Journal of Accountancy

Volume 18 | Issue 6 Article 3

12-1914

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As a prelude it is necessary to present a few figures which I hope will not only make an impression on but set clearly in your minds what a stupendous task the credit men have. In 1866 about 160,000 mercantile concerns were operating in this country; in 1886, there were 969,000; in 1906, 1,390,000; in 1913, 1,564,000. No trustworthy figures can be secured as to the total volume of business transacted during these same years. It is estimated that in 1880 our domestic trade amounted to eight billions, and in 1913 reached the enormous sum of forty billions. And in arriving at this result only one transaction in each article produced was counted, although in fact a large number of articles pass through the hands of middle men before reaching the consumer. In 1866, there were 1,500 failures; in 1913, 16,000—the percentage in one case being .94, and in the other .98.

It was not until 1896 that the credit men made their appearance. This was a strenuous year in business. It brought home to some merchants the thought that better commercial laws and better business methods were needed. A movement was started which resulted in the association I represent being organized. It is impossible for me to review the changes which have since taken place in handling commercial credit. Two developments are the signed statement made for the purpose of obtaining, on credit, either money or merchandise and the employment of certified public accountants to make an annual examination of a concern's books.

The Signed Statement

The signed statement is one of the most important elements in credit work. In a majority of cases it is the basis upon which credit is extended by both banker and merchant, who, how-

* From an address delivered before the Kentucky Bankers' Association at Lexington, Kentucky, September 23, 1914.

ever, reach their conclusions over slightly different routes. The banker lays more emphasis on the quick, or liquid, assets. He aims to lend money to be used in the purchase of raw or manufactured material where the turnover is likely to take place within a reasonable time, and not to furnish capital for use in operating or extending a business. While no less consideration should be given this side by the merchant, he is apt to feel a greater sense of security where there are substantial fixed assets in evidence. Signed statements have grown in importance during recent years. State laws have been enacted making the giving of a false statement for the purpose of obtaining credit a criminal offense. The national bankruptcy act attaches a severe penalty, and the postal laws make it an offense to transmit a false statement through the mail. The day has gone by when Bill Jones was trusted on the say-so of Jim Smith, who said "Bill is as good as wheat." The banker or business man extending credit on such a platform would be false to himself and to those he represents.

A statement, in order to be truthful, must be based upon an accurate and complete inventory. Here is where the first benefit to the maker of the statement arises. He must take an inventory. To illustrate, I quote a paragraph from a letter recently issued by a credit men's association on the Pacific coast:

> The barometer of the retailer's financial condition is his inventory. If he has no inventory, he has no barometer and neither he nor anyone else can possibly tell whether his financial condition is on the upward trend or the retrograde. In many cases the entire family has free run of the stock and cash, and in many cases this condition alone is a direct cause of failure and results in loss to the wholesaler. Probably seventy-five per cent of your customers never take an inventory. There is absolutely no good reason why you should not firmly insist that customers take an accurate inventory every six months. It is for your interest and their salvation. In ninety per cent of all cases it is absolutely required by the federal income tax law. The more firmly this is insisted upon, the less the bad debt loss will be.

A good many houses and banks supply their own statement forms, and where these are used it should be insisted upon that all questions requiring a direct answer be filled in, so that in case of complications arising later on the excuse cannot be offered that any item escaped attention.

The question of signed statements is especially important to banks, who use them not only in direct dealings with their customers, but also in connection with the purchase of what is popularly known as commercial paper. While commercial paper has had a place in the market for many years, it has during the last twenty years increased tremendously in volume. Business houses all over the country are selling their paper in the open market; it is purchased by a majority of banks. In seeking information as to the amount of such paper in the market at any one time I received what I consider to be a very conservative estimate of $750,000,000. I was informed that the total yearly sales of such paper would approximate two and one-half times that amount.

It is customary for brokers in commercial paper to furnish copies of signed statements, the figures contained in which largely influence the sales. It is here where the power of analysis enters, for oftentimes the figures, while not intended to be misleading, are so arranged as to create a more favorable impression than a complete analysis will justify. At this point the work of a certified public accountant plays an important part.

Audit by Certified Public Accountants

It has become customary for many houses to have an annual audit of their books—not a mere perfunctory comparison of the figures contained in the annual statement with those on the books, but a complete investigation of every item entered upon the statement. The value of this cannot be overestimated. The officers of corporations, the members of firms, the individuals engaged in any line of business, and, I might add, bank officers owe it to themselves and those they represent to have an independent audit of their books made at regular periods by competent auditors.

It should be thoroughly understood in advance that such work must be conducted without fear or favor as to results, and absolutely no restrictions should be placed upon the auditors.

The federal reserve act will perhaps force a still closer inspection of statement figures. Banks applying for rediscounts may be called upon to supply statements of recent date in connection with paper offered; bank officers may be required to certify that they have examined the figures contained in such statements and that they are true to the best of their knowledge and belief. If this really comes to pass, the result will surely be a marked increase in the value of audited statements. It is natural for most men to be optimistic over their business affairs. This is really the proper spirit to live in during business hours, for what an unhappy time we would have were every jolt taken to heart! *However, a man can be over-optimistic, even to such an extent that he fools himself. There is only one sane way to proceed—have your business affairs overhauled at regular periods, accepting the result as the final verdict. The real audited statement is the safety valve of a business.*

Let us take up some of the principal items found in a business statement, briefly analyzing them and pointing out the value of an audit:

Quick Assets

It is usual to include under this caption cash, notes receivable, accounts receivable and merchandise.

An analysis of these items is necessary. The principal points to be brought out are:

Notes receivable—Do these represent anything other than merchandise transactions—for instance, loans to officers, individuals or employees—or were any taken in payment of stock or capital? Are any renewals or past due?

Accounts receivable—Do the figures represent sales of merchandise only?

Merchandise—Finished or unfinished? Valued by whom? Basis of valuation?

Frequently it is found necessary to cut down the amount of the notes and accounts receivable and the inventory value. The first, because some are uncollectible; and the second, because the inventory, for various reasons, is valued too high.

Notes and accounts receivable may include advances to partners or to others not customers. In the case of a partnership, an advance to a partner is simply a reduction of his capital and not an account receivable, and while he may expect to repay the advance and would be honest in including the amount in the accounts receivable, it is of course not an account receivable such as we expect that classification to include.

In the case of corporations, it has been found that advances to subsidiary companies are included under the heading of accounts receivable. This is very deceptive, inasmuch as an advance to subsidiary or affiliated companies might, and usually does, represent an equity in accounts receivable, inventories and plant, less liabilities, and is virtually a permanent investment and in some cases not even a good investment.

Inventories may be overstated, and honestly so, unless an independent examination is made; and they even may include obsolete stock about which the management is not informed until the auditors make an examination. The prices may be too high, because of faulty methods in calculating the cost of merchandise.

It is always advisable to have an audit follow closely upon the heels of the annual inventory. This affords an opportunity for the auditors to make physical tests of the stock, and, where stock records are kept, to make tests of the current stock with the current stock card balances, thus to determine whether the records are being correctly kept or not. A comparison of the current inventory figures with those of former years will oftentimes reveal stock which is still being carried in the inventory, although really unsalable.

We shall not go into the details of other assets, such as real estate, machinery, goodwill, etc., further than to suggest their receiving thorough scrutiny, but will pass to quick liabilities.

Quick Liabilities

Under this are included notes payable, for money and merchandise, accounts payable and deposits.

Notes payable—Notes payable for money may represent several sources of supply—banks, individuals, notes sold in the open market through brokers, etc.

Accounts payable—Does this represent anything other than merchandise? Are bills discounted?

Deposits—To whom due? On time or demand? Interest rate?

Regarding notes payable, it is highly important that every source of supply from which money is secured should be definitely known, for it furnishes an index to the methods employed in financing a business.

Under accounts payable bills for advertising and a hundred and one other things may be included. It is important to know the correct amount represented by merchandise; and there is nothing more important than a knowledge of whether bills are being discounted or not.

As to deposits, many concerns receive deposits from employees. In some instances this is to encourage saving, but in some cases the purpose is to secure capital. A firm I know of requires each employee entering its service to deposit with it a certain sum each week. This has proved to be very beneficial; but is it good policy to mix business and banking? This same plan with a savings bank as a depository would be admirable.

Loans from relatives are sometimes treated as capital; also, loans from a special partner in excess of his capital contribution have been treated as capital and not as a liability, although the fact that he was a special partner limited his liability to the amount of his special contribution and all other advances were distinctly liabilities. This is something which seldom is found; nevertheless, instances have been discovered. You can readily see what a different complexion it would place on the statement figures.

Contingent liabilities for endorsements are frequently not mentioned. The necessity of definite information on this point cannot be over-estimated.

Other liabilities, such as mortgages, etc., we shall not attempt to discuss.

Placing the quick assets and quick liabilities in comparison with each other, and finding that the assets exceed the liabilities in proper proportion, which may vary from one and one-half to three times, depending largely on the nature of the business, you would be justified in assuming that solvency exists and that, therefore, credit is warranted.

In connection with all figures contained in a statement, collateral information of much value can be secured. It would be impossible for me to cover every detail at this time; but one of the important points is the amount of yearly loss by bad debts. This will tell the story as to whether or not credits have been made on too liberal a basis, a weak point with many houses, especially those newly organized and ambitious to show a large volume of sales. Many business houses protect themselves against unexpected losses through the carrying of credit insurance. The general plan of credit insurance is to average the bad debt loss covering a period of years and then write a policy against any excess; or in other words, the insured carries the risk up to the point of the average yearly loss based upon actual experience, the insurer taking the responsibility of any excess loss. There are, of course, certain requirements to be complied with, the same as in fire and other insurance.

Definite information as to the amount of fire insurance carried and the names of the companies writing the policies is very important. In the last analysis, in a majority of cases where credit is granted, fire insurance is the collateral behind everything else. Full insurance should be insisted upon, written by companies of known ability to meet their losses.

It may not be out of the way to call your attention to the fact that in the year 1913 the losses by fire in this country amounted to $203,700,000, a record which in ten years was not exceeded, except in 1906, the year in which the San Francisco fire occurred.

The installation of the sprinkler system wherever it is feasible is one of the very best protections against fire loss. Our bankers, especially, should use their influence in the direction of improving fire protection facilities. Take, for instance, the present situation as regards cotton. The carrying over of any considerable quantity will necessarily be a tax upon the present storage facilities. In no circumstances should cotton be stored in units of more than one thousand bales. It should be carefully guarded and every effort made to minimize the chances of loss by fire. If a plan which is proposed in one western city, to store several hundred thousand bales of cotton under one roof, should materialize, consider what a tremendous risk from fire would be involved. If a conflagration were to occur, the losses from which were large enough to eat up the ready money of the insurance companies, their solvency would be imperilled were they to be compelled to fall back on their investments at present prices.

Definite information as to a concern's policy regarding depreciation, both on merchandise and fixed assets, should be required. It is quite customary, now, to ask for a copy of the profit and loss statement.

Business houses receiving a large number of financial statements and all banks should include as a part of their records a comparison sheet. By this I mean a sheet upon which can be noted year by year in parallel columns the figures covering the more important items contained in the statements. This enables one to see at a glance any material changes which have taken place and lessens the necessity for a complete review of each statement as received.

During the last twenty years we have experienced a gradual change in the methods of doing business. We have passed through a period of legislation affecting business greater than ever before. Without much strain we have adapted ourselves to this, and now it would appear that our business men are standing on the threshold of a new era, where they will find themselves competing for trade on a large scale outside of the boundary lines of this country. We have confidence in their ability to take advantage of every opportunity, and the banking fraternity must contribute its share toward the development of our country's commerce. You bankers must solve the financial problems connected with it and must stand solidly behind the manufacturer and distributor in the struggle which is to be waged for the commercial supremacy of the world.