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Bank's Relation to the Problems of Vested and Working Capital; What Information Does the Banker Want in Connection With Commercial Loans?

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Walter H. Johnson Jr.

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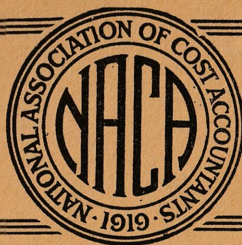

N. A. C. A. BULLETIN

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In three sections—Section I

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NOVEMBER 16, 1925

A Bank's Relation to the Problems of Vested and Working Capital

// N. A. C. A. BULLETIN

Section I

Vol. VII, No. 6 November 16, 1925.

A Bank's Function in the Capitalization of an Industry

BY

H. I. SHEPHERD,
Vice-President, The Guardian Trust Co.,
Cleveland, Ohio.

What Information Does the Banker Want in Connection With Commercial Loans?

BY

WALTER H. JOHNSON, JR.,
Vice-President, Buffalo Trust Co.,
Buffalo, N. Y.

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NATIONAL ASSOCIATION OF
COST ACCOUNTANTS
NOVEMBER 16, 1925

EDITORIAL DEPARTMENT NOTE

The work of the accountant is so intimately related to many of the financial features of the average business, that a fuller apnreciation is needed of the banker's attitude toward certain phases of the financial plans and policies of a business. In broad outline the financial problems of any company may be classified as follows: (1) Those relating to original or fixed capital finance, and (2) Those dealing with the financing of current operations. The first relates to what may well be termed vested capital; the second, to a company's working capital.

This Publication treats of both these phases of the financial problems. The publication is a "double-number," the first of which, by H. L. Shepherd, emphasizes the problems of vested capital; the second, by Walter H. Johnson, Jr., deals entirely with the banker's relation to a company's working capital.

Mr. Shepherd is a graduate of the Law Department of the University of Michigan. After practising law six years he spent two years in charge of the Michigan territory for R. W. Halsey and Company of New York, and for eight years thereafter was the secretary and treasurer of the Toledo Ship Building Company. This was succeeded by six years as the Executive Vice-President of the Ohio Savings Bank and Trust Company of Toledo, after which he spent three years in New York as the fiscal representative of the different companies controlled in the John N. Willys Executive Offices, coming with the Guardian Trust Company, March 15th, 1922. As Vice-President of this latter company, Mr. Shepherd brings to his work the experience of law, bonds and securities, manufacturing, banking and credits.

Mr. Johnson was graduated from Princeton University in 1917. After the war he spent a year with the Interstate Fish Corporation. From 1920-22 he held the position of Advertising Manager of the Marine Trust Company of Buffalo. Together with several of its officers he left that company in February, 1922, and became identified with the Buffalo Trust Co., where he was Assistant Secretary from July, 1922, to January 1, 1925, and was made Vice-President in January, 1925.

A BANK'S FUNCTION IN THE CAPITALIZATION OF AN INDUSTRY

H. I. SHEPHERD

The capitalization of an industry consists in providing the money (or its equivalent) to be used in the conduct of a business. The word is often carelessly used and there must be some definition of it before we enter into any discussion about it.

First of all, regardless of the purpose for which used, the capital of a business may be said to be derived from four sources:

1. The actual cash provided by the stockholders themselves.
2. Long-term or funded borrowings, which are commonly in the form of bonds secured by mortgages upon the property.
3. Short-term borrowings, which may or may not be secured.
4. Earnings left in the business.

All of these classes of capital are represented on the liability side of the balance sheet.

Then, also, the term, "working capital," must be defined. It represents that amount arrived at by subtracting the total current liabilities of a company from its total current assets. The banker has two distinct functions to perform in connection with these two kinds of capital, which may be called, for convenience, "Capital Account" and "Working Capital." When we speak of "capitalization" we generally refer to the money or assets represented in the company's original establishment or its maintenance from the standpoint of plant equipment and fixed assets, in general, plus a sufficient amount to enable the operation of this plant and equipment in the ordinary conduct of the business. This latter amount is for the purchase of a reasonable amount of inventory and the carrying of a reasonable amount of extended credit without having to call upon outside resources for temporary credit assistance.

In treating of capital in this latter sense a banker is not interested, of course, in the first item mentioned, i. e., the stockholder's investment. Stated otherwise, a banker does not loan money directly for the purpose of seeing it made the initial investment of a manufacturing enterprise. It may later loan money upon the stock of an industry that has developed an earning capacity through which a proven market value of the stock is shown. For the purposes of this discussion, however, it can be said that a bank is not interested in, and performs no function in connection with, the stockholders' original contribution to the capitalization of an industry.

In the next item, however, that of long-term borrowings a bank may become interested. In this respect there is a wide variation in different instances. If the property on which an industrial building is to be placed is located where it has a ready market at a fixed value, either for acreage or by front footage, a value is presented which a banker may consider as the basis of a long-term loan. This generally takes the form of a bond. However, the nature of the building which is to be placed on the property will have a controlling influence upon the desirability of such a bond. The building may be so specialized in its character and consequently so peculiar in its construction that it will have no value aside from the purpose of the particular industry. In this event, it may even happen that the building, instead of having a value *per se* for loaning purpose, may serve as a detriment to the real property itself so far as the value for loaning purpose is concerned. This might result from the nature of the change in the property that the erection of a building may create and the expense of removing the building in the event that it might be found necessary to realize upon the property by sale to satisfy the funded indebtedness. On the other hand, if the nature of the buildings to be constructed is such that they may be used for varied purposes they can very

properly become the basis of long-term borrowing in which an investment banker—not a commercial banker—would be interested. This is so because, in the event the particular company itself fails, the buildings will usually find a ready sale for a varied line of manufacture or at little expense can be converted into buildings for other purposes than manufacturing.

A great many elements must be considered in determining the portion of an industrial capitalization that may properly be represented by such long-term indebtedness. In spite of the apparently large amount of long-term industrial financing that is done, the amount in the aggregate when compared to the total capitalization of industry is relatively small, even among those concerns that have a large proportion of their capital tied up in fixed assets. In industrials, as distinguished from public utilities and mercantile businesses, it is estimated that seventy percent of all of the capital employed comes from the stockholders' investment; about fifteen percent comes from long-term borrowings and ten percent from short term borrowings. There are many factors which have to be considered in determining the amount of capitalization that may properly be allocated to funded indebtedness. Two outstanding considerations are the cost of the financing from the standpoint of the interest payments to be made and the ability of the company to pay back the indebtedness within a time sufficiently short to attract money to the investment.

Bonds that are issued for such long-term capital purposes very seldon go directly into the hands of the ultimate holder. They are purchased by some financial institution at a certain price which must cover the cost to that institution, entailed in the examination of the security, the process of buying, and the process of selling to the public. This expense will vary in different instances. The length of time that a security may be carried before sale will depend upon its nature, the condition of the market and the breadth of territory over which the sale will have to be made. These expenses added to the banker's profit, and in some instances also an allowance of a certain margin for sales risk, which may be encountered in the market, must be deducted from the net proceeds received by the company itself from the transaction.

The statement of these conditions seems very simple in an ideal case, but the ramifications of their operation are often very troublesome. New companies are generally promulgated in a spirit of optimism; otherwise the venture would never be undertaken. Adverse business conditions are not forecast, overhead charges are seldom adequately budgeted, sales resistance and all the vicissitudes of competitive marketing are more generally underestimated than otherwise. Accordingly, the anticipated results of the venture by which fortunes are to be made by these companies often fail of realization.

Very frequently a prospectus of a new business is drawn up in accordance with which a profit of ten or fifteen percent seems

certain. On such a basis it will very readily be agreed that a long-term financing costing eight or nine percent appears to be good business. The banker upon whom such financing depends has to be cognizant of all of these conditions. His return, in the event of a successful operation of the plan, is expected to be a reasonable amount for the use of his money plus a small profit produced by the turn-over of his own capital.

On the other hand, unless there is security back of his investment, which will permit of realization in the event of the failure of the enterprise, his profit in the transaction may easily be entirely wiped out.

The length of time that such bonds are to run has to be governed by the probable deterioration or obsolescence of the property. Care has to be taken in arriving at the periods over which funded indebtedness should be retired. In a general sense, it can perhaps be said that funded indebtedness can with safety be permitted to run over a period of from ten to twenty years. Stated otherwise, the issue may run ten years, being paid off serially in the interim; or, in some instances, it may be paid off over a period of twenty years. Ordinarily, however, depreciation of building, changes in methods of building construction, the growth of new manufacturing centers, etc., make it unwise to negotiate an issue running a longer period than twenty years.

I have known of more than one instance where over-optimism in financing of this character has lead to the maturity of bonds or notes in large amounts in one year, or in a period of a few years, with very strong default clauses giving the holders of the securities the right to step in and take possession of the property in the event that the principal or sinking fund payments are not made as provided. In this way many businesses have been lost to their original stockholders and turned over to adverse possessors. In one instance that comes to mind, a competitor in the same line of business secured a valuable property in this way. In this case the maturities had been fixed at a time when the company in question was earning $1,500,000.00 a year. However, at the date of the annual maturities, amounting to $500,000.00, the company had no earnings at all and the default clause provided that the holders of the funded securities could take possession within a period of sixty days after default either in the payment of principal or of interest.

The financing of large building operations, due to the expansion of business during the war period, loaded many companies with a fixed overhead on their capital investment which their net earnings during the years of re-adjustment have been unable to meet. One of the necessities of business at the present time is that undue industrial building shall be held in check until the business of the country can grow to a point where the full use of these buildings can produce a profitable operation.

A great deal of the industrial financing that has been done in the

last two or three years has been for the purpose of relieving companies of the overhead charges that they found themselves loaded with as the result of the conditions just mentioned. One such piece of financing that I have in mind is one in which a company is relieving itself of an eight percent interest charge on preferred stock by means of a six percent refunding issue, maturing gradually over a period of twenty years. This has resulted in an unquestionable financial advantage to the company from the standpoint of its interest charge and its probable ability to pay without embarrassment.

One of the great dangers of long-term financing is that stockholders often count it clever financing to get the public's money into their possession instead of furnishing additional capital themselves. Too often, however, they carry their endeavors to the point of over-borrowing. By sowing the wind in this form, many stockholders have, to their sorrow, reaped the whirlwind.

The next type of financing is that of short-term borrowings. These are of two classes: (1) Secured short-term notes or bonds, and (2) Unsecured short-term notes. The former may be put out at a time when the financial condition of the company is strained. These notes or bonds are often for special equipment and are in the nature of a chattel or purchase money mortgage on the equipment. The favorable or unfavorable character of the current market as expressed in the interest rates may be the determining factor both as to the issue of securities and as to their character.

Where a company is burdened with a large funded indebtedness of a short maturity and faced with a decreasing liquid situation, it is often wise to re-finance by the issuing of stock even though the basis and the cost might at the time seem prohibitive.

The short-term secured note issue is not one that is common and its characteristics are not sufficiently different from other securities to require any special attention.

It is the short-term unsecured borrowings in which the banker is most often interested. These are generally spoken of as commercial loans and have to do more directly with the company's working capital which it uses in its ordinary business turnover. This working capital is usually represented by its cash, its receivables, and its inventory less its current payables, i. e., it represents the difference between its current assets and its current liabilities.

The extent to which inventory may be considered a legitimate part of working capital depends upon its character. In this connection, oftentimes such discriminations must be made as between lumber in the pile, which may be considered a quick asset, and timber in the tree, which is not considered a quick asset. A similar discrimination is to be made between coal on top of the ground ready for sale and coal in the ground even though it is ready to mine. The differences which mark a stock of wholesale groceries

as compared with a stock of millinery must also be taken cognizance of.

As a general rule it may be stated that the ordinary unsecured short-term accommodation is to be used for a purely seasonal emergency and is not for the purpose of creating a part of the so-called permanent or normal working capital needed for the continued operation of the company's business.

It is the ability to distinguish between these two conditions that measures the intelligence manifested in extending ordinary commercial credit. I have in mind a recent instance of a manufacturing concern which had a building larger than its immediate needs demanded and which was manufacturing a machine with comparatively large unit cost. It was selling this machine on long-term payments and was asking for an open line of credit. I want to quote to you directly from the findings of the credit committee. These were as follows:

"The committee reviewed the statement, with the result that in their judgment the cost of the unit manufactured and the length of time that credit is extended produces so slow a turnover of inventory and working capital that on the company's present limited capital it would be impossible for them to increase their business without asking the bank to assist them not as a loan, but in effect as a part of their working capital. Therefore, the extension of a line of credit suggested is not recommended. The necessary money should come solely from an increase in capital stock."

It will thus be seen that the function of a bank in the capitalization of a company is not a limited one. It may have to do with the long-term feature of capitalization alone; or, if the capital with which the company may start or to which it is later increased, is sufficient to provide the necessary working capital, a bank may also become interested in the short-term borrowings of the company. In this instance, its immediate interest is in the fact that this working capital shall be consistently maintained. The most appropriate and consistent manner in which this may be done is that the company shall operate at a profit and that some portion of its profits shall be turned back into the business to increase its working capital. If a company is operating at a profit and these profits are being taken out of the business by stockholders in the form of dividends or if the profit is being used to increase the company's fixed assets, the short-term unsecured accommodation ordinarily granted may be withdrawn.

The process of capitalizing a company from either standpoint is very simple when read from the books. It is the power to look into the future and foretell the result of the contemplated capitalization that tells the tale. In many instances the sober consideration of re-capitalization is left until it is too late. Emergency financing cannot long be profitable nor can it long be substituted for permanent financing. High rates of interest, large discounts

and inopportune maturities almost invariably result and these mean financial difficulties.

As to the type of financing to be used and when to use it, it should be noted that in the turn of the business cycle there come periods when the money market is in a temperament to absorb long-term bonds at a low rate of interest. It is a wise concern that takes advantage of such a situation to finance itself on as moderate a scale as possible over a long term of years. On the other hand there come periods when the public is ready to absorb the capital stock offerings of industries. These times offer the opportunity for a business concern, with an annoying funded indebtedness, to transfer its obligation into stock. To do these things at the right time and in the proper amount is perfectly legitimate financing. To be compelled by the lack of foresight and resulting emergency to take such action at an unfavorable period often measures the sole difference in the financial history of otherwise similar institutions.

In every phase of such a transaction the banker is interested and his interest is always on the side of the perfectly sound and business-like proposition. This is so because it is upon the soundness of business—that is, upon the continued and consistent operation of industry upon a profitable basis—that a bank must depend for its growth through the extension of safe credit and the accumulation of deposits resulting from profitable business.

WHAT INFORMATION DOES THE BANKER WANT IN CONNECTION WITH COMMERCIAL LOANS?

WALTER H. JOHNSON, JR.

What information does the banker want? I take it you mean what information does the banker want from the individual or concern that expects credit. First of all, it is character, the first of the three "C's" of credit, on which all credit structure rests. By character, we mean not only the man's or the company's honesty, but it relates also as to whether the principals are industrious. Do they give the best that is in them to their concern or are golf and travel too much of a temptation once they are started on the road to prosperity? Failure to keep to the straight and narrow ways of business in these days when pleasure is so easy to find has been the downfall of more than one successful house. On the other hand if a man is willing to work, I am sure that banks today will go far to help him. First and last the moral risk is the primary consideration—the most important information the banker asks.

The second and third "C's" of credit, viz, "capacity" and "capital" in any particular situation may be determined from a company's balance sheet. I believe the best way to discuss the information which the banker wants as regards the elements that make up a financial statement is to run over the various items in the order they appear. With reference to each item appearing the banker desires specific and comprehensive facts. These will be taken up in turn.

First comes cash. It may seem that this is an item about which little can be said; cash is cash. But the bank balance is an item in a credit statement to which the banker gives the greatest scrutiny. To you gentlemen, some of whom are treasurers of local concerns, others of whom have occasion to audit the affairs of corporations and thus get into the confidence of the management, if I can only give a fuller realization of the importance the bank places on the balance carried by a borrower or prospective borrower, I shall feel that I have accomplished something to our mutual advantage.

Day in and day out notes mature and on the maturity sheet of the average institution opposite the name of the borrower, is the amount of the particular loan, the amount of his full line of credit and then two spaces for the company's present balance and average balance. What kind of an account is the borrower carrying, one with a meagre balance or an account to be proud of?

If you could just sit for a morning on some bank's discount committee and hear the discussion of the loans. John Smith & Company with a line of $10,000 has a $3,500 note maturing. It

is a safe enough loan. What is their balance? $740 and their average for the past year has been $1,200. The committee's observation is: "Well that's due today, they promised to pay it today, they'd better pay it or materially reduce." Then comes the Jones Company note. This concern has the same line of credit, $10,000. The note maturing is $4,500 and balances have averaged $4,000. When not borrowing, their balances often run $8,000 or $9,000 and right now their balance is $2,200. When referring to this note the committee's attitude is: "Well, let them do what they want." A selfish attitude on the part of the bank you say? Unfair, when the borrower is paying five or six percent for his money, to expect him to carry a balance without interest? Yet it is the same attitude that every merchant and manufacturer takes with reference to his own customers. Banks like other businesses operate to make money, and just as any manufacturer is going to take care of the dealer who has discounted his bills and not been prone to "jew" him down on price but let him make a reasonable profit, just as that manufacturer is going to fill that dealer's orders promptly and in the event of a shortage, is going to take care of his requirements first, so is the bank in a money stringency going to take care of the credit requirements of the manufacturer who has been reasonable with his bank.

That's the information banks want about cash items in a statement. What kind of a balance does the concern carry? Some firms may feel that to carry a balance is costing them a couple of hundred or a couple of thousand dollars a year. But suppose it is. Let money tighten up and this same concern would find it the most profitable expenditure it had ever made.

Next come customers' notes that have not been discounted and trade acceptances. Here the ordinary information is wanted. How good are the makers of these notes and are they invariably taken up at maturity? Are any of the notes past due? In addition to this, however, bankers are interested in knowing whether or not in this particular line of business it is customary to accept notes or trade acceptances in payment for merchandise.

The next item is accounts receivable. The questions asked are first of all, are they current or past due and in what proportions? Are these customers regular buyers year in and year out or are they occasional buyers buying from this concern one month and somewhere else the next.

Then comes merchandise—finished, unfinished, and raw material, i. e. inventory. Here is the sensitive spot in the average credit statement. The banker is interested in knowing whether or not the accountants auditing this company's affairs certify merely as to the "accounts and records" or as to the "accounts, records and inventory," having actually checked the inventory. You can readily see that the former type of certification is much less valuable. It is the accountant's duty to convince his clients of his responsibility in respect to certifying inventory. Beyond the matter of accurate

quantity and value of the goods, inventory value depends on a number of things from the bankers' viewpoint. How basic a commodity is it that makes up the inventory? Does it consist of felt penants labeled Atlantic City or is it angle iron? In other words what is its value in case of a forced sale? Is the inventory current or obsolete (radio)? Is it well balanced or otherwise? Has it been manufactured and purchased to fill firm orders or in the expectation of a market yet to be created?

And along with this consideration of inventory the banker is interested in the firm's commitments. How much raw material has the firm contracted for and how is it to be paid for?

Bonds and investments need little comment except that statements of subsidiary companies should be furnished.

Accounts due from officers and employees represent a very important form of asset or investment in view of the fact that the firm's ability to collect such items usually diminishes very rapidly at the time when such moneys are most needed.

As to property account, the usual questions are to be asked: Is it carried at a fair value? Is it being properly depreciated?

The first item among the liabilities to be considered is direct loans. In this connection has the company established sufficient bank credit, so that it is in a position to take advantage of trade discount, even though they may not be large; for in this way it keeps trade creditors happy?

Next come notes payable. Why does the firm give notes? Do the firm's customers want notes which they may in turn rediscount? In this particular line of business, is it customary to give notes in payment for merchandise? Why not use bank credit? If their notes payable are for money borrowed from individuals, on what terms are they borrowing? Are the individual creditors friendly and in case of difficulty would they be willing to subrogate their claims to bank debt?

Taxes are next. In view of the fact that a bank cannot pass on the merits of the taxes in each particular case, taxes must be considered as a liability and not a reserve.

Next comes the company's fixed debt, its bonds and mortgages. Are the bonds listed? Are they debentures, or are they obligations secured by bond and mortgage on a plant? It is important to know when these bonds are due, whether they are serial bonds or subject to sinking fund requirements. Very often a proportion of such debt is coming due within the current year and if this is the case, that portion should be considered a current liability.

As to the surplus, the following information is desired: Is it earned? If not, what portion is capital surplus? Has it been established through write-up of plant account? Is earned surplus sufficient to warrant dividends? If dividends have been paid, is there any possibility that they have been paid out of capital surplus?

In addition to the balance sheet, banks more and more are asking to see the company's profit and loss statement for the pre-

ceding year—something which is almost equally important. From such a statement showing sales, cost of manufacturing, cost of administration divided into the usual sub-heads, and from a comparison of such statements over a period of years, it is possible in a general way for a bank to trace the factors which are making for a company's progress or decline. Are salaries, are direct costs going up out of proportion to volume of sales and net profit?

And right here is where the banker comes more fully to appreciate the splendid work of men in your line of business. Daily the matter of costs and economical production becomes more important. Touching upon this indirectly the following extract from a recent Wall Street Journal may be of interest. "So far as the present sombre mood is based on logical grounds, it appears to result from the absence of 'new high records' of impressive proportions.

"It has always been rather loosely accepted that trade and business must always be moving vigorously either up or down; that volume of output must be either advancing toward, or retreating from, a condition of overproduction. It has been all but unthinkable that the business of the country could long proceed in anything like constant volume.

"But have there not been important changes in the Nation's methods of handling trade and credit in the past decade—to say nothing of changes in what may be called business temperament?

"The Federal Reserve Act tends to prevent extreme fluctuation. Development of transportation relieves the need for the accumulation of stocks in hands of jobbers and retailers.

"All along the line there is a new spirit of caution against overcommitments in merchandising.

"It is evident that the prevailing habit of seeking rapid turnover with small stock is working in the direction of economy if it tends to prevent the development of old fashioned booms. Failure of the latter to materialize, therefore, no longer has the significance it would have had in the old days when confident overbuying and exciting bidding for commodities were considered the only satisfying conditions.

"Is it not possible that the old-time boom is a thing of the past?"

We are inclined to agree with this editorial and feel that in this new business era you men are coming into your own. Industry needs you. The banks need you. Your task is not easy. From our dealings with customers, we realize how hard it is sometimes to make them understand the value of a cost system or of an audit. We can imagine how difficult it must be for you to work in a skeptical and possibly hostile atmosphere, almost without the raw materials from which to make an audit. We can realize sometimes that your client, a bank borrower, may have set ideas as to how much his banker should have in the way of information. The accountant is between the "devil and the deep blue sea."

And right here let me emphasize that the value of a cost sys-

tem, the value of an audit are determined primarily by the *sincerity* and *honesty* with which the figures are compiled. The accountant is an independent agent. You may be employed by a corporation, *to make an audit,* but when the audit is completed it is not your client's audit; it is *your* audit. Your signature gives it the endorsement of your reputation for integrity and diligence. And strict integrity requires that no essential factor be omitted.

I may have suggested this evening some out of the ordinary information that banks are looking for. In a nut shell, however, let your sense of honor be your guide. With ordinary common sense you will have automatically answered the question, "What information does the banker want?"

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