Journal of Accountancy

Volume 50 | Issue 1 Article 5

7-1930

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Recommended Citation

Burton, Arthur S. (1930) "Accountancy in the Credit Department," *Journal of Accountancy*: Vol. 50 : Iss. 1 , Article 5.

Available at: https://egrove.olemiss.edu/jofa/vol50/iss1/5

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Accountancy in the Credit Department

By Arthur S. Burton

Twenty years ago a bookkeeper who could make a balance-sheet and close his own books was considered an expert. Then came the art of accountancy, and its development within the last ten years has been remarkable. At first the accountant was employed to find out what had taken place within stated periods and to check the accuracy of what was recorded in the books of record, thereby verifying the assets and liabilities as shown in the balance-sheet made from such records. If an accountant today can not do more than picture past history for his client he is of little value, for almost every bookkeeper who has taken a book-keeping course can do the same service for his employer.

Since this is the case the question arises "What value is the accountant to present-day business?" The answer is obvious, as it is only through diagnosis of past history that future policies can be outlined, and a credit manager who is equipped with a sound, practical knowledge of accountancy is far superior to the man who is not versed in the values of a balance-sheet even though he may possess knowledge of business law and bankruptcy matters.

It must be pointed out that the credit department's main function is to prevent selling to financially irresponsible firms and persons, and the department can not perform its duties in a satisfactory manner unless it is managed by someone who knows thoroughly what the individual items on the balance-sheet mean as to values in a going concern as well as in case of liquidation. There is a vast difference between the two values, yet it should be within the knowledge of the credit man who knows his business. It is only through coming in daily contact with concerns which are in financial trouble that one realizes the value of being able to discover accurately and quickly what causes contribute to a condition involving a creditors' meeting or bankruptcy proceedings. It is surprising to find how little many credit men really know about accounting.

Not long ago a partnership doing business under a trade name got into financial difficulties. At the first creditors' meeting the fact was disclosed, for the first time, that the concern really was a partnership consisting of husband and wife. A balance-sheet

was submitted, which showed on the face that the enterprise was solvent. The condition was apparently brought about by domestic trouble and a committee of creditors decided to ask the courts for an order to continue the business for ninety days under a trusteeship, for the preservation of assets. This was granted and at the end of that period an amended balance-sheet was submitted which showed insolvency, although a profit had been made during the ninety days' operation. How did this condition come about?

It must be pointed out that at the first meeting the creditors' representatives were mostly legal men who took the figures as presented at their face value. At the second meeting the amended balance-sheet contained a loan of $4,000, which the husband had assumed as a personal matter. When he realized that his wife had started proceedings for her share, he had the amended figures submitted. Under examination he admitted that his wife had in her name a piece of property consisting of a house and lot, in a good residential section on Long Island. It also appeared that this property had been purchased with money taken out of the business from time to time. The assessed valuation was $10,500 and the deficit on the amended balance-sheet was $3,000, but the property was not contained among the assets. At this point accountancy suggested a line of procedure and the partnership agreement was brought forth, duly signed by both parties, which plainly stated that they were to divide equally any profits made and equally assume liabilities and losses. A new balance-sheet was made with the added asset of property which at that time was salable at about $18,000. The creditors were eventually paid in full over a period of nine months and today the business is making money. Had not the principle of accountancy been applied in this case it is doubtful if the creditors would have been paid fifty cents on the dollar, for it is safe to assume that the property would not have been brought into the picture. It was examination of the cheque books and the discovery of large cheques drawn which first furnished the clue to the real situation.

Frequently when a concern gets into financial distress the debtor endeavors to bolster up his condition in the hope that the creditors will practically finance him or he endeavors to conceal assets if he has the least idea that the creditors will not help him by extension of time.

In the first case, the question as to what caused the distress, together with the possibility of conversion of assets into cash, must be decided before any plan of action can be made. If capital is tied up in the form of seasonable or obsolete merchandise which can not be turned into cash for months, it is quite a serious problem to decide whether extension of time can be profitably granted, as it undoubtedly would require new merchandise to carry along over the dull period. Where $20,000 was involved in an original distress it might easily amount to $40,000 if extension was granted. Decisions of this kind can not be made without looking at the facts, and no one is better equipped to do so than a man who knows accountancy.

The second case has to be viewed from a different angle. There may be loans from sources which are practically impossible to trace. How then can one decide what is right? The accountancy law of averages furnishes a good basis for procedure. It is easy to find the "mark-up" and percentage of gross profit the business yielded, and by working backward one can ascertain what amount of merchandise should be on hand, if any records are kept. It is quite an education to see how records of business are kept in the small retail enterprise, but although they are meagre it rarely happens that the cheque book can not give the clue desired. The problem presented therefore resolves itself into one of accounting.

Some business houses think they have solved the bad-debt problem by setting up a reserve for bad debts. It must be remembered that bad debts come out of profits and are therefore a loss to the business. One can not take care of them in cost of manufacture or cost of goods sold, and the only logical plan is to try to prevent the loss. While it may prove interesting to record the main causes which lead up to the doubtful and bad accounts, which eventually find their way to the debit side of the reserve account, it is too lengthy a subject at this time. One or two instances may suffice to bring out the main points regarding balance-sheet figures.

Under-capitalization is one of the most frequent problems with which a credit man has to contend when considering on a credit application in the case of a man opening up a business for the first time. For example, let us assume that John Doe starts a retail business under the trade name of "The A 1 Store" and submits a statement as follows:

Cash in bank	$5,000	
Store building	25,000	
Furniture and fixtures	4,500	
		$34,500
Mortgages	$18,500	
Accounts payable	4,000	
		22,500
Net worth		$12,000

This is a typical example of balance-sheet presented when a business is started. Naturally a credit man who did not know his accounting values would assume it would be a good risk. Suppose, however, that John Doe has borrowed $4,500 of the cash in the bank from his wife or some other relative. Then, again, on what basis is the valuation of $25,000 in the building computed? The situation would be vastly different should the equity in the building be wiped out through forced sale, and one can readily understand a wife's demanding her $4,500 in case of failure. Of course, a man submitting a false statement can be held for fraud and the penalties are severe if the charges are proved. The point is that it is in the power of the credit man to demand information as to whether capital is owned or borrowed at the time the statement is submitted and to refuse credit unless it is given. If a firm loads a store of this kind with, say, $6,500 in merchandise, with terms of half cash down, balance thirty days, it can be seen at once what working capital is left. There is one man who is the state's guest for filing a false statement, and several concerns are in difficulties through lack of working capital due to overstocking which could have been prevented if the credit man had limited the initial purchases. Putting a man in jail does not pay his debts, but the law must be upheld in order to safeguard business.

Sometimes a debtor who is falling behind can be brought back and put on the good list again, through a little coöperation by the credit man. It must be admitted that the average retail man knows very little about keeping books or running his business on a scientific basis. Consequently when payments are not forthcoming it is the duty of the credit man to see what he can do to remedy the trouble. A conscientious retailer will welcome any advice and help he can get. A concern got into difficulties and

the investigator who visited the store found the following facts through inquiry and examination of the records:

Population of town, 12,000.
Two other stores in similar business.
Mark up, 50%.
Annual sales, $12,000.
Rent of store, $100 a month.
Value of inventory at cost, $9,000.
Number of creditors, 52.
Accounts payable—overdue 6 to 8 months.

One day average from source of supply:

Cash in bank	$125	
Inventory	9,000	
Accounts receivable	400	
Fixtures	750	
Total assets		$10,275
Bank loans	$500	
Accounts payable	4,500	
Original investment	5,000	
Capital earned	275	
Total liabilities and capital		$10,275

This is a picture which is familiar to every credit man. How did the business get into this condition? The causes were, first, overstocking with the mistaken idea that everything had to be carried in quantity; second, competition by two other stores; third, frozen capital in seasonable goods. When these facts were pointed out to the owner he was amazed at what they really meant and a meeting of the principal creditors was arranged to see what could be done to relieve the situation. The stock was examined and about $3,000 was taken back. Notes, over a period of one year, were given to clean off the balance of the old indebtedness. It was agreed between the debtor and principal creditors that his purchases were to be only what were absolutely necessary to run the business and a limit was set on the amount. The current account was to be discounted. Now, after a period of two years, the concern is in fine condition. The owner did not realize the serious state of his affairs and indeed it is amazing to find the number of retailers who are on the verge of impairing their credit through ignorance of accounting principles.