University of Mississippi

eGrove

Haskins and Sells Publications

Deloitte Collection

1963

Assets and the credit manager

Oreson H. Christensen

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

Haskins & Sells Selected Papers, 1963, p. 204-211

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Assets and the Credit Manager

by Oreson H. Christensen
Partner, Cincinnati Office

Presented before the Cincinnati Association of Credit Management, Cincinnati—February 1963

ONE OBJECTIVE of the Certified Public Accountant is to have financial statements presented in such form that reasonably informed readers will not misunderstand them. For a number of reasons this objective is not easily attained.

One reason is that there are many different classes of readers of financial statements—credit men, bankers, stockholders, potential stockholders, managers, financial analysts, and so on. Each of these groups has a somewhat different purpose in mind when studying and interpreting financial information.

Another reason is that although CPAs are guided by what are called generally accepted accounting principles, such principles are not magical formulas ensuring that all CPAs will come up with exactly the same answer under similar circumstances. The principles are general guides to accounting treatment but do not supply ready-made answers to reporting the complex transactions of today's business. Credit men likewise, it is safe to say, have no set formulas to answer the difficult questions arising in the credit-granting process. The activities of each group call for the exercise of analytical judgment.

Both are vitally interested in what is behind the figures appearing in the financial statements, but in the interest of brevity only some of the possibilities of genuine pertinence to a credit manager will be mentioned here, and an indication given of what can be expected from a CPA in reporting on those figures. A good guess is that the credit man's major concern is what lies behind the figures in financial statements not accompanied by a CPA report. No special solution for such concern will be offered except to point out that an awareness of the various possibilities puts the credit manager in a better position to ask some pertinent questions of the potential credit customer.

Receivables and inventories are often the most important of the current assets included in current ratio computations and in measures of working capital. The assumption is that credit grantors still attach some importance to these items, although the many possibilities lying behind such figures render somewhat hazardous too great or sole reliance on these measuring sticks of credit risk.

RECEIVABLES

First consider receivables.

With respect to notes and accounts receivable the CPA is basically interested in obtaining answers to five questions, an interest he also shares with credit grantors:

Are the accounts genuine?

What kind of accounts are they—that is, are they due from customers, officers, employees, affiliates, others?

Are they current or past due?

Are they collectible?

Are they pledged?

If the financial statements are accompanied by a CPA's unqualified report, it may be safely concluded that these questions have been satisfactorily answered. Otherwise, it is pretty much up to the credit man to ferret out the answers to his own satisfaction.

1. Are the accounts genuine?

Obviously, the CPA thinks they are or his name would not be associated with the statements. If receivables are a key factor in determining credit and there is reason to doubt or suspect their authenticity, consider asking for a trial balance, or at least for information about the major accounts included. This may not always be possible since information of this type is guarded rather jealously by many businesses.

2. Are the accounts due from customers, officers, employees, affiliates, or others perhaps not in the ordinary course of business?

Quite often receivables are found for such things as federal income tax refunds, insurance claims, vendor claims, sales of capital assets, as well as for amounts due from officers, employees and affiliated companies. Ordinarily, such receivables cannot rightfully be included in a sales/receivables turnover computation. Accountants would segregate in the balance sheet significant amounts due from other than trade customers; credit men would doubtless do likewise, for example, in making a receivables turnover computation so that only sales and receivables arising from those same sales are compared.

Another point to consider is whether a large portion of the accounts are due from but a few customers or perhaps even only one. CPAs are concerned with this problem and the grantor of credit is certainly aware of the possible implications insofar as the risk is concerned. A pertinent question to be answered in such a situation might be whether or not your credit customer carries credit insurance.

3. Are the accounts current or past due?

The first thing that comes to mind here is an aging schedule. The CPA uses such schedules in support of the evaluation of receivables and as an aid in considering the adequacy of the allowance for doubtful accounts. The credit man is interested in such evaluation too, and further, in what the aging indicates about the liquidity of the receivables. Just because they are in the current asset section of the balance sheet does not mean they are current insofar as being not due or past due is concerned, nor does it always mean they are expected to be collected within the next year. It is not uncommon for current assets to include instalment receivables due many years after the balance-sheet date. This is acceptable trade practice in a number of industries, and may not always be disclosed on the balance sheet or in a footnote.

4. Are the accounts collectible?

This question, of course, is of prime importance and accountants are greatly concerned with the answer. The accountant generally reviews this situation with the credit manager as the one most knowledgeable in this area. The accountant computes turnover ratios, examines loss records, considers economic conditions, etc., in an effort to satisfy himself that the allowance for possible uncollectible accounts is adequate. Generally he finds past experience a good indicator of what to expect in the future (in the absence of special circumstances, of course).

Another matter that must not be overlooked is the possibility that the practices of the customer may require not only allowances for uncollectible accounts, but for cash discounts, trade discounts, freight allowances, and other customer allowances.

Accounts-receivable-turnover ratios

A few points should be mentioned respecting turnover ratios—something both CPAs and credit men should consider.

1. Meaningful interpretation of receivables turnover would result only if credit sales alone are used. Quite obviously, including cash sales would increase the turnover rate. Perhaps in many instances the amount of cash sales is not of enough significance to influence the ratio to an important extent, but this possibility should not be overlooked.

2. A turnover ratio computed by using only the year-end balance of receivables, or perhaps even the average of the beginning and ending yearly balances, may not be as meaningful as would such ratio

using the average of the twelve or thirteen month-end balances. For one thing, the year end of the business may not show a representative balance in accounts receivable—as might be true if the business year end did not coincide with its "natural" year end when receivables are at their lowest point. This possibility of distortion takes on added significance when comparing the turnover of one company with that of others in the same industry whose years do not end at the same time.

Another possibility is that the year-end balance may be artificially depressed as a result of holding the cash-receipts book open for a period after the year end in order to apply such receipts in reduction of the receivables as of the year end. And this could be happening at both the prior and the current year end but is not so likely to be happening at each of the twelve-month ends. This practice, of course, is not considered good accounting and would not be acceptable to the CPA.

5. Are the accounts receivable pledged?

Assigned or hypothecated accounts should be disclosed in the statements. If such sale or receivables took place near the balance-sheet date, inquiry should be made into the possibility that they were reacquired shortly after the balance-sheet date. In other words, a little window dressing in the cash picture might have taken place.

INVENTORIES

Items of interest to both professions with respect to inventories would include the physical existence of the stated quantities and whether or not such quantities contained obsolete or slow-moving items; the qualities and grades of the various classes or types of goods; prices used in compiling inventory values; basis of valuation (cost, lower of cost or market, market, estimated value, or whatever), and the method of determining cost (lifo, fifo, average cost, or some other method). Both professions are interested in whether inventory has been pledged as security; in whether any amounts may be held on consignment for the customer by someone else; in whether inventory is insured against fire and other damage, and in whether there is co-insurance and the requirements therefor; in whether there are commitments to buy or sell and if so, the nature of the terms in relation to current prices.

Some of the things said earlier about receivables would also apply to inventories, especially with respect to pledging of inventory and

to computation of inventory turnover. A computation of turnover using dollars is, of course, just a turnover of total dollars and in no way reflects the turnover of the physical goods. Some physical goods may not have turned at all, while others turned many times more than the dollar turnover computation indicates. A turnover computation for each component of inventory is often quite revealing as showing the actual rate of inventory utilization and replacement.

A fair and important question to ask concerning unaudited statements is whether, when, and how a physical inventory was taken. Do not take a physical count for granted in such circumstances.

Another important analysis to have is the breakdown of inventory into its various components (finished, in-process, raw materials, supplies) for what additional light these figures might throw on buying and production methods of the credit customer, as well as for assistance in evaluating the liquidation worth of the inventory.

Much has been said in financial and accounting literature about methods of determining cost to be assigned to inventories at the balance-sheet date. Since it is generally not practical to keep records showing how much was paid for each specific item of raw material purchased and put through the production process, a flow of goods and costs is assumed—first-in, first-out (fifo), average, standard, last-in, first-out (lifo), etc.

Usually the credit man will be dealing with methods other than the lifo method, and generally such other methods will produce substantially the same inventory value—a value reasonably close to the current cost of replacing that inventory—assuming moderately stable market conditions. The use of standard costing might result in substantial misstatement if the standards are not kept up to date. However, when the lifo method is encountered the statement reader should keep in mind that the value of inventory may not be reasonably close to current cost. It may be higher or lower depending on whether the market has been rising or falling since the adoption of lifo. Because this method assumes the last item purchased was the first item used, the first item purchased remains in inventory, at the cost at the time of purchase when lifo was first adopted.

CURRENT ASSET CONCEPT

There was a time in years past when the measure of a current asset was basically the one-year rule—if the receivable, for example, was due within a year from the balance-sheet date it was a current

asset; if due beyond one year it was a non-current asset. Although this one-year rule is still used it may not be used in all cases.

Current assets are commonly thought of in terms of an operating cycle. For example, cash and other assets generally expected to be realized in cash, or sold, or consumed during the normal operating cycle of the particular business would be considered current assets. The typical operating cycle of a manufacturing business might be the time elapsed between the expenditure of cash for raw materials, their manufacture into finished goods, the sale of finished goods and resultant accounts receivable, and the collection of such receivables in cash.

Most businesses experience more than one complete operating cycle within a twelve-month period, and by them the one-year rule is followed. Where the business has no clearly defined operating cycle the one-year rule also governs. However, some businesses have longer cycles for converting raw materials into finished goods—the distillery and tobacco businesses, for instance—and many businesses sell products on the installment basis over periods considerably in excess of one year. Trade receivables in such businesses may be included in current assets under the operating cycle theory.

GOING CONCERN AND LIQUIDITY

Credit grantors it is understood often place heavy emphasis on the liquidation value of assets and so scale down the values shown in the financial statements. On the other hand the accountant places more emphasis on the going-concern value and less on the liquidation value. On a going-concern basis, what becomes important then is the use to be made of the assets in future operations. The aim is to state current assets at cost, provided such cost is not more than the assets are worth to future operations. Thus, with the possible exception of cash and marketable securities, the liquidation value of current assets is usually something less than their going-concern value. How much less would depend on the particular business and economic climate in which it is operating.

In general the same concept—cost but not more than worth to future operations—is applied to other than current assets except for properties such as land, building, machinery and equipment. Although for such properties accountants stick to the cost concept (appraisal write-ups generally not being acceptable) ordinarily no attempt is made to determine whether they will be worth their full stated value

to future operations; this would require the use of a crystal ball. And, oddly enough it is often the land and buildings, because of inflationary trends, that have a liquidation value in excess of their cost value!

Credit managers must often rely on the earning power of a business for repayment, thereby taking the going-concern approach and looking to future earnings and cash receipts to recover investment. Here cash budgets and operating budgets of the customer should be of assistance in making credit decisions. They should enable the credit man to obtain a better picture of the customer's ability to generate cash in comparison with his need for cash. They should show, for example, how the working capital of a business that owns properties is increased by using such properties in the manufacturing process, in comparison with the business that rents or leases properties.

Not only should budgets be helpful in analyses, but they may indicate that the customer is laying plans for the future, in itself a healthy sign! And they are helpful in keeping watch on subsequent progress in relation to the budgeted intention. Finally the credit manager gains some insight into just how liquid those assets shown on the balance sheet actually turned out to be!

INSURANCE

Insurance has previously been mentioned in connection with accounts receivable and inventories. There are, of course, many types of insurance: fire and other damage to properties and inventories, extended coverage, credit insurance, business interruption or use and occupancy insurance, public liability, key-man insurance, fidelity bonds, and so on. Perhaps most businesses have some of these coverages but certainly not all businesses—especially the small to medium-size companies—have all coverages. A very important item on the credit man's check list should be to determine the extent of the customer's insurance coverage. Many businesses no doubt omit or reduce insurance coverage as a means of cutting corners, or do not maintain adequate coverage because of failure to consider the changing values and needs of their business.

SUMMARY

While the Certified Public Accountant is concerned that those who read financial statements do not misunderstand them, he must rely on the reader to have certain background knowledge about business transactions as reflected in financial statements. The credit

manager in turn can rely on the CPA to have given consideration to those things mentioned herein and to have required disclosure of any important matters known to him that have or may have a material effect on the financial statements to which he attests. Most, if not all, CPAs are anxious to assist credit managers in a proper interpretation of financial statements, and welcome inquiries leading to that goal.