disbursements to be made, such as dividends to be paid, and that what was a satisfactory balance in the bank on, say, December 31st, may dwindle to almost nothing on January 2nd.

While the banker will look first to the current assets for a repayment of his loan, in case of an insufficiency of these, he will have to fall back upon the fixed assets along with the other creditors, provided there are no prior claims on these properties. The report should cover, in a general way, the assets of this nature, stating whether or not they are subject to mortgages, etc., and whether or not they are being maintained in an efficient condition. The accountant should satisfy himself that only actual additions and improvements have been capitalized and that proper provision is being made for depreciation. A point of particular interest to the banker is whether the properties involve heavy carrying charges without any corresponding increase in the income.

The deferred charges at the date of a balance-sheet are of no particular interest to the banker. They should be looked into a general way, however, to insure that the current year's operations are charged with the proper proportion of such items.

Current liabilities consist generally of bills and accounts payable and accruals for salaries, wages and other charges falling due in the near future.

The report should subdivide the bills payable into at least four classes: notes sold through brokers, notes discounted at the applicant's own banks, notes given in settlement for merchandise and raw materials purchased and notes given to individuals, such as officers, stockholders, employees, etc. Needless to say, the report should state the approximate amount falling due each month subsequent to the date of the balance-sheet, together with the interest rates. Information should be given, also, as to the amount of notes of similar classes outstanding at various dates in the past, as this is of value to the banker in determining whether or not the applicant is generally dependent on borrowed funds for the conduct of his business and how near the limit of his credit he may be at the moment.

Notes to officers, stockholders, employees, etc., should be inquired into carefully as they may possibly be secured by liens on some of the assets. Of course, special mention should be made of the fact in case it is found that any of the notes or other liabilities are secured by liens or mortgages on any of the assets, as well as of the fact that notes have been given for purposes outside the ordinary business of the applicant, if such is found to be the case.

The accounts payable should be covered in the report in about the same way as the bills payable. If there are particularly large items in the list, these should be looked into and commented on. The accountant should also satisfy himself that all accounts payable and other liabilities applicable to the period under review are taken up in his accounts.

Reserves covering liabilities actually incurred and falling due within a reasonable time should be included among the current liabilities, and reserves for depreciation, bad debts, etc., should, of course, be deducted from the assets to which they relate.

Long time obligations, such as bonds, mortgages, etc., should be investigated and commented on, as they are generally secured by a mortgage on the fixed assets at least and sometimes may be a lien on the current assets. Furthermore, it is quite possible that some of these liabilities fall due in the near future, and in any event the interest falling due regularly is a current liability. If the provisions of the mortgages securing such liabilities are not being complied with, the fact should be reported.

An important point frequently overlooked in reports for credit purposes and one of decided interest to the banker is that of contingent liabilities. Liability on account of notes discounted, endorsements for allied or subsidiary concerns, accommodation endorsements, liability on contracts for the construction of buildings, purchase of equipment or raw material, and similar matters come under this caption. These should be covered fully in the accountant's report, as they have a decided bearing on the desirability of the loan from the banker's point of view.

A good illustration of the importance of such items is the case of a concern manufacturing farming implements, which recently reported at the year-end current liabilities of about $500,000.00. On going through the contract file, however, it developed that contracts had actually been signed prior to the year-end for additions to plant and equipment involving an expenditure of some $800,000.00, the work to commence in the immediate future.

A profit and loss account should be submitted with the income and expenditures classified under appropriate captions, and, if possible, this statement should show the operations for at least three or four years, arranged in comparative form. If comparative figures for several years are submitted, the accountant must satisfy himself that the figures for all periods are prepared on the same basis. Instances are frequent where concerns make a liberal provision for depreciation, etc., in prosperous years and reduce, or even eliminate, the same item in lean years. Occasionally, a basis of inventory valuation is adopted differing materially from the basis used the year before, and some concerns show a tendency to charge to capital during lean years items of a nature which are absorbed in operating expenses during prosperous years.

Increases or decreases in the sales should be looked into. A recent investigation of a manufacturing concern disclosed a substantial increase in sales when compared with the operations of the preceding year, but on closer investigation it was disclosed that the increase was due entirely to the fact that large orders had been received from two new customers. Had this new business not been obtained, the sales for the last year reported upon would have shown an actual decrease.

The foregoing remarks include some of the more important points to be covered in a report for credit purposes. However, each individual case has its peculiar features which must be looked into and reported on, and the accountant must keep in mind at all times the fact that the banker is relying upon him to disclose all the material facts in the case.