1920

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Recommended Citation
Haskins & Sells Bulletin, Vol. 03, no. 09 (1920 September 15), p. 86-90

and social world is eminently proper. The achievement of that psychological status which grows out of frequent and intimate meeting with men of affairs is nothing upon which to frown. Dignified, genteel, and diplomatic contact with prospective or potential clients may not be regarded as unethical. But the professional man may not become a canvasser. He may not blow his horn as does the peddler. When he reaches the stage wherein satisfaction in the performance of work well done means more to him than financial reward, he will have attained the coveted realm. Such is the concept which distinguishes a profession from a business.

Certified Financial Statements as a Basis for Credit

By John Raymond Wildman

A Paper Read Before the Utah Bankers' Association, Ogden, June 19, 1920

THE way from hiding shell money in the crevices of rocks to the gigantic and versatile financial institutions of to-day is a long one. The sole idea in the former situation was to preserve the funds and protect them against loss. The modern financial institution maintains the same idea but at the same time makes the funds available for use.

The old idea that a bank was a place in which to keep money has given way to a new order of things wherein the bank has become an institution in which to accumulate funds in order that they may be made available for the financial needs of the country.

The country owes much to the banker. He has been an important factor in the expansion and development of business. He has become an instrument of service in financial matters, locally, nationally, and internationally. He gives advice as to investments, taxes, general business procedure, and sometimes matters of accounting. He does all this freely and the service is gratuitous.

The banker makes most of his money through the loaning at interest of funds, which have been deposited with him and for the use of which he suffers, generally speaking, only the expense of keeping the depositors' accounts.

But the banker has certain duties and responsibilities. To his depositors he is liable for maintaining intact the loanable fund constituted largely by their deposits. To the stockholders he is responsible for the integrity of their capital. To the public he may be regarded as having the moral obligation of acting as controller and regulator of industry and business.

Good judgment is necessary if the loanable fund is not to be impaired through losses. Courage, vision, and public-spirited interest are necessary if the banker elects to play his part in regulating financial affairs as opportunities offer.

Some few years ago a previously unknown individual, under the cloak of corporate organization, opened a new department store in New York City. The show windows contained goods which were cheap looking and tawdry. The advertising copy was undignified and unconvincing. Everything about the store contributed to an atmosphere which was anything but first class. The establishment continued only a few months. The company failed. The failure disclosed the fact that three prominent New York banks were creditors in the amount of about three hundred and sixty-five thousand dollars, no part of the loans being secured. Fortunately the resources of these banks were adequate to permit of writing off the losses scarcely without impression on the operating results. But the thing at which one must marvel is that three big banks should fall victim to the guile of so crude a representative of the merchant class. These banks along with the other creditors took a liquidation dividend of about ten per cent. in settlement.

Within the past three months a well-known building in the financial district of New York City was sold to real estate speculators for $2,500,000. Tenants were immediately notified that rentals would be increased as soon as leases should expire. Space on the first floor might be had, it was announced, at $15 a square foot; that on the second and third floors at $10; that on floors above at $6. The average cost to tenants under old leases averaged between $2 and $3 per square foot.

In keeping with their philanthropic policy the real estate operators decided to offer to the tenants of the building the first opportunity to purchase it. The asking price was $5,000,000. At last report it had been reduced to $3,500,000. There is little prospect that the tenants will purchase the building. There is not much doubt that someone will purchase it and in the not far distant future.

The banks are furnishing the money for speculation in real estate, unconsciously, perhaps, but none the less truly, just as they are supplying the money for speculation in other lines. To remedy the situation is first to realize that it exists. To find the remedy is another matter.

Raising the discount rate will not stop speculation. The real estate trader who is able to make from 100 to 125 per cent. per annum on money cares little for an increase of one or two per cent. in the discount rate. Discrimination in the matter of loans would apparently accomplish much more. Loans only for sound, conservative, up-building business purposes would do much to stabilize conditions and bring down the general price level.

The reputed basis for business loans is confidence. The late J. Pierpont Morgan has been credited with the fantastic statement substantially to the effect that he would rather loan a million dollars without security to a man in whom he had confidence than a thousand dollars on the best security in the world to a man in whom he had no confidence.

Confidence is the belief on the part of the lender that the borrower will be willing and able to repay. The belief may be founded on past experience, on the known business standing and reputation of the borrower, or on the result of investigation of his character and integrity. But when he fails to pay at the appointed time the confidence availeth nothing. Many a borrower has taken money in the best of faith. Many a borrower has been willing to pay at maturity without being able so to do.

Some banks loan altogether on confidence. Others ask prospective borrowers to furnish financial statements. There are borrowers who submit statements which are wrong and misleading because of ignorance on the part of those who prepared them. There are others who offer financial exhibits which are intended to deceive.

An applicant for a loan at one of the large trust companies recently submitted a balance sheet which deliberately overstated the assets and understated the liabilities. The cash shown as on hand took no cognizance of the checks outstanding. The customers accounts were all said to be good, yet investigation developed the fact that scarcely one per cent. was really collectible. The inventory stated to be worth $45,000 was found to be worth, on the basis of a liberal appraisal, about $12,000. Liabilities said to be entirely in favor of trade creditors included amounts borrowed from a bank. No mention was made of amounts which had been borrowed from relatives.

The trust company in question refused the loan because the applicant refused to submit a certified statement. The above facts were developed subsequently when in bankruptcy proceedings the attorneys for the bankrupt offered a composition of something like two cents on the dollar and an investigation was made at the instance of certain creditors in an effort to determine the true situation.

The banker is not charged with the duty of being an accountant, but he is scarcely to be classed as a banker these days if he is not able to read and interpret a balance sheet. It should be said in their praise that bankers are as a rule very adept at this sort of thing. But again it is a matter of confidence; the acceptance of the facts as stated; the belief that reliance may be placed upon the representation of the statement.

The unsupported financial statement of the applicant for a loan is better than no statement at all but it does not answer the purpose. First, because it frequently leaves something to be desired in the matter of presentation; second, because it offers no other basis than confidence.

The financial facts represented by the statement should be verified. It is not sufficient that the assertion of the applicant be accepted if the banker would avail himself of every opportunity to safeguard the funds of the bank. Many a plausible story, supported by what has appeared to be good evidence, has carried sufficient persuasion with it to extract money from the cashier of a bank where an armed force could not have done so.

The borrower is naturally biased in his own favor. Without of necessity misrepresenting anything or in any way misleading he is always optimistic as to his financial condition and presents his case in the most favorable light. The independent and disinterested investigator has no such bias. He searches out the cold facts. He presents them in equally cold-blooded manner. Further, he certifies to them.

Some few years ago the American Association of Public Accountants, now the American Institute of Accountants, addressed an inquiry to the bankers throughout the country asking them to express their attitude toward certified financial statements as a basis for credit. Eight hundred and forty-four replies were received and classified as follows:

Strongly in favor	121
Favorable	501
Opposed	15
Strongly opposed	5
Non-committal	202
	844

Among those in the first class were some of the foremost bankers in the country. Those opposed or strongly opposed obviously failed to catch the significance of the inquiry or had experienced difficulty in obtaining through accountants' certificates the measure of protection which they demanded. The non-committal group was comprised largely of banks in small places where the personal acquaintance of the bank officials with the borrowers and their affairs made it unnecessary to require certified statements. As many expressed it, "The idea is all right, but it doesn't apply in our case."

One banker in Omaha, Nebraska, cited an instance where his bank had been saved $40,000 through having insisted on a certified statement which the borrower declined to furnish. Another bank made the loan and subsequently took the loss.

A St. Louis bank official replied as follows: "During this year we have found that three of our borrowers falsified their statements. The net loss to us was about $20,000. Certified statements would have saved us that sum."

From Pawtucket, Rhode Island, comes the following statement: "We give preference in buying brokers' paper to statements certified by public accountants well and favorably known to us."

Statements prepared to be submitted to bankers should be so fashioned as to supply quickly, fully and succinctly the information which the banker needs in coming to a conclusion as to the present status of affairs and prospects for the future. An accountant will only succeed in this respect as he is able to put himself in the place of the banker who reads the statement. A balance sheet prepared for stockholders or prospective investors might contain all the information which the banker needs, but presumably would not be as satisfactory as one which focuses the attention immediately upon the liquid aspect of the situation.

The loaning banker is concerned chiefly with his position in case he makes the loan and with the probability of repayment. It is essential to good banking practice that the loanable fund be not tied up in long term loans. The banker is anxious first, that he shall get back the funds which he has loaned, and, second, that he shall get them back within a short time. Thus is the loanable fund kept in circulation.

Having this in mind the banker generally looks immediately at the liquid assets. He compares them quickly with the current liabilities. He is likely to be interested in the ratio which the net liquid assets bear to the total liquid assets, representing the margin of safety, as it were. Like the credit man he is always more impressed if the liquid assets are at least twice the current liabilities.

One by one he goes over the liquid assets, regarding them always in the light of the rapidity with which they may be converted into cash. Current liabilities will be examined with regard to the order in which they take preference and the pressure which they exert as to payment. All these inquiries the banker directs at the statement with the idea of trying to determine what will be the outcome in so far as he is concerned, if he decides to take the place temporarily of some of the present creditors or furnish additional working capital to the enterprise for a time.

The statement to be satisfactory must exhibit the financial vigor of the business, must show what it has been doing in this respect in the recent past and give some indication of the prospects for the future. For such purposes a comparative statement of financial condition is desirable. It should, however, be supplemented with a statement showing the net sales for the last year. Thus is the reader of the statement apprised of the conditions under which he enters into the relation of creditor.

As one banker has said, "A balance sheet will not validate an inventory." It might be added, no more will it validate any other item thereon. Without certification it is essentially a document which must be taken on faith, and at that, faith in an interested party.

The certified balance sheet does validate the inventories as well as all the other items. It means, as to inventories, for example, that the accountant has satisfied himself that they represent sound values; that they contain no obsolete or unsalable material; that they have been priced at cost or market, whichever is lower, unless otherwise stated; and that, generally speaking, the value placed on the inventories is one which they may reasonably be expected to realize in case of necessity.

In the present peculiar economic condition in which this country now is found, the banker is brought into a position of more than usual importance. First, because the general increase in the price level, having brought about a condition in which twice as much working capital as formerly is required, has sent an increasing number of borrowers, who are not in a position to re-finance, through capital obligations, to the banks for current loans. According to statistics which appeared recently, commercial loans increased from January 1 to April 30, 1920, one billion, one hundred millions of dollars ($1,100,000,000) or 10 per cent. Incidentally, during the same period Wall Street loans decreased 7 per cent.

Secondly, the banker's position is important because during the movement which has as its purpose enforced deflation, the honest commercial borrower will suffer most. Being forced to sell at low prices goods into which have entered high-priced material and labor, the manufacturers and merchants are likely to find themselves embarrassed to meet current obligations and forced to turn to the banks quite legitimately for assistance.

In the third place, the banker plays an increasingly important rôle because of the demands upon him for funds with which to take advantage of present-day financial opportunities. With the present condition of the stock market, nothing is so cheap as securities. There are huge profits to be made in real estate. The manufacture of sweets to take the place of alcohol, and foreign trade ventures give most tempting promise of large returns. The conservative banker who has the good of the country at heart and who wishes to be a factor in settling conditions and bringing down prices so that they will stay, frowns on applications for loans of this character. Nothing will contribute more to the lowering of prices, it is believed, than discrimination by bankers, including the Federal Reserve Bank, in the making of loans.

In all these cases the banker needs facts from which to proceed. It is contended that certified financial statements proceeding from duly qualified independent accountants may be a most effective means of assistance to him in these matters. They may be of help to him in exercising judgment as to the granting of loans. They may help to satisfy him subsequently as to the judicious use of the funds so loaned. They will help him in keeping the loanable funds of the country employed to best advantage while taking every precaution as to their safety and prompt return.

The Tax Situation

CHARLES WALDO HASKINS INSTITUTE has announced a class in Income and Profits Tax Accounting to be given in the class-rooms of the Institute at the Haskins & Sells Building, 37 West 39th street, on Friday evenings, beginning September 17, 1920, from 6 to 7.45 P.M.

This class is a part of the professional section of the Institute's regular curriculum but has been opened to the general public owing to the widespread interest in taxation at this time. There is scarcely any one who is not touched in some way by the present scheme of taxation. A knowledge of taxes has become so vital a part of preparation for business and the accountancy profession that few young men who enter these fields can afford to be uninformed on the subject. Any one who undertakes to practice tax accounting must not only keep abreast of the times but be constantly watching the changing aspects and tendencies of the tax question.

Prior to the enactment of the Revenue Act of October 3, 1917, the Federal income tax was not, owing to the low tax rates, of vital importance to the financial community. The provisions of previous