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## Accounting and Auditing as Related to Credits

BY H. IVOR THOMAS, C. P. A.

Before taking up the relationship of accounting and auditing to credits it will be well to review briefly the nature of credit, its scope and requirements, to determine what features should be provided for in a credit accounting system. In the early days of barter and exchange trades were made by interchange of commodities, and theoretically this is true to a certain extent with regard to international commerce, where the difference in amount of commodities interchanged is known as the balance of trade. The growth of trade gradually made it impossible to adjust balances in products and commodities, and another medium of value had to be developed. Money came into use. With the growth of transactions between individuals, families, tribes, these conditions appeared: dwellers in one section required products dealt in by neighbors some months earlier than they themselves might be able to make delivery of commodities they wished to exchange, and in the absence of cash resources they were obliged to obtain what they needed on the strength of an agreement to deliver an equivalent value at a future date. Thus credit grew.

In these days of large business, more particularly in the wholesale trade, only a small proportion of sales is for cash; in fact nearly all wholesale business is conducted on credit, and in order to make business secure and to guard against losses by advancing credit to firms or persons who may fail to keep their promise it is necessary to establish credit ratings for buyers in order to guard against such loss.

The proper collection and allocation of the information necessary to establish credit rating is of sufficient importance to the wholesale house to justify the creation of a department, the business of which is to gather details of credit information concerning its customers; and upon this department, or its head, rests the responsibility of deciding what credit, if any, shall be advanced to new customers, or what steps shall be taken to shorten a previous line of credit.

Before referring to the nature of the information required

and the means of obtaining it, I would refer to the chief methods of making sales by the wholesaler. The method usually used is through traveling salesmen who periodically visit the retail traders in their assigned territory. The less generally employed method is through the use of the mail service, in which case the wholesaler depends upon catalogues or other advertising media to obtain orders. The advantages of selling through salesmen are that the purchaser comes into closer personal touch with the buyer, thus often securing an order when other conditions are equal; that is, if prices, terms and quality of goods offered by two houses are practically the same, the order may be given to the house which has established a personal connection. A salesman can in many instances get information regarding a customer's credit and general standing in the community that will be of value to the credit manager. He may be instrumental in selling a larger bill of goods than the retailer would buy if ordering from a catalogue, because he is trained by coming into contact with a large number of houses to estimate the probable needs in a district with more certainty of success than the retailer himself.

On the other hand, selling goods by mail has an advantage in that the wholesaler knows at all times what recommendation he is giving his goods and what representations he is making to his customers, whereas he cannot always be sure of the arguments put forward by his representatives. Another advantage is that he does not run the risk, that sometimes occurs, of losing customers when a salesman severs his connection with one house and is able to carry with him a number of his trade.

There are two main methods of investigating the credit standing of a proposed buyer, the direct or personal method, which involves an interview with the buyer in which the credit man should be able to form a reliable estimate of the personality of his proposed customer, and in the course of which he can ascertain through questions facts which it is most essential he should know; and, when he has also an opportunity to examine the books. In commercial credits, no less than in the granting of credit by a bank, the element of personality is of vital importance. Occasions occur during times of extraordinary financial stress, when collections will be below normal, and at such times credits may be extended with greater security to those

buyers known to be personally reliable. Where a personal interview is not possible, the credit man will call for a statement of his proposed customer's financial standing; and though such a statement is not always accepted as conclusive proof, it is valuable if proper weight be given to its important features, which are herein referred to.

It is becoming more and more the custom to require such a statement to be signed by a responsible member of the firm to secure the most reliable information that may be obtained in this manner, as it brings the statement within the scope of the "False Statements in Writing" laws. Even so, a statement prepared in good faith may not contain all the elements necessary to a true statement of condition, and greater protection can be secured by requiring a statement certified by a professional auditor.

The second is the indirect method, consisting in gathering information through a third party representing the credit man. This may be done by the traveling salesman, subject, however, to some drawbacks, chiefly the fact that the main interest of the salesman is at variance with that of the credit man; the salesman's first aim being to obtain an order without reference to the amount of credit that it is safe to allow his customer. Many large firms employ an experienced man to obtain information of this character in person, but such method is too expensive to be used except in the case of large firms. The large body of wholesalers rely for this information on the reports furnished by a commercial agency reporting company; but this business is now almost entirely in the hands of two concerns, Dunn's and Bradstreet's, each of which has been in existence upward of 60 years. Some complaints have been made with regard to agency reports, notably that their information lacks details and requires additional verification from other sources.

One of the causes of this incompleteness seems to be due to a lack of willingness on the part of the smaller traders to furnish as complete information as the agencies desire. There is, however, a growing tendency to overcome this defect, for merchants are learning that they cannot expect to receive full and complete information of the business-standing of others unless they are willing to give similar information concerning themselves.

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To pass to a consideration of items that should be known in order to establish a credit rating, and the method of their acquisition: I would refer to the reports which have been endorsed by the National Association of credit men (where the arrangement differs to some extent from the usual accountant's report), as being most applicable to the purposes for which it is to be used. The fundamental principles of this form of report are the requirement of a complete segregation between business assets and outside assets: the object being to show clearly under the head of business assets all those values which are readily available, to distinguish them from those which could not be readily converted to the extinction of the debt. Another valuable feature of these reports is that they call for the net value of accounts and notes.

The accounting features necessary in a credit department refer to the systematic classification of the reports and the information obtained from them, and their arrangement in such a way that quick reference may be made to any particular case. A good plan for use in this connection is to make use of cards of different colors, for example white, blue and red, to be used in the following way: Record all information of normal cases on white cards; whenever it has been found necessary to refuse credit to a customer transfer his record to a blue card, and always in future keep such a record on the card to which it has been transferred as a reminder at a glance that there was once some trouble in this particular case. Then the red card may be used as a special sign of danger in those accounts where it has been necessary to place the account in the hands of an attorney for collection.

A valuable statement for use in a credit department is one that shows creditors' accounts segregated into columns distinguishing between accounts not due and those over-due for varying periods of time, that is, one column may be used for accounts which are three months overdue, another, for those six months overdue and so on, such statements may be prepared as frequently as the needs of the business require.

The credit department will obtain better results and with less friction if the customers' accounts are carried on a card system rather than in bound books because it will be easier to refer to individual accounts on them, than to require a large book

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to be submitted for inspection whenever it is desired to look over a customer's account. A useful card to be furnished to salesmen is one upon which they can report such information concerning a new customer as they are able to obtain without being obliged to ask questions that would injure the chance of making a sale; and such information can be advantageously renewed by them from time to time in the case of old customers. This information should cover such items as the following: General condition of the business; general appearance of the store; condition of stock; what amount of advertising is used; are the clerks courteous and obliging; is the proprietor a good business man, and how is he regarded in his town? These are a few of the questions that might be inserted on the card, and are given as a guide.

The important feature of the credit business is that of collections. While the retail merchant cannot always insist upon the same promptness of payment of accounts as can the wholesale house the latter should insist upon prompt payment. Whenever a delay occurs in the payment of an account it should be followed up systematically, and wherever possible before resorting to extreme measures a personal visit should be made to the purchaser in order to find out all the conditions, for such a course will sometimes disclose facts that will make it advisable to extend the credit beyond the normal time, and thus save the account. The ideal arrangement with regard to collections is to have them under the direct supervision of the credit department, as the functions of these two branches of the business are so closely connected that the best results may be obtained from this arrangement.

We have referred to the connection between accounting and credits, and will pass to the relation between auditing and credits. The difference between accounting and auditing is: accounting relates to the recording of facts of commercial transactions in the books of account; auditing refers to the correct reading of what the books of account relate. The important requisite of the credit man is the ability to not only analyze correctly a statement rendered to him but, also, to read accurately information furnished by an examination of a customer's books. In other words he should be able to audit a set of books and obtain the correct interpretation. Without such a knowledge he is in

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danger of being misled if the report or statement be incorrectly prepared, and would probably fail to detect weak or unstable conditions which would be evident to an auditor.

While a great deal has been accomplished in some cities by associations of individual trades formed for the purpose of exchanging credit information through a species of clearing house, there is still room for development of this kind of activity. The majority of associations of this nature furnish their members or subscribers information of great assistance in the matter of extending credit; but they usually insist upon evading the responsibility for adverse reports, by concealing the names of those who furnished the reports from the other members.

On the other hand, there is, for instance, in existence in Los Angeles an association dealing in building materials, which by a key system discloses to the members the source of information, and its members claim that this plan has been productive of excellent results, both in demanding publicity with regard to the former conduct on the part of the applicant for credit, and in the collection of old accounts. It would seem that this principle of publicity might well be extended so as to embrace associations covering other lines of business.