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Accountant and Banker

Spencer S. Marsh

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By Spencer S. Marsh

To James G. Cannon of the old Fourth National bank in New York should be given the credit for having first created among bankers a desire to have their commercial loans supported by signed statements from the borrowers, showing their financial condition.

For many years bankers had been in the habit of granting loans to their customers, basing them entirely on the character of the borrower and the meagre knowledge of his business that could be gained from the way he conducted his bank account. This method of determining whether a loan was desirable or not was most unscientific and resulted in creating a wrong attitude on the part of the borrower toward the banker, in many cases giving the borrower a false sense of being injured when asked to furnish a statement of his affairs or questioned too minutely concerning his business.

Through the efforts of a group of men, among them Mr. Cannon, bankers in this country were led to see that they were entitled to statements from their borrowers, and gradually the borrowers were educated to a point where they could see that information given to their bankers was for their mutual good. Credit departments were organized in banks, their function being to keep careful and accurate records of all credit risks, securing statements from all borrowers at least annually, tabulating and analyzing the contents and translating the figures into a standard language that could be read quickly by the banks' officers.

The wisdom and vision of the men starting this movement is shown by one illustration. A large merchandising house of national reputation enjoyed the best of credit. Accounts were kept with several large New York banks. Banks all over the country purchased the paper of this house and its subsidiary companies in large volume from note brokers, taking the recommendation of its banks as to its worth.

The house became involved and failed. Nearly every bank in the country that was a purchaser of commercial paper held some of this paper and great surprise was expressed when it developed

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that one of the large New York banks not only had none of the paper of the failed house, but had asked the concern to close the account formerly carried with it. When asked to explain the position in which this bank found itself, an officer answered simply: "Why, they would not give us a statement of their affairs and we will lend to no one unless he can and will support his application for a loan with a statement."

This experience had a great influence on banks throughout the country and probably did much to crystalize the opinion among bankers that unsecured commercial paper should always be supported by a statement. Before long dishonest merchants discovered that bankers could be fooled by false statements, and it was a natural suggestion that statements be made up by disinterested persons after an audit in a scientific manner.

This demand for accurate knowledge of a borrower's financial condition has grown until it is the general practice of the banks of the country to demand statements from borrowers and often to insist that these statements be made by independent persons. The result of continued education is shown by the willingness of dealers to supply statements and the large number of houses that now employ outside accountants to make regular audits and reports for the manager's own information and use.

Your president suggested that I discuss some of the points of contact between the banker and the certified public accountant. I shall take a liberal view of this text and in a general way try to tell you what a banker wants to know about a borrower and what he tries to get from the statement presented—whether it be made up by the borrower himself or by an accountant.

Better to understand the banker's point of view I think we should remind ourselves of several fundamental principles by which he is guided if he is true to his trust.

First: He is lending other people's money. He therefore wishes to surround his loan with the best scientific knowledge obtainable.

Second: It is the bank's function to supply credit, not capital.

Third: He must so guide his borrowers and limit his loans that his bank shall not become a partner in any business enterprise.

Fourth: This should perhaps have been first—he should base his loans on the *character, capacity* and *capital* of his borrower in this sequence. Any statements filed must help him to apply these principles in determining whether or not the loan is to be granted.

I think that bankers generally want to coöperate with the accountant and would welcome some method of standardizing as nearly as practicable the reports of your audits. I realize that many difficulties must be surmounted before this can be accomplished, but if your principal is told that when your report is to be submitted to his bank as a basis for credit it must contain certain vital information, it may help to surmount some of these difficulties.

When the report of your audit is placed before the officer who is to pass on the loan his first interest will be in the description of the audit made by you—to determine its scope and thoroughness.

This in a general way should recite whether or not the business under review maintains a proper set of books—that show its condition at all times—whether or not these books are run properly and kept in balance. This applies particularly to medium and small concerns, although some large enterprises are subject to criticism in this respect. If the business needs a cost system—state whether accurate or only approximate. The banker will quickly pass to the figures showing assets and liabilities, particularly those showing the quick assets and current liabilities. To be most helpful these should be grouped to show the subtotals of each so that comparison can be made quickly to determine the ratio of current debts to quick assets. The banker is not interested so much in the slower assets and permanent debts as he is in the former figures, for in large measure his decision will be determined by the excess of quick assets over liabilities shown in the statement. While this is so the slow assets should be shown in detail and should be subject of comment. A borrower's ideas of what constitutes a current debt and the banker's idea of the same kind of debt do not always agree.

Then the operating or profit-and-loss statement should have close scrutiny and should show comparison with former years. The slow assets often contain items that vitally affect the firm's credit standing.

To illustrate: A statement showing some three hundred thousand dollars' worth of quick assets in excess of current liabilities had among its slow liabilities an item of $350,000 that looked and acted like a mortgage on its plant. Investigation showed that this item covered notes given by the corporation to its stockholders in payment of money advanced by them to purchase the plant, with an understanding between the stockholders and the corporation that the notes would not become due for ten years. Nothing was in evidence, however, that would prevent the holders of these notes from demanding payment at any time.

This item should have been included among the current liabilities. It put an entirely different complexion upon the cash position as shown by the statement, as the charge wiped out the entire quick assets and could have been remedied only had the holders of the notes placed their money at the risk of the business.

Items placed among the deferred debts should be supported by schedules that explain them completely.

Under existing conditions two asset factors are of the utmost importance to the banker—the inventory and the accounts receivable. During the past year numbers of bankers have realized that the oft-repeated accusation has become true—that bankers under the stress of circumstances had become merchandisers. They are vitally interested, therefore, in knowing all the details possible concerning the borrower's inventory—its volume; whether composed of finished goods; raw material on hand; method of determining the figures, whether estimated or appraised; and how carried, at cost or market values; amount of reserves set up for depreciation purposes.

The accounts receivable need careful attention because the banker looks upon them as a most liquid asset, usually the most capable among the assets of producing the cash quickly. The banker wants to know whether the amounts under this caption are all good, live accounts, what proportion are past due or for any other reason are uncollectible.

An item that is too often overlooked is a firm's contingent liabilities. These may consist of its endorsements on paper discounted, guarantees of accounts, forward contracts for material and any other liability that may be incurred and does not show on the face of the statement.

During the past year shrinkages in values of commodities have occurred that have placed thoroughly solvent concerns in a shaky position because of their inability satisfactorily to adjust contracts which existed before the shrinkage. Such contracts have created contingent liabilities that rise up at the most unexpected times to "smite" the merchant or manufacturer with a most embarrassing demand for payment.

In a very general way I have mentioned items that seem of vital importance to the banker. There may be others that will occur to you. I feel sure that an organization of this kind can be of much benefit in using its influence toward placing the standard for its members so high that the banker or business man will know when he receives a report that it can be accepted without question.

J. P. Morgan said that the first consideration in any demand for credit that he was to consider was the character of the borrower. This must be true of the accountant. You are taken into the confidence and business secrets of the firm engaging you. You are to place before it a report of the business that may be responsible for a course of action which will either make or break the business. The report may be presented to your client's banker as a basis of credit. The client may even suggest to you that you prepare the report so that it will support an application for credit and be passed by a banker. Your position is very much that of a physican who is engaged to keep his patients well. Both the merchant and banker are depending upon your integrity and courage to show any business ill, that it may be corrected at once.

This calls for the highest sense of duty and obligation and means that your organization should not tolerate or condone any breach of the highest ethics.