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What Information Does the Banker Want? *

By Ralph E. Sperry

One authority (James H. Bliss, of Libby, McNeil & Libby) has stated that the important points to be considered in an analysis of a business for credit or investment purposes are:

(1) Character, ability, experience and integrity of its organization;
(2) Strength of its financial structure;
(3) Business conditions affecting the industry and the individual concern; and
(4) Conclusions determinable from analysis of financial statements.

It is therefore evident that the information which the banker wants covers a very broad field. The intention in writing this paper has been to limit the comment to such phases of the subject as will be of particular interest to the accountancy profession.

Some of the thoughts brought out may, when first considered, appear unorthodox and radical. I would not have it understood that such thoughts are treated as an effort to criticize the profession but rather that an effort is being made to present to the profession a different perspective of its opportunities and obligations as seen through the eyes of one engaged in the field of finance.

It is perhaps trite but none the less true to say that all credit is based on the fundamentals of character, capacity and capital, but there is no way of telling just what weight each of these fundamentals should be given in making a decision on a given loan or on an ideal loan.

Character is that elusive, intangible, precious something which is judged by the record of experience and must ring true. The consensus of opinion among those who pass on credit appears to be that any loan made in spite of the existence of a doubtful character record is a dangerous loan. New concerns find it difficult to get credit because the character element is only in the making and the ultimate character product is a matter of conjecture.

Capacity is another fundamental which is somewhat intangible, and therefore difficult to define. Capacity may be considered as an estimate of the ability of the management, a calculation of the

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possibilities of controlled properties and a general consideration of the prospects of accomplishing whatever is attempted.

Capital, as a loan fundamental, is more tangible and therefore more susceptible of measurement. Business employs a number of devices for the purpose of ascertaining the amount of capital employed.

The capital element is measured at times by an appraisal of the assets and liabilities existing. This method is most commonly resorted to in the case of contemplated change of ownership.

A second method of judging capital worth is in use by the investor and consists of capitalizing the earnings of an enterprise.

Probably the most common method of determining the capital worth of a business is the tabulation of its assets and liabilities in a balance-sheet Balance-sheets are commonly prepared at regular intervals and are almost invariably based on modern accounting systems. A picture of the events which have taken place between the balance-sheet dates is fairly well sketched by a study of the operating figures and of the surplus account.

All these methods are useful and are often illuminating when applied at the same time to a given case. There can be little doubt, however, that in this day the best recognized method of measuring capital is that reflected in a series of reports based on a modern set of accounts.

It is interesting to reflect on how much more truly accounting records are a basis for measuring capital today than was the case a score of years ago. Ours is a generation which has seen great progress in the application of better methods to business. The last quarter century was ushered in with the organization of many great business colleges which have had an immeasurable influence. During the last half of this period, Uncle Sam has been a great ally to better accounting in business by confronting the business men of the country with laws which have made accounting a necessity. Federal reserve banks have passed rules which require statements in passing paper.

Speaking more directly to the subject, in commercial loans to manufacturing or mercantile concerns, it is indisputably true that the accountant's report is being relied upon to an ever increasing extent as a basis in forming conclusions regarding the soundness of loans to customers in mercantile and manufacturing pursuits.

While all audits are not made for the purpose of providing a basis upon which to obtain bank credit, it is safe to say that the major portion of them arises from this need, or that the resultant reports figure in credit arrangements. The accountant should, therefore, keep before him the possibility of every report being used as a basis for credit and should write his report accordingly.

Auditors verify. Accountants interpret. Seldom do banks receive reports so written that supplemental analysis is not required to bring out full interpretation. Banks make this analysis with much less information at hand than the accountants had. When banks make mistakes they usually favor themselves.

It appears that there is, at times, an impression on the part of some members of the profession that they are representing the client and that they are justified in coloring the report so that it is cleverly and technically correct—but in many cases positively misleading. Fortunately, this attitude is the exception rather than the rule.

John Eaton of the Merchants National Bank, Boston, Massachusetts, once answered the question, "What does the banker expect an audited statement to show?" by saying, "He expects that it will set forth a correct (and impartial) picture of all the assets and all the liabilities of the company. And he expects that these various assets and liabilities will be classified and described with sufficient detail and exactness to enable him to form a satisfactory estimate of their value as a basis for granting credit."

Mr. Eaton later continued in the same address: "A plain condensed balance-sheet gives one little idea of a company's operations. Without knowing how the figures have been determined, an intelligent analysis of them is impossible. It gives the present position only, and no idea of how this position was reached. Altogether too many of our audited statements are of this character. They are of little more value than the company's own statement of its condition. Of course, we all like to see an accountant's name at the bottom of a statement, indicating that an outside expert has been over the books, but if the concern has in mind having the audit made as an assistance in obtaining credit, the object is almost entirely defeated if the bank is not furnished with details enabling it to make a proper analysis of the figures."

I personally subscribe to all of Mr. Eaton's ideas except that I would in many cases prefer a statement made direct by the borrower on our own form to the condensed balance-sheet with a short meaningless paragraph as a certificate.

Once having accepted a condensed certified balance-sheet, it is often very embarrassing to get the complete audit report or the additional data which would be had on our own financial statement forms. I cling to the view that accountants should only issue certified balance-sheets for the purpose of giving information to mercantile reporting agencies, newspapers, stockholders and perhaps to a few other groups and that all others, including executives of the concern and banks, should receive the complete report.

It is my opinion that the mere condensed certified balance-sheet is not fair from a credit viewpoint to either the client, the banker or the accountant. I think there should be supporting schedules describing the principal receivables, the principal payables, the chief classifications of the inventory, the investment holdings, the details of book value of properties the facts about subsidiary companies, and a list of the owners of the business including the stockholders of a corporation. This latter provision is especially a factor in California where the stockholders have a proportionate liability for the corporation debts.

The statement forms which are generally used by banks are based very largely on the document *Approved Methods for the Preparation of Balance-sheet Statements.* This document was prepared by the American Institute of Accountants and the federal trade commission and has been promulgated by the federal reserve bank. I believe that if this document were to receive the attention and the following that it deserves, a very important and desirable step would be taken in the direction of standardized statements for credit purposes.

Experience proves that there is a remarkable variance as to audit methods. Even in the case of balance-sheet audits, it is possible to make such checks and tests as will quickly and economically give the true situation without undue labor and expense.

There is a growing feeling that in many cases, if not most cases, it is as important for the accountant to circularize the accounts receivable as a part of the audit as it is to reconcile the cash account with the certificate from the bank. Far too often the audit of accounts receivable consists merely of checking a detailed list of the receivables with the controlling account.

There is also a group which believes that inventories are often far too lightly treated in accountants' reports. There can be little doubt that most of the manipulation of financial statements is accomplished by the inventory route. It is therefore no wonder that bankers are not particularly pleased when they read in a report that "the inventory quantities and prices were certified to us by responsible officers after which we satisfied ourselves as to the arithmetical accuracy." I think that it is vital to state whether or not the accountant was present at the time the physical inventory was taken. The method used in pricing the inventory is of great moment. The classification of the inventory on the one hand as to amount of raw material, material in process and finished material, and on the other hand as to description of the principal commodities included is vital but frequently neglected.

When there is material in process to deal with there should always be a discussion of how valuations have been stated. If there is no cost system, it is evident that the method of "by guess and by gosh" has been employed. The existence of a cost system calls for comment as to whether or not the system is satisfactory. It is essential to state whether or not the cost accounts tie in with the general books and on what basis the overhead is distributed and of what the overhead consists.

All cost systems require a perpetual inventory as a part of their plan and many firms not using cost systems make use of perpetual inventories to excellent advantage. The accuracy of the perpetual inventory is worthy of comment. Particular attention should be directed to the matter of obsolete items included as inventory items. Perpetual inventory records help to uncover inactive obsolete items.

Another balance-sheet section which is frequently slighted in the course of the audit is that of the liabilities. It is usual, of course, to get certificates as to the amount of the debt to banks. I think it is desirable to get such certificates also from the most important trade creditors and to make other careful checks to ascertain whether or not all liabilities to those creditors are correctly stated.

One of the most frequently neglected liability classifications is that of income tax. Experience has taught us that many clients have paid tax claims which were not shown on the books during the proper previous periods even though the cases were in litigation. An examination should be made of one or more income-tax returns to determine whether they agree with the books after reconciliation and to establish whether or not the tax laws have been properly applied and minimum taxes paid.

Contingent liabilities are even more troublesome to ascertain and state correctly from the point of view of the accountant and the banker. The solution to the problem is far too often found in the complete absence of any statement about such items.

The net worth of a concern is frequently fearfully and wonderfully set up even on audited statements. In all cases this subject should be so treated that the investment, the retained earnings and the unearned or unrealized values reflected are clearly stated. This applies alike to individuals, partnerships and corporations. In the case of the last mentioned the promotion methods should be discussed and the details of authorized stock and issued stock carefully and fully considered, and there should be careful differentiation between surplus "available for dividends" and other surplus.

In the case of the certified balance-sheet, particular care should be taken to give all possible data in the statement of the net worth. It is dangerous to analyze the surplus account starting merely with the balance at the beginning of the period and reconciling to the balance at the end of the period, because facts important to the understanding of the true financial condition may be buried in the surplus account prior to the period under review.

The operating statement is always necessary in making a study of the financial position of a firm. All bankers would agree that the operating data, in summary form at least, should be a part of every financial report. It seems to me that it would be possible and quite advisable to incorporate this data in condensed certified balance-sheets by incorporating in the statement of surplus the added amount for cash sales and credit sales for the period and the deducted amounts for cost of revenues, executive salaries, interest, depreciation and other items important enough to have individual treatment. The difference between the revenues and the deductions would then be carried into the statement in the usual way.

A particular point is made of the necessity for operating data, as banks are more and more adopting the methods advocated by the Robert Morris Associates and particularly by their capable secretary, Alexander Wall, in examining financial data by the use of ratios. It would be well for all accountants to familiarize themselves with the data necessary to make such analysis for they would then have a much clearer conception of just what the banker wants. Mr. Wall's book, *Analytical Credits*, would be one of my first recommendations for an accounting library.

James H. Bliss of Libby, McNeil & Libby is another important contributor to this field.

There is an appreciated tendency on the part of some accountants to incorporate in their reports comparative balance-sheets and operating statements. A few go a step farther and actually follow the recommendation in the document *Approved Methods for the Preparation of Balance-sheet Statements* wherein it is said, "A statement of the disposition of the profits should then be prepared from this comparative balance-sheet as a further aid in impressing the meaning of the figures upon the mind." Such a statement has been very aptly termed a "where got—where gone" statement and is invariably looked on with favor.

It is a well known fact that some firms resort to the practice commonly known as "window dressing" at about the statement date. Bankers believe that there is an obligation on the part of the accountancy profession to aid in disclosing such attempts to disseminate misleading information.

Accountants would find the banks very attentive to discussions regarding the general efficiency of accounting methods and the existence or non-existence of a proper system of internal check. No doubt, if the true conditions were known, and if accountants were courageous enough to cover such points, bankers would take such action that the accountants would have much system work to do.

In recent years the business world has found much to think of in relation to the subject of budgets. Some concerns have employed the budget with remarkable results, but most firms have considered them impractical or inapplicable to their particular affairs.

Howard Coonley, president of the Walworth Manufacturing Company says, "Budgetary control is now one of the fundamental policies of the Walworth Company. It is our record of the past, our index for the present and our guide to the future. We believe it to be an essential factor in our success."

It seems probable that there would be fewer cases of "over-expansion" and "over-trading" if there were more budgets employed. The investigator may well inquire into the proposed financial plans with a view to determining how clear the management may be on the subject. The banker will be inclined to be comfortable as to the future quite in proportion to the care and thought which the business man demonstrates has been given to budget plans. Of course, the best possible test of the accuracy of the business man's budget plans is to compare past results with the corresponding budget plans. Consideration of the subject of the budget might well be made a part of the audit report.

It is quite generally recognized that the financial reports of many concerns would be far more instructive and much easier to prepare if the concerns made the report on a fiscal-year basis rather than a calendar-year basis. The advantages to the banker of receiving statements prepared at logical inventory dates rather than arbitrarily as of December 31st include

(1) Greater accuracy in the statements, and

(2) Availability of current financial data at the time when the borrower is in a position to consider its financial requirements for the coming season.

You all realize, of course, the advantage of fiscal-year reports to the accounting fraternity in helping to eliminate the "dull season." The matter can usually be arranged as far as the tax authorities are concerned.

To summarize, I would again lay before you the following ideas:

(1) Financial statements and audit reports are not the sole basis for determination of whether or not loans are to be made.

(2) When credit is involved, accountants, who make lengthy investigations, should, in justice to themselves, their clients and the banker, standardize a policy of giving more detailed reports than the bare condensed certified balance-sheet, still so much in vogue. Detailed working papers in the accountant's file do not aid in making loans.

(3) Modern bank practice calls for financial data which are frequently not to be found in the audited reports which are submitted with credit applications.

(4) The accountant would be of more assistance to the client and the banker if he included an interpretation of the financial data in his reports.

(5) Detailed schedules supporting various balance-sheet and operating-statement items are essential in making a credit interpretation of condition.

(6) There are many avenues open for further coöperation between the accountant and the banker.