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CONSUMER AND COMMERCIAL CREDIT MANAGEMENT

CONSUMER AND COMMERCIAL CREDIT MANAGEMENT

By

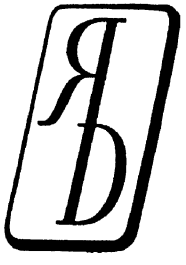
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1960

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MARY ROSE
RUTH MARIE

and our boys

Preface

CREDIT is an increasingly important force in the lives of all of us today. Thus, it is essential for the consumer, the student, the business and financial executive, the professional man, and the government official to have a full and complete understanding of what credit is, what credit does, and what credit can do. To contribute to this understanding is the purpose of this book.

A credit and collections textbook generally is directed toward use in a university or college curriculum. The authors not only have had this ultimate aim in mind, but they also have prepared the material in the following pages with complete recognition of the needs of those executives who currently are charged with the task of management of credit and collection activities. To do otherwise would be to ignore the fact that the task of credit and collection management is an everyday, practical business operation.

Consumer credit has been given its just position in this book and has been awarded equal space to the other major field, business credit. Such has not been the case in many other publications dealing with the field of credits and collections.

The book has been divided into five major parts: (1) an introduction to credit and collections; (2) consumer credit; (3) analysis and management of consumer credit; (4) business credit, government credit, and foreign credit; and (5) management and analysis of commercial credit. In the first part, the discussion is directed toward what credit is and what credit does as well as to the social and economic problems connected with credit operations. In the second part, the reader will find a detailed discussion of the growth and use of consumer credit, as well as a clarification of all aspects of the major types of consumer credit—the retail charge account, the retail revolving credit account, the retail installment account, the service credit account, the cash loan credit transaction, and the home mortgage loan.

The analysis and management of the consumer credit transaction which is discussed in the third part continues the credit task in its normal sequence. Thus, the extent of credit investigation then is discussed, the source data to be used as the basis of the credit decision are explored, the places from which the source data may be obtained are

described, the analysis of the data and the final decision are made, and the credit line or limit is set. Attention then is directed to various credit management techniques, involving such topics as identification and authorization. In Chapter 15 recognition is given to the often-overlooked fact that salesmanship is part of the operation of the credit department. In all credit operations, collections are an inherent part of the transaction and as a result are next discussed. This is followed, in turn, by a survey of how the success of credit operations can be tested.

The fourth part of the book is devoted to a general discussion of business credit, government credit, and foreign credit. Chapter 18 in this part is concerned with business and government use of credit; Chapter 19, with commercial (or as some credit executives prefer to call it, mercantile) credit and terms of sale; Chapter 20, with business use of cash (financial) credit; and Chapter 21, with the complicated and varying problems of selling goods and services outside the United States.

It is believed that from the marketing point of view the problems connected with commercial (or mercantile) credit management are the most important in the business credit field. For this reason, the fifth part of the text is devoted to a discussion of the management and analysis of commercial credit. Here as in the consumer credit discussion, the credit transaction is followed through in its normal sequence. First, management of commercial credit sales is discussed. Next, attention is directed to the basis of the commercial credit decision, with emphasis on Dun & Bradstreet, Inc., specialized agencies, and credit interchange bureaus of the National Association of Credit Management. Two chapters, 27 and 28, are then directed to the interpretation of financial statements. These are followed by an analysis of, and decision making in, commercial credit transactions, to be followed by the determination of credit limits for the account. The last four chapters of this part are concerned with credit insurance, collection policies and practices, and measurement of the efficiency of credit decisions—all of these chapters, of course, concentrating on commercial credit transactions.

The authors would like to acknowledge each individual by name who gave his time, effort, and complete co-operation in bringing this book to its completion. Unfortunately, such an action would be impractical. However, the authors would like to acknowledge their appreciation to Professor H. W. Huegy of the University of Illinois, who provided the initial encouragement to the authors to write this book and who contributed some important manuscript material which is used in certain sections of this book. We wish to thank, also, Dean Leonard

Marks, Jr., of the Graduate School of Business, Stanford University, and Dr. J. S. Wagle, of Oklahoma State University, for reviewing the manuscript and offering helpful suggestions. Much help was received from our many colleagues at our universities and at the University of Illinois. Credit managers in the consumer credit field and the commercial credit field, as well as bank credit executives, provided much material and gave heavily of their time and experience. Trade association executives, credit bureau and agency officials, and many other recognized credit authorities contributed ideas and materials in order that the subject matter of the book might be enriched. Specific reference to the companies, associations, and individuals who contributed is made in appropriate sections of this volume. To all of these the authors express their sincere gratitude.

Finally, and certainly not of least importance, have been the patience, encouragement, and unselfishness of our families while this book was being written.

ROBERT H. COLE
ROBERT S. HANCOCK

March, 1960

Table of Contents

PART I. AN INTRODUCTION TO CREDITS AND COLLECTIONS

CHAPTER PAGE

1. CREDIT—WHAT IT IS AND WHAT IT DOES 3
Medium of Exchange. Limited Acceptance. Documents Simply Represent Credit. The Potential of Credit. Credit Is Also Debt. Credit Is Neither Wealth Nor Capital Use of Credit Can Be Dangerous WHAT CREDIT DOES· For the Consumer. For the Retailer and Service Concern Operator For the Manufacturer. For Our Economy as a Whole. CLASSIFICATION OF CREDIT· Consumer Credit Business Credit. OUR APPROACH TO THE STUDY OF CREDITS AND COLLECTIONS.

2. THE SOCIAL AND ECONOMIC ASPECTS OF CREDIT 25
THE ROLE OF CREDIT IN OUR ECONOMY: Consumers—The Key to Economic Activity. CREDIT AND THE BUSINESS CYCLE EVALUATION OF THE ROLE OF CREDIT IN THE ECONOMY.

PART II. CONSUMER CREDIT

3. GROWTH AND USE OF CONSUMER CREDIT 37
USE OF CONSUMER CREDIT· Early Use of Consumer Credit Consumer Credit between the Civil War and 1920 Consumer Credit between 1920–30 The Pattern of Consumer Credit since 1930 CONSUMER CREDIT—AN ECONOMIC FORCE Government Regulation of Consumer Credit CONSUMER CREDIT IN PERSPECTIVE. Consumer Credit Relative to Business Activity CHANGING PATTERNS IN THE USE OF CONSUMER CREDIT. THE INDIVIDUAL'S USE OF CREDIT Use of Credit to Increase the Satisfactions from Life Use of Credit as a Convenience. Use of Credit as a Necessity Wise and Unwise Use of Credit.

4. TYPES OF CONSUMER CREDIT—RETAIL CHARGE ACCOUNT . . 59
Factors Involved DEVELOPMENT OF RETAIL CHARGE ACCOUNT Early Use. Increasing Frequency of Use. WHAT A RETAIL CHARGE ACCOUNT IS TODAY: Normal 30-Day Account. Bank Charge Accounts. Divided Payment Accounts. Scripbook Accounts. SUMMARY OF CHARGE ACCOUNT CREDIT

5. TYPES OF CONSUMER CREDIT—RETAIL REVOLVING CREDIT AND SERVICE CREDIT 81
RETAIL REVOLVING CREDIT· "Basic" Revolving Credit Plans "Chart" and "Flexible Limit" Plans Modifications or Variations How Revolving Credit Compares with Open Charge Credit. How Revolving Credit Compares with Installment Credit. Factors Affecting the Determination of a Merchant to Sell on Revolving Credit. Benefits and Pitfalls of Revolving Credit INTEREST CHARGE OR SERVICE CHARGE. Connection with Revolving Credit Plans. Influence on Other States. Connection with Other Credit Transactions. SERVICE CREDIT: Problems of Professional Credit. Credit in Service Establishments.

6. TYPES OF CONSUMER CREDIT—RETAIL INSTALLMENT ACCOUNT . 108
FACTORS AFFECTING THE DECISION TO SELL ON INSTALLMENT CREDIT: Financial Requirements. Type of Goods. Competition. Other Factors. DEVEL-

CHAPTER PAGE

OPMENT OF INSTALLMENT CREDIT: Origin and Early Use. Increasing Frequency of Use. PRINCIPLES OF INSTALLMENT CREDIT: Type of Goods. Down Payment. The Amount and Schedule of Payments. Installment Terms Carrying Charges Credit Investigation. CHARACTERISTICS OF AN INSTALLMENT ACCOUNT TODAY Forms of Installment Contracts Finance Charges Method of Computing True Rates of Interest HOW RETAILERS FINANCE INSTALLMENT ACCOUNTS: Development of Sales Finance Companies. Growing Importance of Sales Finance Companies and Efforts to Control Their Activities. Wholesale Financing Purchase of Installment Paper from Dealers Financing by Commercial Banks BENEFITS AND PITFALLS OF INSTALLMENT CREDIT.

7. TYPES OF CONSUMER CREDIT—CASH LOAN CREDIT 137
The Use of Cash Loan Credit by Consumers. CONSUMER CASH-LENDING INSTITUTIONS Commercial Banks Consumer Finance Companies Credit Unions Industrial Banks and Loan Companies Other Types of Lenders. RELATIVE COSTS OF CONSUMER LENDING INSTITUTIONS Types of Risk Accepted Investigation. Capital Bad Debt Losses. Collection Costs. Services.

8. HOME MORTGAGE LOANS 164
Decision to Buy or to Rent. Increasing Volume of Home Mortgage Loans. Financing a Home Sources of These Finances Amortized versus Old-Type Straight Mortgage. Credit Investigation of Applicant for Loan.

PART III. ANALYSIS AND MANAGEMENT OF CONSUMER CREDIT

9. PLANNING THE EXTENT OF THE CREDIT INVESTIGATION . . . 183
DETERMINATION OF POLICY Credit Standards. IMPLEMENTATION OF POLICY THROUGH CREDIT INVESTIGATION Purpose of the Credit Investigation. Facts or Opinions. Prediction or History. What to Investigate Credit Qualities to Investigate Influence of Economic Conditions Investigation and Verification How Much to Investigate Where to Investigate

10. BASIS OF THE CREDIT DECISION—INTERNAL COMPANY DATA AND DIRECT INVESTIGATION 201
INFORMATION SUPPLIED BY APPLICANTS The Credit Application The Credit Interview. Analysis of the Application INFORMATION SUPPLIED BY DIRECT INQUIRY: Inquiry by Mail. Developing Additional Informants. Inquiry by Telephone Inquiry by Outside Representative Inquiry through Credit Group Meetings. Direct Inquiry—Summary. INFORMATION SUPPLIED FROM IN-FILE LEDGER FACTS.

11. BASIS OF THE CREDIT DECISION (CONT.)—LOCAL CREDIT BUREAUS 221
HISTORY AND ORGANIZATION OF RETAIL CREDIT BUREAUS. Beginning and Development of Local Retail Credit Bureaus Origin and Growth of the Associated Credit Bureaus of America Organization and Ownership of Local Retail Credit Bureaus. Confidential Nature of Credit Bureau Work Principal Sources of Their Credit Information. Scope of Bureau Operation Cost of Credit Bureau Services. Evaluation of the Local Retail Credit Bureaus.

12. BASIS OF THE CREDIT DECISION (CONT.)—OTHER SOURCES . . 244
RETAIL CREDIT COMPANY: History and Organization. Users of Retail Credit Company Services. Methods of Investigation Credit Reporting Services Special Credit Services. Disappearance Broadcasts Cost of Services. Evaluation of Service. SPECIALIZED CREDIT BUREAUS AND OTHER SOURCES.

13. FINAL ANALYSIS, DECISION, AND SETTING OF CREDIT LINES . . 259
DECISIONS—THE ESSENCE OF CREDIT WORK. EVALUATING AND ANALYZING CREDIT INFORMATION. CREDIT IS RELATIVE. GRADING AS AN ANALYT-

CHAPTER PAGE

ICAL DEVICE. ELEMENTS TO BE GRADED: Illustration of Grading Income PROCEDURE IN USING GRADING FORMS A CREDIT DECISION IS THE PRODUCT. USE OF THE CREDIT GRADE IN OPERATIONS. SETTING THE CREDIT LIMITS AFTER THE DECISION.

14. CREDIT MANAGEMENT TECHNIQUES 280
RETAIL CREDIT MANAGEMENT Organizations of Retail Credit Managers Organization of Retail Credit Departments Basic Functions of the Retail Credit Manager. Techniques of Identification and Authorization SERVICE CREDIT MANAGEMENT CREDIT MANAGEMENT IN MONEY-LENDING INSTITUTIONS

15. SALESMANSHIP AS APPLIED BY THE CREDIT DEPARTMENT . 301
Should Credit Customers Be Sought? How to Get Credit Customers How to Get More Sales from Credit Customers Good Will Activities. Selling the Credit Department to the Organization.

16. COLLECTION POLICIES AND PRACTICES 319
CONSUMER CREDIT INSURANCE Nature of the Insurance Origin and Development Regulation of Credit Insurance DEVELOPING A COLLECTION POLICY. Factors Affecting Collection Policy A GENERAL COLLECTION SYSTEM. The Impersonal Routine Stage The Impersonal Appeals Stage The Personalized Appeals Stage Drastic or Legal Action Stage IMPACT OF A SOUND COLLECTION POLICY.

17. TESTING THE SUCCESS OF CREDIT OPERATIONS 344
RESPONSIBILITY OF THE CREDIT DEPARTMENT TESTS OF CREDIT DEPARTMENT OPERATIONS Bad-Debt Loss Credit Sales Collection Percentage, Days to Collect, and Turnover of Receivables Number of New Accounts Opened. Acceptance Index Past-Due Index Aging of Accounts. Cost Analysis PRESENTING THE MEASURED RESULTS

PART IV. BUSINESS CREDIT, GOVERNMENT CREDIT, AND FOREIGN CREDIT

18. BUSINESS AND GOVERNMENTAL USE OF CREDIT 361
BUSINESS USE OF CREDIT The Nature of the Demand for Business Credit Commercial Credit Cash (Financial) Credit GOVERNMENT USE OF CREDIT THE INTERRELATIONSHIP BETWEEN GOVERNMENTAL, BUSINESS, AND CONSUMER CREDIT Credit Expansion and Contraction Instruments of Federal Reserve Policy Impact of Credit Expansion and Contraction PRODUCTIVE NATURE OF BUSINESS AND GOVERNMENTAL CREDIT VERSUS CONSUMER CREDIT.

19. COMMERCIAL CREDIT AND TERMS OF SALE 375
FUNCTION OF COMMERCIAL CREDIT Financing the Movement of Goods Essential to a Mass-Distribution Economy. Changing Attitudes toward Commercial Credit TERMS OF SALE. ESTABLISHING TERMS OF SALE Factors Influencing Terms of Sale TERMS OF SALE CLASSIFIED. Prepayment Terms. Cash Terms Ordinary Terms. Single-Payment or Lumped-Order Terms. Special-Datings Terms Consignment Terms. CASH DISCOUNTS OR TRADE DISCOUNTS? Discounts and the Equivalent Rates of Interest. Cash Discounts and Federal Legislation.

20. BUSINESS USE OF CASH (FINANCIAL) CREDIT 393
COMMERCIAL CREDIT MANAGEMENT VERSUS CASH CREDIT MANAGEMENT. COMMERCIAL BANK LOANS· The Need for Commercial Bank Loans. Kinds of Loans Bank Interest Rates—Discount Rates. Commercial Banks Credit

CHAPTER PAGE

Policy. The Line of Credit and Compensating Balances. FINANCING AND FACTORING ACCOUNTS RECEIVABLE: Financing Accounts Receivable. Loan Advances and Charges. Use of Accounts Receivable Financing by Businesses. Factoring Accounts Receivable. LONG-TERM LOANS. The Need for Long-Term Financing. Forms and Sources of Long-Term Borrowing

21. EXPORT TRADE CREDIT 411
CREDIT PROBLEMS OF EXPORT TRADE. Currency and Exchange. Business Practices. The Distance Factor. Export Credit Insurance. Collections. SOURCES OF FOREIGN CREDIT INFORMATION: Commercial Credit Reporting Agencies. Foreign Credit Interchange Bureau. Commercial Banks. Department of Commerce. Other Sources. EXPORT TERMS OF SALE: Consignment Terms. Open Account Drafts. Letter of Credit. Cash before Delivery Terms. DIRECT VERSUS INDIRECT EXPORTING.

PART V. MANAGEMENT AND ANALYSIS OF COMMERCIAL CREDIT

22. MANAGEMENT OF COMMERCIAL CREDIT SALES 427
THE COMMERCIAL CREDIT EXECUTIVE—HIS STATUS, PLACE, AND FUNCTIONS Changing Status and Qualifications of Credit Management. The Credit Department in the Organizational Framework of the Company Basic Functions of Commercial Credit Management. OPERATION OF THE COMMERCIAL CREDIT DEPARTMENT Handling Orders from New Customers. DATA-RECORDING METHODS IN THE CREDIT DEPARTMENT.

23. BASIS OF THE COMMERCIAL CREDIT DECISION 441
The Need for Credit Information. Classification of Sources of Commercial Credit Information. Selecting Sources of Credit Information INTERNAL INFORMATION AND DIRECT INVESTIGATION: Internal Information. Direct Investigation. EVALUATION OF INTERNAL INFORMATION AND DIRECT INVESTIGATION.

24. BASIS OF THE COMMERCIAL CREDIT DECISION (CONT.)—DUN & BRADSTREET, INC. 459
THE GENERAL MERCANTILE AGENCY: Origin and Development of Dun & Bradstreet, Inc. THE ORGANIZATION, SERVICES, AND ACTIVITIES OF DUN & BRADSTREET, INC TODAY Principal Activities of Dun & Bradstreet. Methods of Collecting Credit Information. Principal Types of Credit Reports. Regular Reports Analytical Reports Continuous Service Key-Account and Special-Purpose Reports. Use of Credit Reports by Subscribers THE DUN & BRADSTREET REFERENCE BOOK: Contents of Reference Books. Explanation of Ratings. Use of Reference Books by Credit Managers. EVALUATION OF DUN & BRADSTREET.

25. BASIS OF THE COMMERCIAL CREDIT DECISION (CONT.)—COMMERCIAL CREDIT REPORTING BY SPECIALIZED AGENCIES 481
DUN & BRADSTREET'S INTEREST IN SPECIALIZED CREDIT REPORTING: Credit Clearing Division. National Credit Office, Inc. LYON FURNITURE MERCANTILE AGENCY. Lyon Red Book. Interchange of Trade Experience. Credit Reports. JEWELERS BOARD OF TRADE. CREDIT EXCHANGE, INC. OTHER SPECIALIZED MERCANTILE CREDIT REPORTING AGENCIES. APPRAISAL OF CREDIT SERVICES RENDERED BY THE SPECIALIZED AGENCIES.

26. BASIS OF THE COMMERCIAL CREDIT DECISION (CONT.)—CREDIT INTERCHANGE BUREAUS OF THE NACM 506
NATIONAL ASSOCIATION OF CREDIT MANAGEMENT. CREDIT INTERCHANGE BUREAUS. CONTENTS AND INTERPRETATION OF A CREDIT INTERCHANGE

CHAPTER PAGE

REPORT Heading. Business Classification. How Long Sold. Date of Last Sale. Highest Recent Credit Now Owing Past Due. Terms of Sale. Paying Record. Comments When to Use a Credit Interchange Report. APPRAISAL OF THE CREDIT INTERCHANGE SYSTEM.

27. FINANCIAL STATEMENTS—ANALYSIS AND INTERPRETATION . . 521
REASONS FOR FINANCIAL STATEMENTS. SOURCES OF STATEMENTS Directly from Risk. Indirectly from Mercantile Credit Agencies. PURPOSES OF STATEMENT ANALYSIS. PRELIMINARY APPRAISAL OF FINANCIAL STATEMENTS: Window Dressing or "Putting Best Foot Forward" Undue Optimism or "Reluctance to Face Unpleasant Realities." Inability to Reflect Current Facts. Actual Falsification. FINANCIAL STATEMENT LEGISLATION. METHODS OF STATEMENT ANALYSIS.

28. FINANCIAL STATEMENTS—ANALYSIS AND INTERPRETATION (CONT.) 538
METHODS OF STATEMENT ANALYSIS Simple-Evaluation Method. Percentage-Comparison Method. Where-Got, Where-Gone Method. Ratio Analysis OTHER CONSIDERATIONS AND ILLUSTRATIVE USE OF RATIO ANALYSIS. CONCLUSIONS ON STATEMENT ANALYSIS.

29. ANALYSIS OF AND DECISION IN COMMERCIAL CREDIT AND SETTING OF CREDIT LINES 563
CORE OF THE COMMERCIAL CREDIT TASK: Establishment of a "House Standard" Automatic and Nonautomatic Initial Orders Credit Decisions as a Routine Operation CREDIT LINES Advantages Limitations Methods of Setting Credit Lines. To Inform or Not to Inform Customers REVIEW OF DECISIONS

30. COMMERCIAL CREDIT INSURANCE 576
PURPOSE OF COMMERCIAL CREDIT INSURANCE ADVANTAGES OF COMMERCIAL CREDIT INSURANCE Balance between Sales and Profits Improvement in Collections Improvement in Borrowing Capacity. DISADVANTAGES OF COMMERCIAL CREDIT INSURANCE Cost False Sense of Security. Collection Restrictions Limiting Policy Features Credit versus Other Types of Insurance BASIC FEATURES OF COMMERCIAL CREDIT INSURANCE.

31. IMPLEMENTATION OF COMMERCIAL CREDIT MANAGEMENT THROUGH COLLECTION POLICIES 586
FACTORS AFFECTING COLLECTION POLICY Classification of Debtors Capital Competition Type of Business and Type of Goods. Profit Margin Credit Policy Followed Types of Records. PRELIMINARY STEPS IN ESTABLISHING A COMMERCIAL COLLECTION SYSTEM.

32. IMPLEMENTATION OF COMMERCIAL CREDIT MANAGEMENT THROUGH COLLECTION PRACTICES 600
DEVICES AVAILABLE. Single Creditor and Single Debtor. Group of Creditors and Single Debtor. Third-Party Actions. BETTER COLLECTIONS—IS THERE A SOLUTION?

33. MEASURING EFFICIENCY AND CONTROL OF COMMERCIAL CREDIT DECISIONS 615
TESTS OF CREDIT DEPARTMENT OPERATIONS: Bad-Debt Loss. Credit Sales. Collection Percentage, Days to Collect, and Turnover of Receivables. Number of New Accounts Opened and Acceptance Index. Aging of Accounts and Past-Due Index. Cost Analysis. ADAPTATION OF NEW MANAGEMENT TOOLS TO TESTING CREDIT OPERATIONS. THE MEASURED RESULTS.

PAGE

APPENDIXES

APPENDIX
A. CREDIT INSTRUMENTS 627
B. SUMMARY OF STATE INSTALLMENT SALES LAWS 633

INDEX

INDEX 641

PART I

AN INTRODUCTION TO CREDITS AND COLLECTIONS

CHAPTER 1

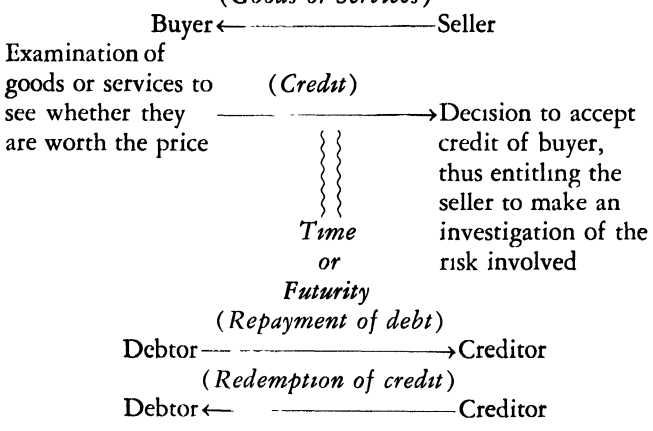
Credit—What It Is and What It Does

WHEN THE word "credit" is heard or seen, different meanings of the term may arise in the minds of those hearing or seeing it. To the family that has just purchased a new television set, credit may mean the only way that such a good could be purchased and enjoyed now but which must be paid for during the future months. To the retailer who sold the set, it may raise the picture of a promise to pay—an account that was established in most instances after careful investigation and that is due and payable on the date or dates agreed upon by the retailer and the family. To the financial institution loaning money to the retailer, it may produce the image of the dollars which were carefully loaned to the retailer to carry on his business and which the retailer agreed to repay at some future time. To the television manufacturer, the word credit may cause him to think of the method by which his goods are usually sold, of the length of time he allows before payment is due, and of the discount allowed for prompt payment.

Credit is thus one of the many social inventions with which we are familiar and which we use freely, whether we be the family, the retailer, the wholesaler, the financial institution, the manufacturer, or any one of the many other institutions engaged in moving goods and services into the hands of the ultimate consumers.

Writers on economic and business subjects have developed a great variety of definitions of the term "credit." When analyzed, many of the definitions proposed are descriptions of credit or statements as to the use of credit, rather than definitions of credit itself. To contribute to an understanding of what credit is, and of what it does, we will, therefore,

FIG. 1–1. How credit works.



think of *credit as a medium of exchange of limited acceptance.* The diagram shown in Figure 1–1 may help clarify this definition.

Medium of Exchange

In the diagram, it is seen that credit acts as a medium of exchange in that it facilitates the passage of goods or services from seller to buyer. Just as money is recognized in our economy as a medium of exchange permitting the easy passage of goods or services between seller and buyer, so is credit recognized.

Early in the development of trade it was found very inconvenient to exchange material things by the process of barter. The use of money, in the form of metallic coin, was a great improvement over barter but was not entirely satisfactory. Paper money was invented centuries ago and was a further improvement of the medium of exchange. At times it is a token, the representative of the metallic money which is held in reserves at a central point; at other times it is simply government credit. Thus paper money represents an attempt to facilitate the process of exchange by the use of a medium of exchange which is more convenient than barter or than metallic money and which is easily recognizable. Governments have generally made the issuance of paper money a government monopoly and have frequently abused their monopoly power.

Even paper money left something to be desired as a medium of exchange. A further improvement in our exchange media was attained by the development of credit. Such credit is not a monetary medium of exchange, although it is created for the same purpose—that of facilitating the passage of goods or services from seller to buyer.

Credit is often a more efficient medium of exchange than the other media for which it substitutes. If all exchanges were made by the slow and clumsy process of barter, much more of our time and energy would need to be devoted to the process of exchanging products, and thus production would be reduced. If exchanges are made by the more convenient device of hard money, there is a definite gain over barter, but the precious metals are still not the most efficient medium of exchange. For the process of circulating metallic coins wears them out, they are lost, and they deteriorate with use. There also is some expense in coinage. Thus in modern economies coins have been replaced in large part by the more convenient and more readily portable paper representative. But even paper money is being replaced by credit because of its greater economy and efficiency. Although the use of credit goes back into the dim dark ages before recorded history, the increased extent of its use in modern times has led us to speak of our times as being a credit era.

Credit, viewed as a medium of exchange, does have particular characteristics. It is a medium of exchange which is created at the time of the transaction and which arises for the purpose of facilitating that particular exchange. It is a medium of exchange which, after being issued, does not close the transaction; there is a promise that at some future time a further step will take place, that the credit will be redeemed by the process known as payment.

The creation of this medium of exchange brings into existence certain rights and privileges. With this thought in mind we may point to the fact that credit is given by the buyer to the seller, and the seller exchanges goods or services for the buyer's credit. It is only after agreeing to accept the buyer's credit that the seller transfers the goods or services.

Limited Acceptance

When a customer offers a merchant a $10 bill today in exchange for a hat priced at that figure, the retailer does not stop to analyze whether the $10 bill should be accepted (except perhaps for caution against counterfeiting) but takes the money, knowing that he in turn will find others highly willing to accept it from him. Thus our metal money and paper money today have a characteristic that can be called "unlimited acceptance." Therein lies the main difference between credit which is generally considered to have limited acceptance and money which has unlimited acceptability.

This limited-acceptance concept of credit is perhaps more clearly understood when reference is made again to the diagrammed definition. While it is true that the buyer has the option of examining the goods or

services to see whether they are worth the price asked by the seller and so deciding offers his credit for them, the seller also has the right to make an investigation of the buyer and to decide whether or not to accept the individual as a credit risk. For in every credit transaction, there is a passage of time before repayment of the debt occurs. It is because of these two elements, "risk" and "time," found in every credit transaction that we say that credit has limited acceptance.

When the two parties to a transaction exchange goods or services for credit, we call them "buyers" and "sellers," but after the exchange we can and do use the legal term indicative of their continuing relationship, namely "debtor" and "creditor." The exchange does not end their relationship, which continues into the future and links them until the credit is redeemed by the exchange of credit of general acceptability, that of money, for the credit of limited acceptability first issued by the buyer and accepted by the seller. Upon payment, the buyer then has his credit returned to him, and he is in a position to reuse this credit in purchasing other goods or services if he can find a seller willing to accept the credit offered.

Documents Simply Represent Credit

Credit is itself an intangible; it may, however, be represented by a tangible document. The document is not credit; it is merely a credit instrument which is evidence of the intangible. These various credit instruments are the concrete, visible, representatives of the intangible. They make the promise, which is basic to the intangible, more definite and specific and more readily transferable. These representatives may be considered more desirable because through the process of legislative and judicial interpretation they carry with them certain legal rights and thus confer certain powers. Although they give exactness and definiteness to the promise, they should not be confused with the reality, which is the intangible, the credit. No strength of the document will give greater strength than is conferred by the quality of the intangible, the promise.

From time to time as we discuss credit operations we shall refer to various documents.[1] Each type has its specific legal definition and its proper use. But the task of credit evaluation must concentrate on the quality of the promise, the intangible, rather than on the representative, the tangible.

Mention should be made at this point as to whether a check should be

[1] Documents are described in some detail in Appendix A.

considered as a credit document. In everyday business operations, checks have become so commonplace that they are viewed generally in the same light as paper money. It should be remembered, however, that in the promise behind every check there are inherent the two elements of limited acceptance—risk and time. True, these elements vary widely in extent and application. But to the merchants who annually cash worthless checks amounting to more than $100 million, these elements are forcefully apparent. Thus, despite the over-all general soundness of check use, checks will be considered in this discussion as a credit document.

The Potential of Credit

Credit may be thought of as a power inherent in all of us—the power to create a medium of exchange. The quantity of this power which each of us can issue depends upon the acceptance we can obtain for it; upon how many persons we can induce to accept our credit and in what amount. Thus for all practical purposes credit as a power cannot be measured.

Quality, however, cannot be separated from quantity—the question is always of acceptable quality for what amount. Relative to quality the question must always be raised concerning the certainty of redemption in accordance with the conditions under which the credit is accepted. The standard of quality is necessarily a variable which ranges from virtual certainty without reasonable doubt to the barest possibility that redemption will be in accordance with the agreed-upon conditions. Obviously the greater the certainty the more readily the credit will be accepted and in larger quantity. Everyone, however, has a quantity limit which is raised by the inability to convince others that additional credit should be accepted in exchange for the goods or services sought. Redemption of outstanding credit is likely to enhance the power to issue additional credit, and an excellent record for redemption in accordance with the previously determined conditions increases the acceptability and the quantity.

Since credit is an intangible which involves the prospect of future performance, acceptability rests on confidence—the confidence that future performance will be consistent with current promises. Such confidence must necessarily rest on an appraisal of available information and a forecast of future circumstances. In any such appraisal we are necessarily limited by the availability of information and the correctness of our interpretation of the information at hand.

The sources of data available to the credit manager to secure accu-

rate, complete, speedy, and reasonable information are numerous. These sources are discussed in detail in several of the subsequent chapters and include information supplied by the credit applicant himself on application forms or through personal interviews, data from direct investigation, facts from in-file ledgers, and information from local retail credit bureaus, the Retail Credit Company of Atlanta, banks, Hooper-Holmes Bureau, Inc., Dun & Bradstreet, Inc., specialized credit bureaus, and other miscellaneous sources. The credit qualities that are covered by these sources of information generally include the applicant's income, employment, payment record, residence, marital status, age, reputation, reserve assets, and references. In certain instances, reserve assets and collateral also are important qualities to investigate. All of these qualities must be viewed, of course, in the light of the current economic conditions prevailing at the time credit is sought.

The power to issue credit is thus limited by the extent to which we can convince others of its acceptability. Such recognition of our power to issue is limited or enhanced by the extent of the information available and by the quality of the information which our lives and conduct have made a part of that record. The credit record we make in the conduct of our affairs is thus the most significant contribution we can make to the enhancement of our power to issue acceptable credit. And an important contributor to this record is the character of our past credit dealings; past redemption in accordance with agreement is a significant portion of this record; but it is importantly modified by the forecast of our future ability to adhere to our promises. The record is basic; the extent of recognition of the record is the other important element. No matter how good our record may be in fact, it remains sterile unless others can be persuaded to validate it by accepting the credit offered them. It is this willingness to accept our credit power which we say rests on confidence.

Credit Is Also Debt

When discussing credit it is easy to forget that credit is also debt. As we have seen, once credit is accepted we can call the parties to the transaction by their technical names, *debtor* and *creditor.* The credit outstanding is a debt, an obligation to pay at some future time. The obligation may be highly formal and embodied in a contract which details the rights and duties of the parties. The obligation may be quite informal, relying upon statutory law and common law, as well as equity, to determine the rights and duties of the parties only when the situation requires formal legal action. But regardless of the formality or infor-

mality of the agreement, the fact remains that a debt exists. This debt must remain until it is discharged by payment or by the acceptance of a new agreement.

The semantics of our language tend to make "credit" a rather pleasant, "debt" a somewhat unpleasant, term. In retail work the credit department may be called the Department of Credit Sales, not the Department of Debt Collections, but the latter term is equally descriptive of the duties. We can refer to statistics of credit outstanding, but we would be equally correct to refer to the debts unpaid. Our banker friends have succeeded in an interesting semantic switch when they concentrate our attention on their deposits as though these were a source of strength when really they represent the obligation, debts, of the bank to their customers. Few businessmen have succeeded so well in making their liabilities appear as their source of strength.

In order to keep our analysis clear we will speak of the "issuance of credit" or the "acceptance of credit," meaning thereby the exchange of credit for other values, but we must remember that the party issuing the credit which is accepted thereby becomes a debtor and thus is in debt; he has a liability to pay.

Credit Is Neither Wealth Nor Capital

Credit is often confused with wealth or with capital. Since it is intangible, it can be neither, because of the definitions used for wealth and capital. "Wealth" is usually defined as scarce material goods that are transferable and useful; "capital" is usually defined as wealth that is used for the purposes of further production. Thus credit, being an intangible, is neither wealth nor capital. But credit does transfer wealth and capital. In the process of transferring wealth or capital, it may make them more productive; that is, more useful than they would otherwise be. A saver, a person having no productive use for the wealth he accumulates, would find that wealth, so long as it remains in his hands, sterile and unproductive. Through credit it is possible for him to transfer his wealth to a businessman who desires to use it productively. The wealth thus becomes more socially useful than it otherwise would be.

Because credit facilitates the transfer of wealth it makes it easier for wealth to be put to more productive uses. In the process of bidding for the right to use wealth, those borrowers who are best able to use it will be able to bid the higher prices for it and/or offer greater certainty of future redemption. This bidding is done through the interest rate which they offer for the privilege of using the wealth of others and through the certainty of redemption which they can provide. The premium paid for

the use of wealth is in itself a stimulus to the additional accumulation of wealth through saving. Wealth which is accumulated and remains idle is unproductive and has no earning power; thus it does not encourage further savings. When wealth can be loaned to others and a return thus obtained, there is more encouragement for an additional expansion of savings and a resulting increase in capital resources. Since in a modern economy the enlargement of productivity is dependent upon the use of capital, credit is productive even though it is not itself wealth or capital.

Use of Credit Can Be Dangerous

Although properly used credit is an efficient medium of exchange and an aid to the productive use of wealth and capital, its use also is associated with some dangers. There are, for example, times when the use of credit permits the capital of savers to be allocated to nonproductive rather than to productive uses. Thus, accumulation of savings may be lost by unwise acceptance of credit.

At times the use of credit can lead to the creation of an excessive or redundant medium of exchange. This may lead to overstimulation of business activity, to inflation and boom, to be followed by a corrective action. Such errors of judgment have widespread repercussions. Because credit joins all units of the economy together intimately, the entire economy suffers as a result of the errors of those who make mistakes in their use of credit. Just as credit benefits all members of the economic community, it can cause all to suffer. Credit is a very sensitive transmitter of economic shocks, which through it are transmitted quickly to the farthest reaches of the economic society.

Because there are dangers resulting from abuses and excesses in the use of credit, it is necessary that this social device be used with care. This means that buyers and sellers, borrowers and lenders, debtors and creditors, credit men and sales managers should all strive to use this important medium of exchange wisely, in effect, to use rather than to abuse the services which credit offers. Each creditor and each debtor should recognize his individual responsibility and strive, so far as sound judgment permits, to avoid the mistakes which interfere with receiving the benefits which are otherwise gained from the use of this highly useful social and business device, credit.

Better understanding of the nature of credit and the role which it plays in our marketing and credit economy will contribute to the care with which credit is used. Debtors who understand the benefits which may be obtained from the use of credit, and the consequences which may follow its abuse, will use their credit more intelligently, more

carefully, in a sounder manner. Credit managers who understand the principles which contribute to the safe use of credit will be more effective and will do a better job of controlling their acceptance of credit. To contribute to this better understanding of the wise use of credit, all should study the subject of credit management, whether they intend to be professional credit managers or merely occasional users of credit.

WHAT CREDIT DOES

For the Consumer

The individual consumer uses credit basically for one of the following reasons: (1) because of a desire to raise his standard of living or to increase his enjoyment; (2) because of the convenience offered by the use of credit; or (3) because of the pressure of necessity.

Unhappily, consumer credit and its use appears to stir emotions, and it is difficult to consider its use without emotional involvement. For centuries, the use of credit by the consumer was condemned by religion and by ethics. It still is regarded by many as being neither respectable nor legitimate. To say that its use is suspected by some is an understatement. It would not further our present purpose, however, to examine the arguments about consumer credit which were so much a part of the doctrine of the early scholars nor to trace the history of its gradual approach to respectability. Suffice it to say that while the journey is not yet complete the developments in recent years have brought the use of consumer credit to a place where it is considered respectable, legitimate, and highly desirable by the vast majority of our American consumers.

Human nature being what it is, the consumer has a desire to raise his standard of living and to gain more enjoyment from life by having more of those goods and services which contribute to these ends. True these may be obtained by a regulated program of saving, but it is difficult to imagine a high-consumption economy such as ours in which everyone saved a sufficient amount to purchase his home without the use of credit. Likewise, it is hard to imagine the present volume of automobile ownership unless some system of "pay as you ride" was available. This is in no sense saying that credit should be used indiscriminately and without care and caution, but it is saying that a credit system such as we have devised has provided the American consumer with the highest standard of living as measured by material goods and services that any civilization has ever known.

Convenience also is a vital reason why consumer credit has come into almost general acceptance. The ease of buying goods and services without the need for the consumer to carry the money with him to pay

for his purchases has been a large factor in his desire for credit. This convenience is making its influence felt more strongly at the present time in the marketing of services than ever before.

Credit as a medium of exchange may well be much more convenient than purchase with cash. Goods can be ordered by word of mouth, by telephone, or by telegram without bothering to send a remittance with the order. Mail orders also are more convenient when the order can be charged. Goods purchased with credit can be received, checked, and inspected before payment.

Payment also may be more convenient when it is settlement of an open account than when it is made for each individual transaction. Many consumers make frequent purchases from the same retail or service concern. It may be more convenient for them to be able to pay for a number of purchases at one time rather than to make payment for each transaction separately.

Necessity does not apply to all types of consumer credit, as many purchases that are bought on credit could be handled on a cash basis, except perhaps for the convenience involved. But in the purchase of higher-priced consumer goods, credit is practically a necessity for a consumer if the sale is to be made. Likewise, loans to consumers by personal finance companies and commercial banks often fall into the category of necessity, especially when the cash loan is made to permit the family to have the necessary medical and hospital care.

For the Retailer and Service Concern Operator

Credit for the retailer and for the service concern operator serves a twofold purpose. First, it enables him to sell more of his goods and services by allowing his customers to purchase these items by offering their credit in exchange. Secondly, it permits him to purchase his own goods on terms that will normally allow him to resell these goods and thus have the money with which to make payment.

Why should the retailer or service operator prefer, or at least elect, to use credit when as a medium of exchange it may be somewhat more risky than other mediums which might be used? One obvious explanation is the desire to sell more goods. Since the buyer of the goods prefers this medium, it becomes somewhat of a patronage inducement to be willing to accept his credit. In fact the extent to which the merchant lowers his standard of credit acceptability will often determine the extent to which he can enlarge his market opportunity. By the acceptance of credit he is able to get a larger volume of business from those customers whose financial resources are limited and who often would not be in a position to make the purchases they desire without the use of

credit. We often speak of credit as being a customary service offered by sellers—while it may be a service, it is one which should not be offered unless there are some very tangible marketing benefits flowing from its use. Looking at this aspect of the operations, it is evident that the retail and service concern is closely connected with the problems of consumer credit and all its ramifications.

Credit also enables the retailer and service operator to purchase his goods and services on a time basis and to pay for them at some future date. Thus the importance of commercial credit appears, as most merchants desire to exchange their credit for the stock of goods which they plan to sell in the future. When by means of credit they are able to stock additional goods, they can increase their working capital, their resources, bringing into their establishments more merchandise than their cash resources permit them to pay for at the present moment. By deferring the time of payment they are enabled to obtain funds from the sale of these goods, either in part or in total, before the time of payment arrives. This, of course, enables them to do more business than they could do if their transactions were limited to their present cash resources. Likewise, the importance of commercial banks and other financial institutions appears, as these provide funds generally needed by most business establishments. Looking at the total aspect of this situation, it is evident that the retail and service concern also is closely connected with the problems of business credit and all its ramifications.

For the Manufacturer

With many manufacturers, their problem is to make certain that their merchandise has the maximum exposure to consumers—more sales will follow when the goods are offered in a large number of outlets. Thus a device that enlarges the number of sellers stocking the line will increase sales. These accounts whose working capital will not otherwise permit them to add to their stocks are accounts which will increase profitable sales. Also, a manufacturer seeking entry into a market in which he is unknown has to overcome the lack of confidence in his merchandise and in himself. Since confidence is likely to generate confidence, or nonconfidence generate nonconfidence, his offer to show confidence by accepting the buyer's credit is more likely to develop acceptance of himself and of his line. The acceptance of credit is likely to generate a series of transactions rather than termination of the relationship with a single sale. Thus credit relations are more likely to be continuing relations. The buyer will tend to continue to patronize the firm where he has established credit and not drift so readily into dealing with a variety of firms. He is more likely to remain a customer.

To be realistic, consideration also must be given to another major factor in a manufacturer's accepting credit; that is, competition with other manufacturers. Some companies that have believed that they were the undisputed leaders in their particular industries or fields have on occasion attempted to tighten credit terms. They have discovered, when competition did not similarly reduce terms, that they were forced because of lost business to return to the former, longer credit terms.

It also should be pointed out that this manufacturer himself makes widespread use of commercial credit in his own buying from his sources of supply. Likewise, he is concerned with the availability of all types of cash (financial) credit. In total, he is vitally concerned with all phases of business credit, but he is not involved directly with consumer credit unless he is distributing his goods to the ultimate consumer.

All of the above comments relating to the manufacturer's use of credit could be applied equally well to wholesalers and other types of middlemen operating in our distribution system.

For Our Economy as a Whole

Ours is a mass-producing, mass-distributing economy. It has been said that credit is the lubricant that makes the system work. One has only to view the total consumer credit figure (see Table 1–1) and to

Table 1–1

CONSUMER CREDIT*
(Millions of Dollars)

End of Year	*Total*
1939	7,222
1941	9,172
1945	5,665
1951	22,617
1952	27,520
1953	31,393
1954	32,464
1955	38,882
1956	42,511
1957	45,286
1958	45,586
1959†	52,046

* Exclusive of home mortgage loans.

† Includes data for Alaska and Hawaii beginning with January and August, 1959, respectively.

Source *Federal Reserve Bulletin*, February, 1960, p 198.

realize that the vast majority of all business credit transactions are carried on through credit to understand that credit is the device that enables this vast machinery to work and work smoothly. Mass production is not possible without mass distribution and mass distribution is not pos-

sible without credit. But the credit involved must be the type that is soundly analyzed and appraised before it is accepted; it must be the type that does not place a burden upon the people and businesses faced with future repayment—a burden that in some instances is so heavy as to remove all benefits and joys from the goods and services received.

CLASSIFICATION OF CREDIT

We have defined credit as a medium of exchange of limited acceptance. We have explained how credit varies from money and have pointed out that credit also may be viewed as a potential in the hands of users as well as a debt once the credit is accepted. The differences between credit and wealth and capital have been noted, and the dangers inherent in the use of credit have been discussed. But throughout this entire introduction, credit has been viewed as one concept and no distinction has been made between the various and diverse types of credit that appear in our economy today. Thus it should be recognized that even though credit in general may be defined as a medium of exchange of limited acceptance, the specific aims and results of the different types of credit are multifold. While many classifications are possible and many have been used by other writers in this field, the following classification is advanced with the view that it permits a practical and workable examination of credit as it is found in our present economy.

Private Credit
- Consumer Credit
  - Merchandise (Retail)
    - Open Charge
    - Revolving
    - Installment
  - Service
    - Open Charge
    - Revolving
    - Installment
  - Cash (banks, personal finance companies, insurance companies, etc.)
    - Single Payment
    - Revolving
    - Installment
- Business Credit
  - Merchandise and Services (Commercial)
  - Cash (Financial) (banks, finance companies, factors, commercial receivable companies, insurance companies, etc.)
    - Long-term Borrowing
    - Intermediate-term Borrowing
    - Short-term Borrowing

Public Credit (Federal, state, and other governmental units.)

It will be noted that credit has been divided into two main classifications according to the form of the debtors' responsibility—private credit and public credit. The names given to these two major groups are indicative of the parties involved. Private credit is concerned with credit of individual ultimate consumers and with credit of private business concerns. It is with the field of private credit that this book is primarily concerned.

Public credit, on the other hand, involves the credit activities of the federal, state, and municipal governmental units. Whereas only limited space is devoted to the study of public credit, it must be recognized that private credit cannot be considered as operating in a vacuum, that is completely separated and apart from public credit. The reason for this is that the use of credit by the various governmental units and by the institutions established to administer public credit has an important influence on the amount and types of private credit found in the economy. In the United States we have numerous governmental bodies—federal, state, and local—and the local become even more diffuse, such as municipal, school districts, sanitary districts, park boards, counties, townships, and similar units. All issue credit of various types. A common characteristic of their credit is that it generally is not self-liquidating but is expected to be retired from the citizens. In addition, government bodies have created a complex set of subsidiary or auxiliary bodies, some of which have the authority to issue credit. In the case of the federal government such agencies as the Commodity Credit Corporation and the Reconstruction Finance Corporation are given authority to borrow money; in the case of some states, their road and bridge authorities or port authorities have this right. The quality of this credit and its acceptance by citizens ultimately rests on the ability of the governing body to service the debt by the collection of tax revenues, in other words the income of the citizens.

Consumer Credit

While the study of credit as a vital function of business was begun early in the 1900's, the attention that has been directed to consumer credit can be considered a present-day development. This phase of credit, which has received increasing attention since the beginning of World War II, may be defined as the medium of exchange that an individual consumer may offer to a seller of goods or services or to a lender of money in order to obtain these items at the present moment on the promise to repay at some future time the debt incurred. In most texts on the subject of credit, the study of consumer credit has been rele-

gated to a decidedly secondary position, with business credit, and in particular commercial credit, occupying the top position. Such an approach does not seem practical, as almost every student of credit—in fact practically every person in America—will at some time in his life come into contact with some phase of consumer credit. The extent to which a consumer uses his credit will, of course, vary, with some individuals perhaps buying only the barest minimum on credit, such as utilities of gas, water, electricity, and telephone, as opposed to other persons who start using their credit extensively early in life and remain in a state of indebtedness throughout their lifetime. Such is not the case with business credit, as many individuals will never have occasion to come into contact with commercial credit and the other types of business credit.

There are three major types of consumer credit—merchandise (or retail) credit which may be broken down further into open charge, revolving, and installment; service credit which also involves open charge, revolving, and installment; and cash credit which is concerned with the loaning of cash to be repaid in single payments, revolving, or installment arrangements.

Merchandise (Retail) Credit. This type of credit is concerned with the sale of goods on the retail level to the ultimate consumer. This sale may take place as an open charge, a revolving credit, or an installment transaction.

Retail Open Charge Credit. If the average housewife were asked what the term "credit" means to her, she probably would think first of her open charge accounts at retail stores, and in particular at department stores, which today have replaced the corner grocery store as the typical credit establishment. This retail charge account enables the customer to purchase goods now and to pay for them usually 30 days later without any carrying charge or expense to the buyer. Any number of purchases may be made, providing that the combined dollar total does not exceed the credit limit that the store feels it can accept from that one individual. Many modifications of this type of credit are found in the retail and service establishments of the nation, with many similar plans appearing under widely varying names.

Retail Revolving Credit. This type of credit is a relatively new development in the field of consumer credit and has some of the characteristics both of an open charge account and of an installment account. Under the most common type of plan a customer is allowed to purchase goods up to a predetermined amount and in return agrees to make a regular monthly payment in which is included a service charge for the

privilege of using this type of credit. So long as the balance due the retail store is below the predetermined dollar amount, the customer is automatically eligible without any further investigation by the store to make additional purchases on her revolving credit account. To many stores, revolving credit has become, since World War II, one of their most important credit arrangements with their customers. Many other stores have just introduced the plan and have not had a sufficiently long experience record to know the benefits and pitfalls of such an arrangement.

Retail Installment Credit. Perhaps the type of consumer credit that has received the greatest attention over the years in the form both of praise and of criticism is retail installment credit. It is this form of credit that is involved when an agreement is reached between the buyer and seller by which payment for the goods is extended over a considerable period of time and by which a carrying charge is levied on the customer for this privilege of delayed payment. It generally involves the purchase of only one item and the installment account is usually secured by some additional legal agreement, such as a conditional sales contract or a chattel mortgage. Retail installment credit which takes many forms and is called by many different names has become a permanent and integral part in facilitating the movement of the higher-priced durable goods into the hands of the American family, thus providing a means of mass distribution needed by a mass-producing economy.

Service Credit. This type of credit is often neglected or overlooked in any discussion of consumer credit, but it should be recognized that this type of credit rapidly has become a customary method of doing business between consumers and business concerns and businessmen dealing in services. The doctor, the dentist, the lawyer—to name only a few—have become accustomed to billing their customers for the services rendered. Today, more than ever before, the traveling American is using credit arrangements to pay for his hotel or motel accommodations and is encouraged to "charge" his rail, air, and bus transportation costs. The use of credit for utilities (gas, electricity, water, and telephone) is almost accepted without thought by most consumers. It should be noted also that in this field of service credit, the three arrangements of open charge, revolving, and installment credit are found.

Cash Credit. Not only does credit facilitate the movement of goods and services to the consumer, but there is another whole field of credit activity in the loaning of *money* directly to the consumer. This money may be repaid under one of three arrangements: (1) single payment; (2) revolving; or (3) installment. Although borrowing for

personal use has occurred throughout history, cash loan credit as we know it today is a development of the past fifty years. Today we find consumer finance companies (or as they are sometimes called, personal finance companies or small-loan companies), commercial or industrial banks (personal or consumer loan departments), credit unions, insurance companies, and other types of lenders serving the needs of their customers through the loaning of money which consumers in turn agree to repay. An interest or carrying charge is almost always included in the amount repaid. The development and rapid expansion of this type of credit has been in response to the definite need for places to which consumers can go to obtain funds to meet emergencies and other vital requirements and which they can trust will not entangle them in such a mesh of legal terminology that repayment is almost a virtual impossibility with skyrocketing borrowing costs characteristic of a "loan shark."

Although there is some controversy as to whether home mortgage loans should be considered a form of cash credit to consumers to be repaid in installments over an extended period of time, consideration will be given in this text to this type of credit which has been badly neglected in the credit literature. The tremendous upsurge since World War II in home building and in home buying urgently calls for a reappraisal and clear understanding of this type of credit. The American family in deciding to purchase a home is almost always committing a larger portion of its future income for this one good than for any other good that it will purchase. The amount borrowed generally will be the largest amount for which the family will offer its credit, and the repayment period certainly will extend over a period of time much longer than that involved in the purchase of any other good.

Business Credit

The second major field of credit appearing in our classification is that of business credit. It will be recalled that consumer credit was defined as a medium of exchange which an individual consumer may offer to a seller of goods or services or to a lender of money in order to obtain these items at the present moment on the promise to repay at some future time the debt incurred. This same definition applies equally well to business credit, if the word "business" is simply substituted for the word "consumer." Business credit is one of the principal means by which businessmen can translate into reality their interpretation of the opportunities that exist to carry on productive ventures. It thus gives businessmen a valuable means by which they may obtain goods and services (or money with which to purchase goods and services) vital to

the successful operation of their business activities. Having performed their customary functions upon these goods and services obtained, the businessmen then endeavor to sell their products for a profit, thus enabling them to repay the debts created. Thus it may be said that business credit is self-liquidating.

Our classification of business credit contains a two-way breakdown: (1) commercial (or mercantile as it is sometimes called) credit, and (2) cash (or financial as it is often called) credit.

Commercial Credit. The most important form of business credit, from the marketing point of view, is commercial credit. This form of credit is the type that enables a business firm to buy goods and services from another business concern and to pay for these items at a specified future time. If a firm sells both to consumers and to other business firms, only the credit sales to other firms are considered to come under the commercial credit classification, whereas the sales to consumers are classed as consumer credit transactions. Commercial credit is perhaps the outstanding example of how our economy operates on a self-liquidating credit basis, with an estimated 90 to 95 per cent of our transactions between commercial and industrial concerns being carried on through the medium of credit exchange (transactions covered by a check payment being considered a credit activity).

Cash (Financial) Credit. As is true with consumers, business concerns also experience the need to borrow money to be repaid at some future time. The sole use of commercial credit would leave most business enterprises short of other working capital requirements. Most businesses use their credit power to borrow cash to acquire both current assets and fixed assets and agree to repay the amounts borrowed over a long-term (over five years), over an intermediate-term (one to five years), or over a short-time (less than one year) basis. The principal sources of business loans are commercial banks, investment companies, insurance companies, factors, commercial finance companies, and individuals.

The first form of credit generally needed by a business firm starting operations is long-term (over five years) credit through which funds are obtained by the concern to enable it to purchase necessary plant and equipment. This long-term credit also is often needed by going concerns to refinance long-term obligations and to secure capital goods for replacement or for expansion purposes. It should be recognized, moreover, that most business concerns have need for additional investment capital for what is called an intermediate period of one to five years to meet the growing needs of a going operation.

Rounding out the needs of a business concern for money is that of

short-term borrowing. The principal sources for this are commercial banks and commercial finance companies. In general, short-term loans from these sources are available to businesses for periods of less than one year and frequently for a maximum of two or three months and are designed to meet the current needs of businessmen for funds that will permit the completion of the production and marketing functions being performed.

OUR APPROACH TO THE STUDY OF CREDITS AND COLLECTIONS

There are many approaches that may be taken in the study of credits and collections. Most of the previous ones have tended to give greater emphasis to business credit, and in particular to commercial credit, and to view consumer credit in the light of a necessary but unwanted stepchild. A quick glance at the table of contents of this book will show that our approach is one which recognizes that consumer credit has come of age and accordingly is awarded its true place of equal significance with business credit.

The social and economic problems connected with credit operations are also discussed. In this a summarization is made of the role of credit in our economy and the influence of credit on the business cycle.

In our discussion of consumer credit, the authors have deemed it necessary to follow first the descriptive approach and to present a picture of present-day credit arrangements that are available between the customer and the retailer, the service concern, and the financial institution. Too often there is the belief that since many of our more common forms of consumer credit have been in force for years, everyone knows about them and understands their operations. Experience has shown that this is anything but true, especially among students who are being exposed to a study of credit for the first time. In this descriptive matter attention also has been directed to the new types of consumer credit that have appeared or have gained importance in recent years—for example, revolving credit and charge account banking operations. More emphasis has been placed on service credit than has been the practice of other authors, as it is believed that this field of credit has grown in stature and importance in recent years and that it will show even greater strides in the future. The tremendous field of home mortgage loan credit is described, because of the vital place it occupies when any study is made of the debt of the American consumer.

After this preliminary descriptive approach, our chief concern then turns to credit department operations, that is, the acceptance of credit

rather than its issuance. The conditions or problems of credit issuance are considered only as they affect the decision to accept or to reject credit offered.

Being interested in the operating aspects of credit, we need to consider the technical knowledge and skills used in credit work, and the management problems and policies. Management of credit operations is no different than management in any field of business. It consists of applying sound principles of management, which are general to all management problems, to the special technical or operational conditions of credit operations. Thus the good credit manager must know the technical aspects of credit work as well as the general management principles. It is desirable at this point to emphasize the fact that while this book treats the problems of credit operation and management of the large firm, in no way is the small businessman neglected. It is recognized that in many instances the owner of the business is the buyer of the goods, the principal salesman, and the credit manager; there is not sufficient business nor adequate funds to establish any form of full-fledged operations. Yet this merchant has his problems of how to carry on his credit transactions in a profitable manner just as much—and in many instances even more so—than the large competitor next door with his highly specialized credit department.

The approach from the point of view of credit department operations and decision making follows the entire procedure step by step as it actually occurs. Once a concern decides to embark upon a credit arrangement and decides to introduce such a policy, it has to decide what type or types of credit to accept, what standards it will use to judge the credit offered, what and how much investigation of the risk it will conduct, where it will secure the information on which to base the credit decision, what guideposts or warning signals it will use in determining the amount of credit to accept, how the credit department will be organized and what techniques of operation will be introduced, what types of salesmanship will be applied by the credit department, how the collection policies and practices will implement the credit management techniques, and finally what tools are available to test the success or failure of a consumer credit and collections operation. It also should be emphasized that not only is the question of "what" action to take covered but of equal or perhaps greater importance is the discussion of "why" such techniques, practices, and policies are adopted.

Practically the same approach is taken in the discussion of the commercial phase of business credit. This is done with the recognition that some duplication may occur. For example, there are certain principles and objectives in collection operations that are common to both con-

sumer and commercial credit but to take up a general discussion of collections after all other phases of consumer and commercial credit are discussed would defeat the plan of following through the consumer credit activity and the commercial credit transactions from their beginning to their logical and final conclusion—payment. Also, it should be recognized that while some duplication may result from this approach, the actions taken in these two major types of credit vary widely in many, many instances. For example, the wage assignment as a method of collection often appears in consumer credit but has no application in commercial credit.

The emphasis that has been placed upon commercial bank and other types of financial credit is limited, as these are topics generally dealt with in special courses in money and banking or corporation finance and investments. Government credit is usually the subject matter for discussion in courses in investments or courses in public finance, although it is also an important consideration of general economics and forecasting.

REVIEW AND DISCUSSION QUESTIONS

1. Credit has been defined as a medium of exchange of limited acceptance. Explain what is meant by this definition. Be sure to use a diagram in your explanation.
2. Why is credit a medium of exchange?
3. What two factors cause credit to be of limited acceptance? Explain the differences between these factors.
4. Why is it recommended that checks be considered to be credit documents?
5. Define wealth. Define capital. Explain why credit is neither wealth nor capital.
6. What are the basic reasons the individual consumer uses credit?
7. Explain why the retailer, the service concern operator, the wholesaler, and the manufacturer use credit in their operations.
8. Discuss the trend in the growth of consumer credit, as shown in Table 1–1.
9. What are the two main classifications of credit? Define each of these two main types.
10. Distinguish carefully between consumer credit and business credit.
11. What are the main types of consumer credit? Explain the basic differences between these types of consumer credit.
12. What are the main types of business credit? Explain the basic differences between these types of business credit.
13. Explain the differences between business credit and commercial credit.
14. Review the organizational plan of the book by studying the chapter titles in the Table of Contents.

CHAPTER 2

The Social and Economic Aspects of Credit

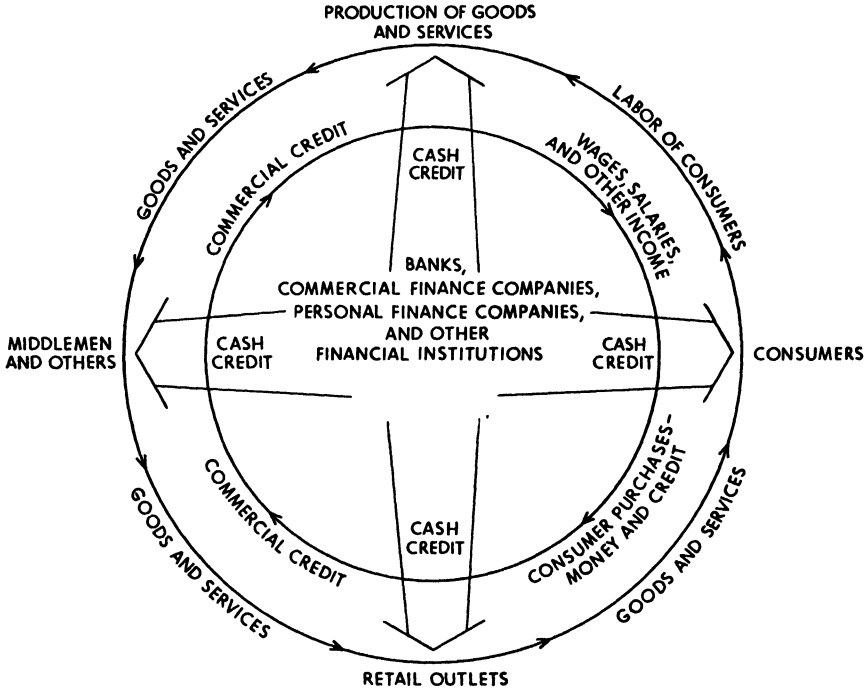
ONLY IN recent years have economists attached significance to the important place of credit in our economy. The reason for this is that several types of credit were of little or no significance in the market place until the middle or late 1920's. For example, consumer credit, whose growth and use is traced in the next chapter, is a phenomenon of only the last three or four decades, but with enormous growth since World War II. In fact, the broadened scope of credit activities by financial institutions serving the credit needs of both consumers and businesses are of quite recent origin. Despite the prolonged use of some types of credit throughout the history of commerce, its widespread use, the development of particular types of credit, and the importance of credit as a device for financing governments, few types of credit were used in sufficient proportions to register an impact on business and consumer life.

Even though each type of consumer credit and each type of business credit represent highly specialized business activities, they nevertheless have far-reaching effects on the social and economic aspects of our nation. The same may be said for any of the public credit used by governmental bodies. Throughout this book the social and economic aspects of consumer credit and business credit are specifically emphasized so as to provide the student with a keener appreciation of the role of credit in our economy. Now that the student has a basic understanding of what credit is, and what it does, and also understands our classification of credit, it is quite appropriate to survey some of the more important social and economic phases of this subject.

THE ROLE OF CREDIT IN OUR ECONOMY

One way of appreciating the importance of credit in our economy is by examination of Figure 2–1. This chart shows the flow of goods and services from point of manufacturer into the hands of consumers. Money and credit is exchanged for these goods and services as they progress through the channels and are finally purchased by consumers. While it is perhaps impossible to accurately depict the role of credit by

FIG. 2–1. The flow of goods and services versus the flow of money and credit.



means of a flow chart, it is desirable to sacrifice precision for the concept. The chart does, however, show the close interdependence which exists between consumer credit and much of the business credit used in producing and distributing the nation's goods and services.

Economists are not in agreement as to the particular forces which generate economic activity. For the purpose of our discussion, we take the view that the chain of events shown in Figure 2–1 commences when consumer demand is stimulated and consumer purchases materialize. Rather than pay cash, either because of greater convenience or because of necessity, many consumers will satisfy their material needs by use of

their credit, or in other words, exchange their credit for goods and services. Retailers of goods and services then are *holders* of consumer credit, and in turn they finance their inventories and other working capital needs by using their business credit. Retailers' inventories are usually financed by middlemen and manufacturers as they *hold* the retailers' credit. This same chain of events repeats itself again and again with the multiplicity of transactions throughout the entire productive, distributive, and consumptive processes.

Financial institutions such as commercial banks, commercial finance companies, insurance companies, and personal loan institutions feed cash credit into the various segments of our production and distribution systems. This is also shown in Figure 2–1. Funds which are loaned to either businesses or consumers are utilized in any number of ways, but most such credit is put to a productive use. Businesses may require additional cash for long-term needs such as financing plant and equipment, or for short-term needs such as financing inventories and other current assets. Likewise consumers have similar long-term and short-term cash needs, as financing real estate purchases and financing durable goods such as automobiles, major appliances, and other goods. The channeling of cash, or cash credit, into the various segments of the economy registers an impact on each using segment. In fact the economic segments are subject to the impact of cash credit supplied by financial institutions as well as the impact of that merchandise credit held by virtue of the flow of goods and services in the distribution channel. This "broad-broom" type of analysis indicates the interrelationships and interdependence of the various kinds of credit. Without this concept of the role of credit an intelligent understanding of its importance is difficult to come by.

Consumers—the Key to Economic Activity[1]

When one begins to analyze the relative importance of the various segments of the economy, he is struck by the dominant role played by the behavior of the American consumer. It is amply implied in Chapter 1 and to this point in this chapter that the consumer is the most important single factor in determining the level of American business activity.

[1] For an excellent and more complete discussion of this subject by an industry spokesman, see paper titled "The Role of the Consumer—and of Consumer Credit—In Our Economy," by Dr. Ernst A. Dauer, Director of Consumer Credit Studies, Household Finance Corp. Chicago, Illinois. This paper was presented by its author during 1958 at workshops for Economic Education at several Midwest colleges and universities. Copies are available from his firm upon request.

It has been only in recent years, namely since World War II, that consumers' reactions in the market place have been recognized as playing the dominant role of setting the pace and level of much production and distribution of goods and services.

During peacetime years consumer purchases of durable goods, nondurable goods and services account for 60 to 65 per cent of the gross national product. This has been true throughout the 1950's despite heavy government purchases and expenditures for national security. Another valuable observation is the fact that for almost three decades American consumers have spent more than 90 per cent of their disposable income (personal income less taxes). The only exceptions to this are the depression years of 1932 through 1934 when they spent more than they earned and during the World War II years when savings rose rapidly because there were only limited goods available to them.[2] In general, consumers can be relied upon to spend a heavy proportion of their incomes on goods and services. The stability of these expenditures is very great because, despite the added millions to the middle-income groups during the past 20 years, few consumers have an excess of income.

The more modern approach, then, is to regard business behavior as a product of consumer behavior. In other words, the quantities of goods and services purchased for industrial use, and the eventual flow of finished goods through the channels of distribution are based on the businessmen's forecasts of what the consumer is expected to do. In this country where the consumer has the freedom to choose how he spends his income, and also the freedom to shift his purchases from product to product, the consumer is the *key* to business health. During 1957 and 1958, for example, consumers decreased the proportion of their incomes spent on durable goods, particularly automobiles, and this caused unemployment in the automobile industry.

Credit comes into this picture, because of the large number of families who use it and because of the enormous amounts of credit built up as a result of consumer purchases. Of the $52.0 billion of total consumer credit outstanding at the end of 1959, about $39 billion was installment credit representing purchases of automobiles, major appliances, and a number of other durable consumer goods.[3] These figures do not take into account the turnover of consumer credit, but even without the turnover factor its great impact on the productive and distributive segments

[2] See the past and current issues of *Survey of Current Business, National Income Number,* U.S. Department of Commerce, for exact year to year changes in these data.

[3] See Table 3–2, p. 44.

of the economy is apparent. But this credit, and for that matter consumer cash purchases, does not function in a vacuum. Instead consumer purchases (credit or cash) indirectly generate the need for most business credit, the amounts of which are determined by the production and distribution needs required to satisfy consumer demand.

It is now desirable to point out that credit in our economy is best visualized as follows:

As an Aid to Mass Production. Credit makes possible the productive genius of the nation's enterprises by providing the means by which manufacturing opportunities can become a reality. As markets for goods and services expand, and/or contract, a manufacturing firm's credit stands ready as a flexible device to finance its operations. When businesses forecast profitable and expanding market opportunities, the need for business credit expands in order to finance at least a portion of the larger operations. Conversely, as the business outlook and opportunity appears to be declining the need for credit declines, but the proportion of the business financial burden carried by credit may increase.

As an Aid to Mass Distribution. Without mass distribution its counterpart—mass production—would not be possible. A mass-distribution system is an essential to the objectives of a mass-production system and again credit plays an important role. It is not enough that vast quantities of goods and a great variety of goods move through the marketing channels. The goods, services, and the marketing institutions themselves must be financed in one way or another. At each successive stage of distribution larger inventories and expanded business operations must parallel the accomplishment of the mass-distribution task. Credit's role is to provide the financial means thereby permitting businessmen to take advantage of expanded market opportunities. Larger inventories, for example, can be financed by the commercial credit transactions between suppliers and resellers. Payment for the broader and deeper inventory lines is deferred until such a time as the merchandise is sold. Consequently, middlemen can be more flexible in their decisions to take advantage of market opportunities not otherwise possible by the use of their own limited financial resources.

As an Aid to Full Employment. The employment of labor to produce goods and services is of course dependent upon businessmen's forecasts of future market expectations, which in turn are importantly influenced by consumers' desires and their ability to fulfill these desires. Consumer credit itself is a vital link between mass production and mass distribution because it functions to give most consumers the power to buy goods and services over and above their limited cash resources.

Credit in the hands of consumers does not entirely influence the level of their consumption, but it does give them the potential of registering a significant impact on the quantity of goods and services consumed. Most American families depend on credit to help them acquire many of their high-priced goods and services and their great inclination to use their credit indirectly influences the level of employment. Today, for example, the *major* proportion of new homes and new automobiles is financed by means of installment credit, and a *substantial* proportion of all other "high-ticket" items is acquired in the same way.[4] Quite obviously, if the families of today were required to pay cash for their homes and other high-priced consumer items, the demand for these products would be sharply curtailed.

It should also be noted that business credit is an aid to full employment inasmuch as it permits businessmen to expand their operations. This function of credit is discussed in the earlier paragraphs of this section. Expanded business operations often has its counterpart the employment of more labor.

As an Aid to a Higher Standard of Living. American families enjoy the highest standard of living in the world and much of it is attributed to the abundant use of consumer credit. The mass demand for consumer durables, stimulated by consumer credit, could become a reality only by a change in the attitudes toward credit. It was not until the mid-1920's that businessmen generally recognized consumer credit as an effective tool for increasing sales of high-priced items; and similarly, consumers changed their philosophies with regard to their use of credit to acquire the "better things in life." Today, rather than forego the enjoyment of a higher standard of living by saving their money, families use their credit to acquire durable goods. In this way they enjoy the goods, the higher level of living, and pay for them by means of "forced savings."

The widespread acceptance of credit as a socially desirable and safe medium with which to purchase durable goods has undoubtedly made possible the present scale of production of automobiles, refrigerators, automatic washers and dryers, television, and many other durable products. Business credit as the device which aids the mass production and flow of goods in the channels of distribution, and finally consumer credit in the hands of consumers have made it possible for almost all families to share the products of our industries. We now enjoy these products on a scale unequaled in less advanced economies.

[4] See p 113 Chapter 6 and p. 164 Chapter 8 for specific data on the per cent of selected items so financed.

CREDIT AND THE BUSINESS CYCLE

All credit, whether consumer credit, business credit, or government credit can function as an activator or stimulant of business cycle fluctuations. Contrariwise, credit may also function to aggravate contracting phases of the business cycle.

In recessions and during periods of marked business declines business purchases and consumer purchases are contracted to a level more in keeping with general economic conditions. As buyers (business and consumer) decide to reduce their purchases the need for their use of credit declines, and accordingly the volume also declines. On the other hand, during the recovery phases and prosperity phases of the business cycle, general optimism prevails among businessmen and consumers. The optimistic outlook results in increased purchases and the use and volume of both business credit and consumer credit begins to increase. During sustained periods of prosperity the influence of the high level of economic activity is generally reflected by a continuing high or increasing volume of credit.

Business credit and consumer credit also play some part in weakening economic forces during recessive stages of the business cycle. During the recession stages credit men are torn between two opposing considerations. On one hand they would like to aid in maintaining sales volume and even help to increase sales by relaxing their credit standards, but this adds to the risk of an already poor situation. So, on the other hand they, too, are influenced by conservatism, the need to reduce risk, and generally they regard their customers as a deteriorating lot. Theoretically, the expansion of credit during the declining phases of the cycle will contribute to a softening of the trend downward. Practically, however, credit men, and for that matter their companies' managements, are not willing to act as public benefactors during this time. Instead they tend to adopt a policy of "tightening standards, limiting extensions, and pressing for collections." There is no question that this attitude tends to reduce sales (consumer and business) to a level much lower than safety might dictate. Perhaps most affected by these policies are the weaker buyers. The financial restraints placed on weak business concerns can be so great that they fail for want of financed working capital.

In a later stage, as general economic recovery prevails, credit men reverse their policy and now aid in increasing sales volume by accepting the credit of the marginal buyers. The upswing of business conditions may be considerably exaggerated by credit men who now become over-

confident and they tend to evaluate their customers' credit standing generously.

During sustained periods of business prosperity it is perhaps true that credit men, their standards of acceptability, and their thinking with regard to risk taking approach greater normalcy. What the norms should be is very difficult to establish because each creditor is heavily influenced by his own operating and financial condition. But, it is perhaps accurate to state that a higher degree of credit objectivity and normalcy will prevail during periods of sustained economic optimism. Such has been the case during the 1920's and the more recent 1950's.

EVALUATION OF THE ROLE OF CREDIT IN THE ECONOMY

Despite the important role played by credit in our economy there is not unanimity among economists as to its effects and its desirability. There also are many consumers who view the use of credit in acquiring material things as dangerous and imprudent. Some of these same attitudes and beliefs are held by economists because of their refusal to regard the consumption function as the dominant objective of economic activity. Furthermore, commercial credit which is heavily emphasized in this book has often been overlooked as an important device for financing the short-term needs of businessmen. The authors are of the opinion that in the future a growing amount of emphasis and economic significance will be given to both consumer credit and commercial credit. If this does occur many of the views stressed in the preceding pages will be more universally understood.

Consumer credit is often singled out for attack by economists who are responsible for advising the President of the United States. With the exception of a few postwar years the President's economic advisory council has viewed with alarm the volume of consumer debt. As recently as late 1959, the chairman of the President's economic advisory council warned the nation's bankers not to get involved in a great splurge of consumer credit expenditures. He further warned that the too-rapid expansion of credit in 1955 was partly responsible for the recession of 1957–58.[5] These views are the same as those criticized in Chapter 3 because we believe the absolute volume of credit has little meaning unless it is evaluated in relation to other economic factors.[6] It seems quite appropriate that we should expect this type of credit, as well as the other types, to expand along with the recent expansion of other economic fac-

[5] *Time*, November 9, 1959, pp. 91–92.

[6] See pp. 49–52, Chapter 3

tors. Credit men, however, should not lose sight of the social implications when credit standards are lenient and families are encouraged to overobligate themselves and not be prepared for periods of financial setback. It is perhaps well to consider the desirability of individual credit transactions rather than the aggregate data. This seems desirable because, in general, American families have in the past successfully met their obligations to creditors. But, when an individual family is subject to the pressures of too much debt part of the blame lies at the feet of creditors.

At this writing it appears as though credit will play an ever-increasingly important role in our economy. Those who refer to ours as a "credit economy" are apparently accurate in their description of its role, inasmuch as credit has replaced to a marked degree the use of cash as a medium of exchange. This is true for an increasing proportion of transactions by government, business, and the consumer. There are also a number of underlying tendencies to expand the opportunities for consumers to buy on their credit. Almost every conceivable line of merchandise and most consumer services appear destined for purchase by means of credit.

Another observation at this writing may have even more significance in the immediate future. An increasing number of state legislative bodies have taken steps to examine prevailing interest rates on consumer loans and service charges on merchandise sold on the time payment plan. It now appears that within the next few years more states will enact legislation and hence exert more control over consumer credit activities. The objective of most of these laws has been, and in all probability will continue to be, to abolish the socially undesirable aspects of credit created by a few credit grantors and lenders. If state laws are necessary to wipe out some of the existing abuses of creditors then this remedy appears justifiable as a social advancement. Credit, the same as money, can ill afford even a nominal amount of abuse by its users.

As the reader progresses through this book he should take particular note of the specific references and discussions which are further elaborations of this important topic. By doing so, the reader's knowledge in regard to the social and economic aspects of credit will be enriched.

REVIEW AND DISCUSSION QUESTIONS

1. Why is it that only in recent years economists have attached significance to the role of credit in our economy?
2. In what ways are the various types of consumer credit and the various types of business credit interdependent?

3. To what extent do personal consumption expenditures affect the economic activity of the nation?
4. Does credit play any role in the consumption expenditures of American families?
5. As a businessman, what advantages do you see in the intelligent use of business credit?
6. Explain how credit functions as an aid—
   a) To mass production.
   b) To mass distribution.
   c) To full employment.
   d) To a higher standard of living.
7. What are the theoretical and practical workings of credit throughout the various stages of the business cycle?
8. Why don't credit men attempt to expand credit during the recession phases of the business cycle when it is perhaps most needed?
9. Can the overexpansion of credit, as claimed to have occurred in 1955, be a contributing cause to a recession a few years later, such as experienced in 1957–58?
10. What evidence exists today which would indicate an expansion of the opportunity for consumers to satisfy their wants by use of credit?
11. What are the more important social implications of the widespread use of credit?

PART II

CONSUMER CREDIT

CHAPTER 3

Growth and Use of Consumer Credit

THERE IS A strong tendency for most people to regard the growth and widespread use of consumer credit as a modern business development. It is quite true that most of our modern-day credit institutions are of recent origin, but consumer credit itself dates back to ancient times. The story of consumer credit development, like so many other business phenomena, is one of dramatic change and growth. A brief look at some of the early uses of consumer credit will increase our appreciation of its importance today.

USE OF CONSUMER CREDIT

Early Use of Consumer Credit

The buying of goods to be paid for at some later date and the borrowing of money to be repaid sometime in the future are prehistoric practices. There is much documentary evidence that consumer credit played an important role in ancient societies. Some of this evidence has been uncovered by archeologists while the Bible provides us with numerous references to creditor practices, credit regulations, and the actions of debtors. Writers of history tell us of many early uses of consumer credit. For example, Paul Einzig, an English monetary authority, points out: "Credit existed on a fairly extensive scale long before the stage of money economy was reached."[1] He makes reference to the fact that in many primitive societies, with no trace of a medium of exchange, transactions involving credit in kind played an important part in the life

[1] Paul Einzig, *Primitive Money* (London: Eyre & Spottiswoode, 1949), p. 372.

of primitive communities. Even before the development of barter, credit existed because of discrepancies between the values in goods or services traded or because deliveries had to be deferred due to natural conditions. Typically, a creditor would loan seed to a debtor who would repay his debt out of the next harvested crop. Primitive man appears to have used his credit for other reasons too. Rents for land and shelter were fixed in kind over long periods of time and loans were made so as to enable debtors to pay ". . . ransom fines, tribute, blood money, bride money . . ." and to carry on trade.[2]

Turning now to the early history of the United States, we find much interesting evidence of consumer credit practices. A case in point is Wilbur C. Plummer's informative study of consumer credit in colonial Philadelphia.[3] In this early period of United States history Philadelphia merchants were accustomed to sales on credit for all kinds of commodities and services. Plummer's examination of professional and business records shows conclusively that it was common to transact the major proportion of business on credit. In fact, he writes ". . . it seems certain that credit rather than cash was the rule."[4]

It is impossible to draw reliable conclusions on the volume of consumer credit during these early periods. Reliable data were not gathered on this subject until 1930 by the U.S. Bureau of the Census. Despite this limitation of data several types of consumer credit-granting institutions are known to have developed in the period from 1800 to the Civil War. The merchant, the physician, and the pawnbroker were the principal agencies of consumer credit. Business records and advertisements of some early businesses and professional men are available in museums and certain libraries. These sources of data permit historical researchers to make reliable generalizations on the growth and uses of consumer credit during the formative years of the United States.

Merchants, prior to the Civil War, not only sold merchandise on the open-book account but they sold pianos, organs, sewing machines, stoves, and the like on the installment plan. Service credit was granted principally by physicians and dentists. Credit extended by physicians is the earliest type of service credit and much of it was uncollectible. This was caused by the ethics of the medical profession which provided services without regard to ability to pay. Pawnbrokers were the first agency to make cash loans to the consumer in this country. By 1800 they were

[2] *Ibid.*, pp. 372–73.

[3] Wilbur C. Plummer, "Consumer Credit in Colonial Philadelphia," *Pennsylvania Magazine*, October, 1942, pp. 385–409.

[4] *Ibid.*, p. 409.

operating in New York City, Philadelphia, and Boston on an extensive scale. In certain respects the pawnbroker is not a consumer credit agency because their transactions involve no explicit promise to pay. Their claim is against the property which is pledged in exchange for the cash loan. Technically, the transaction is a conditional purchase of the "borrower's" personal property. In this respect the pawnbroker resembles a merchant more closely than a consumer credit agency.[5]

Consumer Credit between the Civil War and 1920

During this period of United States history dramatic economic changes took place. Large numbers of people were drawn from farms to industrial cities; manufacturing industries became firmly rooted and prosperously large; the interior territories of the country grew rapidly; and many department stores and chain retail institutions had their origin during this period. Paralleling these developments were the more widespread extension of installment credit, the rise of the small loan business, and the origin of several important consumer credit institutions and associations.

The credit policies that characterized the period prior to the Civil War were liberalized shortly thereafter and goods of many descriptions were commonly sold on the installment basis. Pianos, organs, melodeons, and stoves were sold on liberal terms and low down payments. Nugent writes, "By 1870 furniture dealers in the principal industrial cities had begun to sell goods on small down-payments and long-term contracts to wage-earners of very modest incomes."[6] Newspaper advertisements of retailers in the larger cities offer much evidence of a general liberalization of credit terms during this period.

The small loan business had its origin in Chicago about 1870 and spread rapidly to the principal cities of the East and Middle West. Household Finance Corporation, the largest personal loan company in the nation, was established in 1878. Other well-known companies in this field had their origin at about the same time. The more successful personal loan companies organized chains of offices which operated over wide geographical areas. This type of consumer credit grew so rapidly that by 1910 the two largest companies had more than 100 offices in operation and several companies had more than 30 offices. A large number of single-office companies had come into being by 1910. Small personal

[5] Rolf Nugent, *Consumer Credit and Economic Stability* (New York: Russell Sage Foundation, 1939), pp. 42–64. This is the definitive book in the field. The first several chapters of this book are an excellent reference for the student who desires an authoritative account of the early growth and development of consumer credit in the United States.

[6] *Ibid.*, p. 66.

loans to wage earners were the outgrowth of the sociological changes of the times. Wage earners, out of necessity, required personal loans to pay debts, meet emergency needs, and to compensate for differences in income and expenses. The origin and rapid growth of the small loan business are testimony to the fact that a large proportion of the American families and individuals had no source of funds with which to meet emergencies. For the most part this group of cash lenders loaned money on the security of chattel mortgages on household furniture, wage assignments, or on unsecured promissory notes. It was many years later that banks of the United States recognized cash loans to consumers as a legitimate phase of their operations.

In 1907 and 1908 the Russell Sage Foundation financed studies of the personal loan business which had attracted many lenders who charged exorbitant rates of interest, practiced deception, and utilized questionable collection practices. After careful investigation, the Foundation concluded that the most effective way of combating usurious lending and other questionable practices was to legalize an interest rate on small loans that would be sufficient to attract reputable businessmen into the business. In 1911 Massachusetts enacted a consumer loan law based on the findings and recommendations of the Russell Sage Foundation. One state after another enacted the Uniform Small Loan Law. This law was originally drafted by those lenders willing to submit to regulation. The law has since served as a model and basis for legislation in most states. Today more than 30 states have adopted legislation based on the original provisions of the Uniform Small Loan Law.

With the growing demand for small loans and the need for legitimate organizations to meet the demand, the credit union and industrial bank developed in the United States. The first credit union was organized in 1909 in Manchester, New Hampshire, and within several years there were 142 credit unions operating in six states. Paralleling this rapid development was the growth of the industrial bank. Credit unions are co-operative associations, while industrial banks are business corporations. Further discussion of these cash lending associations will be found in Chapter 7.

It is impossible to be entirely accurate concerning the quantitative developments of consumer credit during this period. Accurate interpretation of consumer credit developments is hampered by the lack of complete statistical data. However, some general conclusions can be drawn concerning the consumer credit development during this period. With the growth of population and retail sales, there can be little doubt that the over-all scene was one of greater use of consumer credit facilities.

The fact that many of our present-day institutions had their origin during this period seems to establish the growing demand for consumer credit of all types. The growth of consumer credit reporting agencies closely accompanied the growth of consumer credit granting. As early as 1906 thirty credit reporting bureaus banded together to provide for an interchange of information. This amalgamation arose from the need for credit information as to the extent of obligations existing at any one time against an individual.[7] Singular developments of this nature could not have come about except for the rapid and widespread use of consumer credit in our economy.

Consumer Credit between 1920–30

The automobile, the electric washing machine, the vacuum cleaner, and other household goods made great strides during this period. Consumers began to enjoy a wider variety of goods, many of which contributed to an increased enjoyment of life. The widespread use of such merchandise called for even greater utilization of consumer credit. Several hundred sales finance companies were established during this period. Many of them grew to large proportions in a matter of a few years.[8] Paralleling this development other consumer credit institutions had similar growth and development, as the greater variety of goods found their way into American homes. Merchants who formerly had regarded installment selling with skepticism now began to regard time payment plans as an integral part of their merchandising program. While this type of selling was enjoying a rapid growth and was gaining a more respectable place in the American economy, the cash lending institutions were also registering dramatic change. From 1923 to 1929 the number of regulated small loan offices increased from about 600 to approximately 3,500. The services of these institutions were in such great demand by American households that they increased their loan balances sixfold.[9] This rapid growth followed closely after the enactment of small loan laws in many states. Credit unions, industrial banks, and the personal loan departments of commercial banks underwent rapid growth and their loan balances increased in similar proportions. In 1928 The National City Bank of New York organized a personal loan department. This step, by then the largest bank in the world, was

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[7] Frank T. Caldwell, *Credit Bureau Text and Reference Book* (St. Louis: Associated Credit Bureaus of America, 1940).

[8] Thomas W. Rogers, *The Development of the Sales Finance Industry in the United States* (Chicago American Finance Conference, 1954).

[9] Nugent, *op. cit.*, p. 99.

met with mixed reaction in banking circles. Soon thereafter, however, many other banks took the same step and actively entered the consumer finance field.

The developments cited in this section indicate in general a decreasing prejudice against installment selling and small loan operations. The retail charge account expanded to greater proportions during this period. This type of consumer credit was accepted by more stores, and a greater number of families began to enjoy its benefits. As the retail charge account came into widespread use, retail merchants began to recognize credit accommodation as a competitive force. It took only the

Table 3–1

PROPORTION OF TOTAL SALES TO KIND OF CREDIT SALES
January–June, 1930

Type of Retail Store	Per Cent		
	Cash	Open Credit	Installment
Department	47.4	45 6	7 0
Furniture	8.5	27.8	63.7
Jewelry	24 0	56.4	19 6
Men's clothing	42 4	54 6	3 0
Shoes	58.4	41 6	
Women's specialty	42.7	56 5	8
Electrical appliance	12 7	16.3	71 0

Source, *Retail Credit Survey, January–June, 1931*, U S. Department of Commerce, Domestic Commerce Series No. 53, p 2

short span of years during this period for credit to become firmly established as a retail promotional device. Retail store customers in increasing numbers commenced to "expect" this service.

It was generally apparent toward the end of this period that consumer credit had become an important force in the American economy. The first organized attempt to collect and analyze consumer credit statistics was made by the Bureau of Foreign and Domestic Commerce of the U.S. Department of Commerce. These studies were undertaken at the request of the National Retail Credit Association, which reflected the wishes of a large proportion of the country's retail merchants. The first published analysis of consumer credit statistics revealed that a sizable proportion of total retail sales were credit sales. Table 3–1 is a summarization of the data for January–June, 1930. The economic importance of consumer credit which had been claimed by many students of the subject now became a realistic fact as shown by these data. Hence, the period from 1920–30 was one in which consumer credit

became a common occurrence for many American families, as more and more merchants adopted the policy of selling their merchandise for credit as well as for cash.

The Pattern of Consumer Credit since 1930

The American economy has been subjected to a series of strenuous tests since 1930. In September, 1929, the stock market collapsed and the so-called Great Depression ensued. After a brief period of recovery the United States was plunged into World War II. After almost four years of intensive war effort, 1946 marked the beginning of a decade or more of great prosperity and inflation. These diverse conditions affected the growth and use of consumer credit in many ways. A study of the pattern of consumer credit during these periods is both interesting and revealing to the student and practitioner.

For all of the years since 1929 reliable statistical data are available and are currently published in the *Federal Reserve Bulletin.* An analysis of consumer credit statistics shows that fluctuations in the volume of consumer credit are closely related to general economic conditions. All types of consumer credit are somewhat deflated during prolonged depressions and conversely inflated when the nation is prosperous. From the graphic presentation in Table 3–2, it can be seen that the volume of consumer credit reflects to a marked degree general business conditions. During the period of the Great Depression depicted in Table 3–2 it will be noted that charge account and service credit deflation were moderate as compared to installment accounts and single-payment loans. This may be accounted for by the fact that installment credit and single-payment loans are utilized for different reasons than service credit and the charge account. The latter two types of consumer credit are primarily a convenience to the customer, whereas the former types come into use by virtue of necessity. Another fact which may explain this phenomenon is that during hard times consumers have a greater tendency to cut back rapidly on merchandise of high unit value. Further, it may be added that charge account credit and service credit represented a relatively small volume of the total credit and they are generally considered nonpromotional forms of credit. It is quite obvious from these data that consumers drastically adjusted downward their purchases of durable goods during the early 1930's. Purchases of automobiles, radios, household appliances, and other items of high unit value could well be postponed, whereas the purchase of merchandise or services for "everyday living" could not be as readily delayed.

The rapid deflation of consumer credit continued until 1934 when an

upturn in general business conditions began. By 1936 and continuing through 1941, the recovery from the Great Depression had come about. Relatively prosperous times followed the depression, as the United States became an arsenal for its allies who were involved in the early stages of World War II. It is well to note that installment credit, which resulted principally from the sales of new and used automobiles, led the expansion of consumer credit just as it led the earlier deflation.

The World War II period shown in Table 3–2 is one which is characterized by a scarcity of consumer goods. The mass production facilities

Table 3–2

VOLUME OF CONSUMER CREDIT BY MAJOR TYPES
(Millions of Dollars)

Period	End of Year	Total Consumer Credit	Install-ment	Single Payment Loans	Charge Account	Service Credit
	1929	6,444	3,151	1,112	1,602	579
	1930	5,767	2,687	1,037	1,476	567
	1931	4,760	2,207	772	1,265	516
The Great Depression	1932	3,567	1,521	549	1,020	477
	1933	3,482	1,588	450	990	454
	1934	3,904	1,871	493	1,102	438
	1935	4,911	2,694	575	1,183	459
	1936	6,135	3,623	707	1,300	505
	1937	6,689	4,015	797	1,336	541
	1938	6,338	3,691	777	1,362	508
Recovery	1939	7,222	4,503	787	1,414	518
	1940	8,338	5,514	800	1,471	553
	1941	9,172	6,085	845	1,645	597
	1942	5,983	3,166	713	1,444	660
	1943	4,901	2,136	613	1,440	712
World War II	1944	5,111	2,176	624	1,517	794
	1945	5,665	2,462	746	1,612	845
	1946	8,384	4,172	1,122	2,076	1,014
	1947	11,570	6,695	1,356	2,353	1,166
	1948	14,398	8,996	1,445	2,673	1,284
	1949	17,305	11,590	1,532	2,795	1,388
	1950	21,395	14,703	1,821	3,291	1,580
	1951	22,617	15,294	1,934	3,605	1,784
Postwar Prosperity	1952	27,520	19,403	2,120	4,130	1,867
	1953	31,393	23,005	2,187	4,274	1,927
	1954	32,464	23,568	2,408	4,485	2,003
	1955	38,882	28,958	3,002	4,795	2,127
	1956	42,511	31,897	3,253	4,995	2,366
	1957	45,286	34,183	3,364	5,146	2,593
	1958	45,586	34,080	3,646	5,060	2,800
	1959*	52,046	39,482	4,176	5,351	3,037

* Includes data for Alaska and Hawaii beginning with January and August, 1959, respectively.
Source Board of Governors of the Federal Reserve System.

of the entire nation were quickly converted to production for a wartime economy. Consumer durable goods of all types virtually disappeared from the retail stores, as the raw materials used in their manufacture were diverted to war goods. Only the essential consumer goods remained available, often at a sacrifice of quality. Here again installment credit led the deflation of consumer credit. Even though the American worker had increased earnings to spend, he found little on which to spend his money. Hence, personal savings rose to the highest level ever recorded. It should be noted that charge account credit and service credit volumes increased during the war. The higher levels of charge account credit which were attained may be explained by the increased ability of consumers to maintain a high-level consumption of those goods which were available in retail stores. The service credit increase seems to reflect the ability of the American consumer to seek professional services which could easily have been postponed during the previous decade.

Since the end of World War II the growth of consumer credit has been phenomenal. In one decade, from the end of 1946 to the end of 1956, consumer credit expanded more than five times. The postwar prosperity saw the vast production facilities of American industry turned to the production of consumer goods. Not only did American industry produce consumer goods at an unparalleled pace, it also provided a greater variety of goods than the American consumer had imagined possible. Since 1950, the vast majority of consumers have bettered their standard of living by purchasing the outputs of industry. Automobiles were purchased at an unprecedented rate; black and white or color television became a reality to the vast majority of American households; dream kitchens and completely modernized household laundries have relieved the housewife of much of the drudgery of the homemaking tasks; hi-fi, deep freeze units, and large and small appliances of every description became commonplace in millions of American homes. Consumer credit facilitated the mass distribution of these goods inasmuch as the major proportion of consumer durable goods were purchased through the consumers' utilization of their credit. The mass production and attendant mass distribution of consumer durables would most certainly not have been possible without the widespread use of consumer credit. During the short span of years since World War II the American consumer has reached a level of living which is the envy of those in less fortunate nations. The American consumer, whether at work, rest, or play enjoys the advantages of our productive genius and capacity which is afforded him by our consumer credit structure. Future expansion of living standards and consumer markets will most certainly be accompanied by additional surges of consumer credit.

CONSUMER CREDIT—AN ECONOMIC FORCE

Those economists who have closely observed consumer behavior in the market places recognize consumer credit as a powerful force. It is clearly evident in Table 3–2 that the expansion of consumer credit parallels periods of rising prosperity; conversely, it contracts in periods of declining business activity. This phenomenon is evident to some extent in the late 1920's, but to a much greater extent in the late 1940's and in the 1950's. In periods of prosperity consumer credit exerts an inflationary influence and can add to the pressures which drive prices upward with a consequential cheapening of the dollar. An important factor in the expansion of capital goods is the demand for consumer durable goods which in turn can be greatly stimulated by expanding consumer credit. When full employment or near full employment prevails, consumers have a tendency to purchase durable goods which otherwise may have been delayed. Some durable goods purchases are made that may not have been made at all. These tendencies result in consumer credit expansion which is one of the dynamic factors exerting an inflationary influence on the economy.

One is able to detect the inflationary and deflationary periods by observing the rate at which installment credit is extended and at which it is repaid. These data are published monthly by the Federal Reserve System. When the amount of new installment credit exceeds the amount of repayments, it is said to be inflationary. On the other hand, when the rate of repayment of outstanding debt is greater than the amount of new debt extended it is said to be deflationary. The liquidation of installment debt in particular is precisely what occurred between 1929 and late 1932 as repayment of debt was being accomplished at such a rapid rate that the volume of consumer debt fell to about 1.5 billion dollars. The year 1955 is an appropriate example of consumer debt exerting an inflationary influence as the amount of credit extended greatly exceeded the repayments. By way of contrast most of the year 1958 was definitely a recessional period. Whereas total consumer credit reached $45.3 billion by the end of 1957, by July, 1958—only seven months later—the total had declined to $42.9 billion. From there it moved up slowly, reaching $44.0 billion by November, 1958, and jumping again rapidly to $45.6 billion by the close of the year.

When the amount of new credit extended just about equals the amount of repayments, the total volume of consumer credit remains constant and is neither deflationary nor inflationary. Inasmuch as many

business decisions are influenced by the rate of consumption of consumer goods it can readily be seen that consumer credit, especially installment credit, is an important economic factor.

Government Regulation of Consumer Credit

The expansion of consumer credit during periods of rising prosperity and its inflationary impact on the economy has caused some to view with considerable alarm the use of consumer credit. In the recent past, the question of curbing the use of consumer credit has arisen each time that general economic conditions tended to indicate a period of inflation. The proponents of consumer credit regulation were successful in seeing Regulation W imposed during World War II, during the postwar period until 1948, and again during the Korean conflict. As a selective control imposed on a particular segment of the economy, Regulation W was issued by the Federal Reserve System as an anti-inflationary measure. During World War II all areas of consumer credit were covered by Regulation W, while during the other two periods the regulation was more tempered. The most important phases of the regulation dealt with: (1) the amount of down payments and the length of the repayment periods in installment selling, and (2) prohibition of continued activity of charge accounts which were past due for a specified period of time. In considering only the down payment provisions as applied to installment sales contracts, any regulation which established the down payment requirement can also effect the amount of credit created. Regulation W, in all three control periods, first established the down payment on new automobiles at 33⅓ per cent. While many sellers in the automobile trade had previously subscribed to the principal of one-third down, this field is one which is usually harassed by many sellers offering very lenient terms. To illustrate the effect of increased down payment requirements, let us assume a potential new car customer has saved $700, or has a comparable amount of equity in his present car. Either cash or equity can be used for the down payment on a new car. The amount of credit created by our new car customer as he uses his $700 cash or the comparable equity as a down payment under varied down payment percentages would be as follows:

Down Payment Cash-Equity	*Down Payment Per Cent*	*Maximum Purchase Price*	*Amount of Credit Created*
$700	10%	$7,000	$6,300
700	20	3,500	2,800
700	33⅓	2,100	1,400

In the above example, the new car purchaser would, under the provi sions of Regulation W, be restricted to the purchase of a $2,100 auto mobile and hence $1,400 of installment credit would be created.

When the length of installment sales contracts is regulated, the ob vious effect is to shorten the repayment period and consequently increase the amount to be repaid per installment. During much of World War II the maximum repayment period on automobiles was 15 months. A re payment period of this duration has a particularly negative influence on the lower-income groups and those households with relatively heavy financial obligations. As a result, by the regulation of the down pay ment requirements on installment sales contracts and the shortening of the repayment period, the quantity and quality of credit was supposedly regulated.

Has Regulation W had any penetrative effect on the volume of con sumer credit? The answer to this question appears to be—no! While the intended effect of Regulation W has been illustrated, the actual re sults are open to question when one examines other aspects of the con trol periods. During World War II few consumer durable goods were available in retail stores and consumer income was unusually high. Con sequently, those goods which came under Regulation W registered sales declines for reasons other than the curbing Regulation. During the same time, savings rose to a high level and a great pent-up consumer demand existed at the close of World War II. The effect of regulation during the postwar period and the Korean conflict was mild. It may be that only those of the lower-income groups and those with heavy obligations on their incomes were obliged to delay purchases of durable goods. For the major portion of consumers, their incomes were high enough and their savings sufficient to meet the regulatory standards. Further, a scarcity of goods prevailed for several years after World War II and by the time the United States was involved in the Korean conflict the in effective results of the previous regulations were well understood. Regu lation during the Korean conflict was mild and applied only to the down payment and length of the repayment periods on installment sales con tracts. And in this instance the goods under regulation were very limited, while all other goods were free of controls.

CONSUMER CREDIT IN PERSPECTIVE

The widespread use and powerful force of consumer credit may lead one to believe that the volume of consumer credit could be subject to debate and even controversial discussion. This is especially true when

the absolute volume of consumer credit during the postwar years is regarded. Since 1946 the absolute volume of consumer credit has risen from in excess of 8 billions to over 45 billions by the end of 1958; an expansion of approximately five and one half times. Particularly significant is the fact that installment credit volume grew from slightly more than 4 billions to over 34 billions during this same period; an expansion of more than 8 times. The absolute increase in consumer credit is regarded by some authorities with alarm, with the view that the phenomenal growth of consumer credit is an abnormal part of an expanding economy. The apparent lack of objectivity in reasoning from absolute statistical data is responsible for the frequent attempts to have Regulation W re-enacted. As recently as January, 1956, President Eisenhower, in his Economic Report to Congress, referred to the dangers of installment buying should it get out of hand. Periodically, depending on world conditions or the nation's economic status, recommendations are made to Congress which would give the President stand-by controls over consumer credit. The authors recognize the fact that some observers may support the view that the volume, growth, and use of consumer credit are excessive, dangerous, and imprudent; however, when the growth of consumer credit is studied relative to other business activity, a more rational perspective may be gained.

Consumer Credit Relative to Business Activity

Inasmuch as the absolute dollar amounts of consumer credit outstanding do not show its growth in proper perspective, it is necessary to relate consumer credit to other important economic factors. Other important relatives to the volume of consumer credit are retail sales, disposable personal income, and personal savings. Table 3–3 shows these important economic factors in two ways. It will be noted that when the data are not adjusted for the influence of higher prices, the per cent increase of these data reach great magnitudes. Hence, the unadjusted percentage increase of consumer credit from 1940 to 1958 is 449.4 per cent, while retail sales, disposable personal income, and personal savings registered increases for the same period of 331.9 per cent, 315.9 per cent, and 459.5 per cent respectively. Another, and perhaps more objective approach to the analysis of these data is to adjust them for changes in the consumer price index and hence remove the influence of higher prices. The consumer price index from 1940 to 1958 rose from 59.9 to 123.5, an increase of 106.2 per cent. When this adjustment is made it is seen that consumer credit actually increased 165.5 per cent instead of 449.4 per cent. Retail sales increased 119.9 per cent rather than 331.9

per cent; disposable personal income increased 101.8 per cent instead of 315.9 per cent; and personal savings registered an increase of 171.4 per cent rather than 459.5 per cent.

The economic factors analyzed in Table 3–3 are all relevant and important to the growth of consumer credit. That is, the American consumer has responded to the purchase of a greater quantity and variety of goods as his income and savings registered increases. Consumer credit is

Table 3–3

GROWTH OF SELECTED ECONOMIC FACTORS
(1940 and 1958)

Economic Factor	1940 (Billions)	1958 (Billions)	Increase (Billions)	Per Cent Increase Unadjusted	Per Cent Increase Adjusted
Consumer credit*					
Unadjusted ...	$ 8 3	$ 45 6	$ 37.3	449 4%	%
Adjusted .	13 9	36 9	23.0		165.5
Retail sales					
Unadjusted	46 4	200 4	154 0	331.9	
Adjusted	77 5	170 4	92.9		119.9
Disposable personal income					
Unadjusted .	76 1	316 5	240.4	315.9	. .
Adjusted	127.0	256 3	129.3		101.8
Personal savings					
Unadjusted . .	4 2	23 5	19.3	459 5	..
Adjusted	7.0	19 0	12 0		171.4
Consumer price index	59 9	123 5	.	106.2	...
Index of physical volume, manufacturers of durable and nondurable goods	66 0	136 0	. .	115 2	...

* End of year figures

Sources *Federal Reserve Bulletin*, February, 1960, pp. 198, 214, and 217 *Survey of Current Business*, March, 1959, p. S–9.

a direct result of the interrelationship of these data. When consumer credit is seen in this way, we find that its growth is closely associated with the general economic growth of the economy. While the percentage increase of consumer credit is greater than most of the other economic factors used, its growth does not appear to be significantly out of proportion to the other data.

Another important relative measure which is closely associated with the growth of consumer credit is the increased physical volume of production. The index of industrial production for manufacturers of durable and nondurable goods rose from 66 in 1940 to 136 in 1958, an increase of 115.2 per cent. In other words, more than twice as many things competed for the consumers' dollars in 1958 than in 1940. Even though consumers used their credit to a greater extent as indicated by the 165.6

per cent increase (adjusted), several facts must be remembered. First, during the postwar years it was possible for consumers to purchase a greatly increased variety of goods with their credit. Second, consumers greatly increased their standard of living and actually purchased a greater variety of goods as their incomes rose with the expanding economy. Third, the increased number of households on the American scene has also influenced the ability of manufacturers to market their increased outputs. When analyzed in this way, the growth in consumer credit is seen as a normal part of a greatly expanded economy.

A principal limitation to the preceding analysis concerns the use of aggregate data in regard to consumer credit. Credit practitioners and students should not lose sight of the fact that a debtor-creditor relationship exists in each and every credit transaction. Aggregate data while depicting an inherent soundness in the volume of consumer credit should not be regarded as an invitation to relax one's credit policy. In the last analysis the soundness of our credit structure relies on the worthiness of the credit applicant. While consumers as a group are in a healthy credit position and the volume of consumer credit appears relatively normal, there are many instances in which the consumer position is unhealthy. With the symptoms of credit strain in the form of slower collections, larger balances carried forward on accounts, and larger cash loans, some credit executives find little solace in aggregate data. The ability of a consumer to meet his credit obligations satisfactorily is to a large extent dependent on a balanced relationship between his income and his debts. When disposable personal income declines, a consumer has less with which to meet his fixed obligations. It seems essential that each debtor-creditor relationship be analyzed closely so that forecasted changes in income, prices, and individual desires do not put a strain on the continued good relationship of the debtor and the creditor. If the soundness of the total volume of consumer credit is to prevail for individual accounts, it is necessary that credit grantors not lose their technique of applying basic credit fundamentals. In this connection, some observers have questioned the desirability of granting credit for items which are consumed or expended before the debt is extinguished—for example, the early frozen food plans which provided in some instances for 36 to 48 months of credit for freezer and for food which was consumed within six months. Other students of credit have expressed the doubt as to the wisdom of the currently existing credit plans for vacation trips, granted through airlines or travel agencies and paid for after the trips are completed. These observers are quick to point out that the number of consumer credit counselors have increased rapidly as a result of the over-

extension of credit in these and related fields. At the same time they do acknowledge the generally low loss ratios of most of the retailers, commercial banks, finance companies, and other granters of consumer credit.

CHANGING PATTERNS IN THE USE OF CONSUMER CREDIT

The rapid expansion of consumer credit during the past few decades, as depicted in this chapter, can in general be attributed to two things. First, merchants selling goods to the ultimate household consumer have come to recognize credit as an important part of their selling technique. Today as contrasted with the 1920's, credit is recognized as an important sales-producing function for retail stores. Second, household consumers have accepted the procedure of trading upon their credit as a commonplace means of satisfying their almost unlimited needs and desires. It was not so many years ago that retail merchants and a substantial portion of their customers viewed the use of consumer credit with skepticism and alarm. But, as the American economy expanded and the consumer began to visualize the ease with which he could raise his standard of living the use of consumer credit became an everyday occurrence for increasing numbers of households. The successful experiences of retailers and consumers alike in the use of consumer credit have brought about changed attitudes toward this medium of exchange. So much have earlier attitudes changed that numerous credit plans have been devised to cover the credit purchase of all types of goods and services. Furthermore, various credit plans have been devised to cover the vast majority of goods and services available to the American consumer.

Authoritative evidence of the present-day widespread use of consumer credit is available from the "1959 Survey of Consumer Finances" conducted by the Board of Governors of the Federal Reserve System in co-operation with the Survey Research Center of the University of Michigan. This indicates the basic characteristics of credit purchasers and some idea of the per cent of which some consumer goods are financed. Contrary to popular belief, the lower income groups are not the most common users of consumer credit. For example, only 43 per cent of the spending units with 1958 money incomes (before taxes) of $1,000 to $1,999 reported some debt in the early part of 1959. On the other hand, groups with higher incomes seemed to be frequent users of consumer credit as evidenced by the fact that 71 per cent of the spending units with incomes between $6,000 and $7,499 reported some debt. In the $10,000 and over income groups, some debt was reported by about half of the spending units.

Interesting information is given in these surveys, showing the percentage of automobiles and other durables which are financed. Approximately 63 per cent of the new automobiles are financed, while only 54 per cent of the used automobiles are purchased in a similar way. Furniture and household appliances are financed in approximately 55 per cent of all such transactions. The study also confirmed the fact that married spending units are the more likely credit customers rather than the single spending units. In particular, the younger families (under 45 age group) with children under 18 years of age reported personal debt most frequently. These are the families most likely to be in the market for a large number and variety of goods and services. They are the most likely purchaser of homes, furniture, new automobiles, appliances, medical care, and travel.

THE INDIVIDUAL'S USE OF CREDIT

When an individual uses his credit, a debtor-creditor relationship is established. The principal motivation of the creditor in the relationship is to increase sales volume and hence gain a profit. Different motivating forces influence the customer in this transaction. It is generally recognized that credit is used by individuals for one or more reasons. In most instances close observation will reveal the motivating influence as an attempt to *increase satisfactions from life, convenience,* or *necessity.* In some instances the individual may be motivated by a combination of these reasons.

Use of Credit to Increase the Satisfactions from Life

Primarily the individual uses credit in order to increase the satisfactions which he can obtain from life. Credit enables him to have and enjoy things now—rather than postponing the purchase and use of these things until some indefinite future time. By means of credit he is able to obtain the use of goods or services and defer payment until the future. The alternative would be for him to accumulate funds—doing without now in order to save for the future. This, to him, is not nearly as attractive a proposition as buying now and deferring payment until some future time when, optimistically, he thinks his ability to pay will be greater than it is at the present moment.

Because he can use credit as a means of payment rather than having to save and accumulate funds, the range of goods which are available for his choice is considerably increased. There are certain commodities which have a high unit value. Very rarely will he be able to accumulate

cash in advance so that he can pay for them immediately. One of these is a home. Most homes are purchased through credit and paid for over a long period of years. In the development of our modern economy, there has been added to the customary scale of living a number of other commodities of this same type. Generally these are durable goods with a high unit value. Frequently, these items are purchased on the installment plan of payment. If this credit device were not available to the individual consumer, very few of the lower- and middle-income groups would be able to use and enjoy these commodities. Once they have committed themselves to the purchase, they are impelled to make regular payment by the terms of the contract which they have signed. Were they not under contract and instead were attempting to save in advance of the purchase, it is rather doubtful if they would be able to accumulate the necessary funds. It is more likely that day-to-day temptations would arise and they would dissipate their funds in what might be called "non-lasting" purchases.

Use of Credit as a Convenience

Another important reason for using credit is simply convenience. This often explains the use of the retail charge account. It is far more convenient, when shopping, to be able to say, "charge it, please" than to have to carry the cash which otherwise would be necessary. Also when a charge account is available at one or more of the local stores, other members of the family may be sent to the store without worrying about the cash. It may also facilitate the process of household budgeting to have the merchant assume part of the responsibility for keeping the household accounts. Many people pay their bills only once a month although their bank account is ample throughout the month, so that they could well pay cash.

When the use of credit is dictated by considerations such as this, the desire to enjoy things now rather than postpone that enjoyment is not so evident. The retail charge account, however, may function to transfer the enjoyment of things into the present rather than postponing them into the future.

In noting the use of credit as a convenience, recognition should be given to the growing number of credit plans that have expanded rapidly during the 1950's. Perhaps the most important of these are the revolving credit plans that have appeared primarily in department stores across the nation. Also the bank credit cards are being promoted on the basis that one may purchase many items from many different stores and at the end of the month or over a period of months make a single pay-

ment to the bank each month for the variety of purchases of goods and services. Similar illustrations arise from the increasing use of credit cards for goods and services, such as the gasoline company credit cards, the Diners' Club, the American Express Credit Card, the Hilton Carte Blanche, the Sheraton Dining Club—to name only a few. One of the most recent developments in this connection is the type of personalized loan service being offered by an increasing number of banks over the country. This is simply a revolving loan account, uniquely combined with personal checking privileges. When such an account is opened, the consumer may use part or all of his maximum credit for whatever he wishes, whenever he wishes, up to the total approved by the bank.

Use of Credit as a Necessity

A third reason why many people are impelled to use credit can be described as a necessity. There is something which presses upon him so strongly that to do without is quite an undesirable choice. Under these circumstances, he does not pay cash but resorts to credit. The ordinary affairs of life are responsible for many of these occasions: birth, death, sickness, and similar events which demand a large immediate outlay. Not having a reserve sufficient for the occasion, the individual is pressed by what he regards as an emergency to secure a loan or to use his credit for goods and services. Occasionally, of course, there may be some difference of opinion as to what constitutes an emergency. Very often credit is resorted to under emergency conditions when the funds obtained are spent for purposes which the outsider would scarcely regard as an emergency. The use of credit in order to pay off other bills may be classified as an emergency need. Frequently, items purchased on the installment plan impose payments greater than the current revenue will meet. The collector is pushing hard for his money and unless paid promptly threatens some dire consequences, such as repossession of the article bought on the installment plan or perhaps suit, garnishment, or some legal action. This being clearly an undesirable event, the individual resorts to the use of credit to avoid less desirable consequences. Generally, the form of credit used under these circumstances is the cash loan, made from one of the various cash-lending agencies.

Wise and Unwise Use of Credit

The question may be raised as to whether or not the individual is wise or unwise in his use of credit. The use of credit often imposes a cost. Installment buying generally is accompanied by carrying charges which place the cost of the credit directly upon the person who uses it.

Charge account credit, frequently, means trading at stores which may have a slightly higher price than would be available if the purchase were made at the so-called strictly cash store or the cash-carry store. Borrowing from cash lenders generally results in the payment of interest charges. Is the payment of these additional amounts justified? It is difficult to set any definite criterion by which we can judge whether the individual has been wise or foolish in using credit. About the only criterion we can cling to with any degree of certainty is the individual's own judgment. If he actually knows what it is costing him, if he still makes the decision to use credit, and if he feels that the additional satisfaction obtained by the use of credit is greater than the cost of the credit, then we must conclude that it has been a good bargain from his standpoint. To do otherwise is to attempt to substitute our judgment for that of the individual. This is not in accordance with the principles of a society in which the individual enjoys freedom of choice. We can, and should, however, insist that the individual, before using credit, be able to appraise the true cost of the credit to him. He should be fully informed as to the charges which he will have to pay, and he should be sufficiently sophisticated relative to these charges to calculate them accurately. If he is an intelligent buyer he will appraise the result from using credit as against the alternative of doing without the immediate enjoyment of the commodity purchased, the convenience of purchasing upon credit, or the necessity which he will meet by using the funds which he intends to borrow. If, then, his decision is in favor of making a credit purchase, no one should interfere with his freedom of choice in this respect. In this connection, however, some observers point to the occasional unwise use of some advertising which eliminates the general advantages of product or price and simply promotes the product or service on the basis of the monthly payment required to purchase the article or service.

Is it true that all cash buyers are intelligent shoppers? Frequently, impelled by the urgency of the salesman, or just because of insufficient willpower, or because of lack of foresight and inability to appraise correctly the need for the article as against the usefulness of the purchase being considered, cash buyers may make an unwise decision and find the satisfaction obtained is not as great as they expected it to be at the time of purchase. When credit is used as a medium of exchange, there is probably more opportunity for errors of this sort than when the purchase is made for cash. Credit is, apparently, a very easy way to purchase. Also, it is necessary for the individual using credit to make two calculations as to future circumstances. First, the future enjoyment he will obtain from the things he is getting now; and second, the future difficulties and dis-

utilities he will suffer from the necessity of having to make payment at some time in the future—both of these must be considered.

There is a natural tendency to exaggerate the pleasures of the present and to minimize the difficulties of the future. This leads to unwarranted optimism. It seems to the individual that it will be quite easy to make payment in the future. Surely, his circumstances at that time will be better than they are now. Surely his income will increase, and he will find it easier to pay then, than it would be now. Also, we all are inclined to feel that present pleasures are better than postponed pleasures. For that reason, we are quite anxious to have the thing we are considering purchasing and it seems that it will be quite easy to pay when the time comes.

There also is considerable difficulty in calculating the cost of credit. Frequently the method of quoting these costs means that they are necessarily concealed. Credit is offered by the seller in order to increase his volume of sales. Not wishing to impose any handicap upon this increased volume he seeks to obtain, he naturally attempts to quote the cost of credit in such a way as to make it appear as small as possible. The calculations frequently are difficult for the customer and often are beyond the mathematical ability of many purchasers. Frequently purchasers do not even stop to calculate the difference between the cash and the credit selling price.

These occasional errors in the use of credit may be considered abuses rather than necessary results. Too often the entire credit device is condemned because of occasional abuses and errors. The abuses may be on the part of the buyer; they may be on the part of the seller. Certainly, it is not the part of good judgment to critize the entire credit mechanism and condemn the individuals' use of credit because occasionally some individuals use it not wisely, but too freely.

REVIEW AND DISCUSSION QUESTIONS

1. Distinguish carefully between a credit economy, a money economy, and a barter economy.
2. Does the fact that the U.S. Bureau of the Census did not gather data on consumer credit until 1930 mean that consumer credit had its beginning in that year? Explain.
3. Describe the developments in consumer credit between the Civil War and 1920.
4. What is the Russell Sage Foundation? What is its principal contribution to the consumer credit field?
5. Describe the developments in consumer credit between 1920 and 1930.

6. Why were commercial banks reluctant to enter the consumer credit field? Why has this attitude changed?
7. From a study of Table 3–2, discuss the trend of consumer credit from 1929 to the present.
8. Why has the volume of consumer credit expanded so rapidly since the close of World War II?
9. Explain what Regulation W was and discuss the effect it had on the volume of consumer credit outstanding.
10. Why should any analysis of the trend of consumer credit take into consideration the trend of other factors, such as retail sales, disposable personal income, and personal savings?
11. Why doesn't an analysis of consumer credit in the aggregate give the individual credit manager a complete picture of the credit condition of his firm?
12. Read the latest "Survey of Consumer Finances" in the *Federal Reserve Bulletin.* What changes have occurred since the 1959 Survey?
13. What are the three motivating forces that are connected with the individual's use of credit? Distinguish carefully between the three.
14. How should the consumer be protected from unwisely using his credit?
15. What are some of the more recent developments in the different types of consumer credit plans?

CHAPTER 4

Types of Consumer Credit— Retail Charge Account

THE DECISION of whether to sell on credit is a prerogative of the individual retailer. There are no laws or enactments that force a merchant to offer his goods to a consumer on a credit basis. He is free to choose whether to make his store strictly a cash institution, strictly a credit institution, or an institution that has adopted the policy of selling under both arrangements.

A well-managed store operates on the basis of sound policies predetermined to guide the courses of action that the store will follow. One such policy is the determination of whether or not to sell on credit. Credit policies cover a considerable variety of situations and are effective at a number of levels of importance. A discussion of the determination of consumer credit policies appears in Chapter 9, but at this point in our discussion we should realize that once the decision is made to sell on credit, then other corollary decisions must follow. One of these decisions is what type or types of credit to accept from the individual customers. The type that is of immediate concern in this chapter is the retail charge account, or as it is often called the open account or the 30-day account. Under this traditional retail charge account arrangement, the customer is allowed to make any number of purchases provided the total dollar amount purchased does not exceed the quantity the store desires to accept from this individual. The terms of this type of credit usually read "accounts are due and payable the tenth of the month following purchase." No down payment is asked, and carrying charges are generally not involved.

Factors Involved

It should be recognized that in his decision to adopt the retail charge account type of credit, the merchant must take many factors into consideration. The most important of these factors include effect on profits, desires of customers, amount of capital available, competition, type of goods, and location of community in which the store is located. Let us examine each of these factors separately.

Effect on Profits. Whether or not to introduce or to expand charge account credit depends primarily upon the effect on profits that the merchant expects such an action to have. Despite all the other factors that were enumerated and that will be discussed subsequently in detail, unless a merchant believes that increased sales accompanied by increased profits will result, he will not introduce or will not attempt to expand his charge account credit activities. Consideration should be given to the fact that in some types of retail stores—for example, the grocery supermarket—the margin of profit generally is too small to permit the use of any kind of credit arrangement, and cash transactions are the rule.

Desires of Customers. The retailer must determine whether his customers actually desire to have the opportunity to buy goods and to pay for them some 30 days in the future, with no charge for this delayed payment. Of course, the fact that a store has a policy of accepting 30-day accounts has the reciprocal effect in that this policy attracts new customers who desire this established type of credit arrangement.

It is particularly true in the smaller retail establishments operating on a cash basis that the desires of customers often cause a change in policy and an introduction of the charge account. The smaller merchant finds his regular customers often asking him to trust them for a few days until they have the money to pay for the goods purchased, and in a short time he often finds himself doing a substantial share of his business on credit. Of course, there are firms that claim to be cash stores which carry the accounts of some of their "privileged" customers and thus should really be considered credit institutions.

Amount of Capital Available. To be able to operate a retail charge account arrangement, the merchant must realize that he automatically increases his capital needs. No longer is cash received immediately for every piece of merchandise sold; instead he is faced with the prospect of waiting 30 days (and longer) for payment of the goods sold. He is not given longer terms by his own suppliers simply because he is operating on a credit basis, and as a result is often faced with the prospect of having to borrow money from commercial banks to pay his own

bills on time or of having to invest larger amounts of his own capital (if available) to meet the needs arising before customer payments are received for goods bought on account. The fact that this indebtedness is evidenced only by entries in ledger accounts handicaps the merchant in his attempts to secure bank loans, as he is not provided with a credit instrument that may be easily and customarily discounted at some financial institution. He must rely primarily upon his own credit standing in his attempts to secure loans for working capital to meet his recurring needs. All these points should be taken into consideration and weighed carefully by the retailer in his decision to sell his goods on a charge account arrangement.

Competition. Many retailers are faced with the situation that their competitors are offering charge account arrangements, and as a result they are forced to make equivalent types of credit accommodations. It is virtually impossible to visualize a department store serving the long-time residents of a community without some type of charge account arrangement, and this is especially true if competing department stores offer such an accommodation to these same customers. It is difficult to imagine a major gasoline company operating without some type of arrangement to accept the credit of customers for gasoline and oil purchased, when other major competing concerns are using some form of credit cards which permit delayed payment. Of course, examples may be cited of retail stores that have grown and prospered with the adoption of a cash-carry policy, such as retail grocery supermarkets. But essentially these supermarkets are competing with similar stores selling under similar cash-carry arrangements. Only indirectly are the smaller retail grocers who offer services such as credit and delivery competing with these supermarket operators.

Type of Goods. The lines of merchandise carried by a retailer are a determinant in the advisability of adopting and actively utilizing a charge account system. Such a device is adapted primarily to merchandise that can be paid for easily by the customer within the normal 30-day repayment period. A retail store that stocks principally higher-priced consumer durables such as refrigerators, stoves, and television sets—not to mention automobiles—will find that such merchandise is not adaptable in most instances to a 30-day credit arrangement. To handle such consumer goods on a credit basis requires some arrangement in which the customer is given a longer period of time to make payments, and usually an opportunity to make partial payments (installments) is afforded the buyer.

It also should be noted that some stores handle merchandise of such

low prices that the adoption of a charge account system of credit has not been considered feasible. Customers do not expect charge account arrangements in variety stores, for example, in which items are generally priced very low. Some variety stores[1] have adopted the practice, however, of allowing persons to "lay-away" merchandise and to make a series of payments on it until such time as the full amount is paid, and the customer is then permitted to take the merchandise with him. This latter type of arrangements does not belong in the regular charge account classification.

Location of Community. The section of the country in which a retail store is located often exerts a considerable influence on the wisdom of a retailer relying upon a 30-day charge credit system as his sole device under which to accept credit. In some areas—primarily agricultural—income is not something that is received every Friday or Saturday night, but it is something that is dependent upon receipt of payments for various crops harvested and sold. Stores catering to such persons find that some type of credit other than the charge account is often more adaptable. In those communities, however, in which income received is a regular weekly, biweekly, or monthly occurrence, the charge account is readily usable.

DEVELOPMENT OF RETAIL CHARGE ACCOUNT

Early Use

There is a strong belief on the part of most of us Americans that consumer credit is a modern, present-day development. The fallacy of this concept is clearly seen in the following comments:

While it is true that most of the agencies of consumer credit are new, consumer credit itself is extremely ancient. About a year ago Paul Einzig, a well-known English monetary authority, wrote a book on *Primitive Money*. He pointed out that the evolution of money tended to follow this pattern: first, barter; second, barter with credit to make barter more flexible; and third, money. Since primitive people make their economic plans on a day-to-day basis, and since they have little capital, their credit operations were largely for consumer goods. Consumer credit is prehistoric and many primitive people in remote parts of the world use it today.

What about consumer credit in our own early history? Professor Plummer of the Wharton School of the University of Pennsylvania has made a study of consumer credit in colonial Philadelphia. He concludes that a very large amount of the local trade was carried on, on a credit basis. That should not be surprising. There were no banks, and money was not always plentiful, at least dependable

[1] Some variety chains also are experimenting with the use of revolving credit plans which are discussed in Chapter 5.

money was not. He says, "it seems certain that credit rather than cash was the rule." He cites the example of David Evans, a cabinetmaker who kept records over a 32-year period, 1775 to 1811. These showed 92 per cent of all sales on a credit basis. There were other similar cases. Collections were slow in those days. Samuel Powel, Jr., a linen merchant, expected that few if any customers would pay him in less than a year. Benjamin Franklin paid his bookseller, on the average, in nine and one-half months. Francis Hopkinson, who bought more books than Franklin, took two and one-fourth years on the average to pay his book bill. Under such conditions the ratio of bad debts was high.

. . . . . .

Developments in consumer credit did not change radically in the two generations before the Civil War. Most consumer credit was probably still in the form of store charge accounts. . . . Lewis Atherton who wrote a study of pioneer merchants in the Midwest in this period says that credit extension constituted a serious problem for most merchants. . . . According to Professor Fred Jones of Illinois, well over half of a western store's sales were on a credit basis. A frequent cause of failure was the injudicious granting of credit to customers. Merchants generally granted six months' credit without interest (those were the terms they got from wholesalers), and after six months they charged a stiff rate of interest.[2]

Thus it appears that charge account credit in the United States dates back to the country general stores in colonial days, although the present 30-day account did not appear until much later in our history. It was expected even in that time that purchases would be kept well within earnings accruing to the buyer of the goods, and that full settlement would be made upon receipt of income, however irregular that might be. In the rural areas, many of the farmers of those days found themselves in the position of possessing relatively little cash with which to make purchases. As a result, credit was employed to buy the goods needed, and harvest money was used to settle accounts for goods bought on time. This situation was not confined to the rural areas, however, and there is ample evidence that open-book credit was common in many cities in the early 1800's. All of these credit transactions were highly informal; credit was an accommodation extended to those customers who paid their bills as agreed; and the principal collection weapons were suspension of credit privileges and the pressure of public opinion.

In the commercial development period between the Civil War and World War I, banks increased rapidly in number, and capital was becoming more plentiful. In the retail stores of the nation, the average length of time that charge purchases were allowed to run was shortening, and the proportion of charge credit sales to cash sales was declining.

[2] Donald L. Kemmerer, "An Economic Historian Looks at Consumer Credit," *Consumer Credit Today* (Urbana: University of Illinois Business Management Bulletin No. 76, June, 1951), pp. 6–8.

The reason for these changes may be explained in part by the shortening of the credit terms extended to retailers, the introduction of more frequent paydays in industry, the expansion of installment credit in the purchase of higher-priced consumer goods not adaptable to charge account credit, and the successful operation of many types of retail stores on a "cash sale only" basis. During this period of time, however, there appears to have been a rather consistent expansion of open-book credit granting among department stores and among clothing, jewelry, and furniture stores, other than those that had begun to sell their goods on the installment plan. This situation is shown clearly in the following quotation:

> The expansion of open-book credit-granting in the clothing, jewelry, furniture, and department store fields was induced by the competition of instalment merchants. Many of the "quality" stores shunned any association with instalment merchandising because of the taint given this business by low-grade merchants. But they felt the competition of the more reliable instalment houses and in order to meet it they liberalized their charge-account policies and began tacitly to accept partial payments on open-book accounts.[3]

Also during the latter part of this period, the development of retail credit bureaus provided a source of comprehensive and reliable information on individual consumers. More expert credit analysis was thus possible, permitting charge account credit acceptance with less fear of crippling bad-debt losses.

Increasing Frequency of Use

In the years following the adjustment period after World War I, there appeared an expansion of open-book credit, stimulated even more strongly by the active competition for the consumer's dollar between stores and between products in the same store. Credit accommodations became a vital factor in competition, and more liberal credit policies were the result. Products which faced the competition of other commodities sold under installment plans were afforded more liberal open-book credit terms, and many merchants were highly hesitant in pressing good customers for prompt 30-day payments in fear of losing these desirable buyers to more lenient competing retailers. This situation has prevailed down to the present time.

The Federal Reserve Board has compiled a statistical series (Table 4–1) showing the dollar volume of charge account credit since 1929 to the present time. This series has been related percentagewise to the total volume of consumer credit (excluding home mortgage loans), and these percentages also appear in Table 4–1. An analysis of the dollar-volume

[3] Rolf Nugent, *Consumer Credit and Economic Stability* (New York. Russell Sage Foundation, 1939), p. 84.

Table 4–1

THE CHANGING IMPORTANCE OF CHARGE ACCOUNT CREDIT

End of Year	Dollar Volume of Charge Account Credit (Millions of Dollars)	Dollar Volume of Total Consumer Credit (Millions of Dollars)	Charge Account Credit as a Per Cent of Total Consumer Credit*
1929	$1,602	$ 6,444	24 9%
1930	1,476	5,767	25 6
1931	1,265	4,760	26 6
1932	1,020	3,567	28 6
1933	990	3,482	28 4
1934	1,102	3,904	28 2
1935	1,183	4,911	24 1
1936	1,300	6,135	21 2
1937	1,336	6,689	20 0
1938	1,362	6,338	21 5
1939	1,414	7,222	19 6
1940	1,471	8,338	17 6
1941	1,645	9,172	17 9
1942	1,444	5,983	24 1
1943	1,440	4,901	29 4
1944	1,517	5,111	29 7
1945	1,612	5,665	28 5
1946	2,076	8,384	24 8
1947	2,353	11,570	20 3
1948	2,673	14,398	18 6
1949	2,795	17,305	16 2
1950	3,291	21,395	15 4
1951	3,605	22,617	15 9
1952	4,130	27,520	15 0
1953	4,274	31,393	13 6
1954	4,485	32,464	13.8
1955	4,795	38,882	12.3
1956	4,995	42,511	11.8
1957	5,146	45,286	11 4
1958	5,060	45,586	11.1
1959†	5,351	52,046	10.3

* Excluding home mortgage loans

† Includes data for Alaska and Hawaii beginning with January and August, 1959, respectively.

Source Board of Governors of the Federal Reserve System.

statistics reveals that after reaching a low at the close of 1933, charge account credit expanded steadily until our active participation in World War II. After declining in 1942 and 1943, the dollar volume of charge account credit has expanded rapidly, reaching new heights in almost each succeeding year. The general customer acceptance of charge account credit as a highly respectable transaction acceptable to all social circles, the expanding population (especially urban and suburban), the increasing level of retail prices, the recognition by urban department stores of the promotional opportunities in encouraging customers to become "privileged" credit customers—all these factors and others have

contributed to this expanding dollar volume of charge account credit.

A decidedly different picture of charge account credit is revealed, however, when the percentages (charge account credit divided by total consumer credit) are analyzed. With the declining severity of the Great Depression, the situation arose in which the importance of charge account credit dropped rapidly as compared with the other types of consumer credit accepted. The growing importance of automobiles and other higher-priced consumer durables resulted in rapidly expanding installment transactions. This situation was reversed temporarily throughout the World War II years, primarily because of the scarcity of such goods and secondarily as a result of government regulations (Regulation W) which controlled the amount of down payment and the length of the repayment period on installment sales. With the reappearance of these consumer durables, charge account credit once again declined rapidly in importance as a contributing factor in the expanding over-all consumer credit picture.

WHAT A RETAIL CHARGE ACCOUNT IS TODAY

It will be recalled that the retail charge account has been explained earlier as an arrangement by which the customer is allowed to make any number of purchases provided the total dollar amount purchased does not exceed the quantity the store desires to accept from this individual; down payments and service charges are usually not involved. Under the generic term "charge account," numerous plans have been devised by retail merchants in their attempts to sell merchandise and to collect for these sales in a relatively short time. All of these plans have the same objective—to sell merchandise at a profit; each, however, represents some variation in the need or the ability of the merchant to meet competition and to carry the account until the customer pays the amount due the store. The variations in retail charge account plans have become decidedly more numerous in recent years, and many of the larger retail stores—especially the department stores—have attempted to mold, and have succeeded in molding, their own plans and to make them distinct aids to their sales promotional activities.

Normal 30-Day Account

The traditional retail charge account is the one that most normally comes to the mind of the American woman when the word "credit" is mentioned. The department store is the retail institution with which this type of credit generally is associated. Under this kind of credit arrange-

ment, goods are bought during a month; the buyer receives her goods before any payment is made; the buyer is not asked for any down payment nor is she required to pledge her purchases or any other assets as collateral; carrying charges are not generally levied even for late payment; and full payment is expected a few days after the bill is rendered by the store.

Another outstanding example of the use of the 30-day charge account is by the major gasoline companies. The purchase of gasoline, oil, tires, and other types of commodities—as well as the purchase of repairs and other services—may be charged by the customer and paid for on the regular 30-day basis. The billing is a consolidation of all of the customer's purchases over a period of time, generally 30 days. It should be pointed out, however, that the period between purchase and billing at times may be longer than is the case in department store transactions. This is especially true during the heavy-driving summer months. For all intents and purposes, however, these transactions are considered to be part of the 30-day credit accounts.

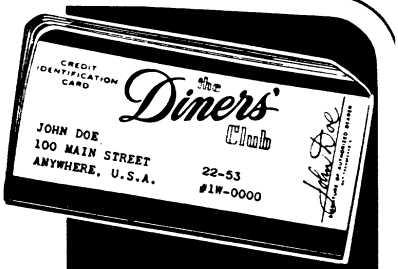
Similarly, the 30-day charge is the basis of many of the new credit plans that have appeared since World War II. The Diners' Club plan advertises that "only with this Diners' Credit Card can you 'Charge It' at over 17,000 member establishments and receive just one itemized monthly statement . . . conveniently pay for all charges with one monthly check." This organization also points out that they give the customer an itemized record of expenditures and travels through the monthly statement—this record serving as supporting proof of legitimate business expenses for tax filing purposes (see Figure 4–1). Actively competing with the Diners' Club is the American Express Credit plan which was inaugurated on a world-wide basis on October 1, 1958. A description of this plan, its services and cost, is shown in Figure 4–2. Similar credit arrangements for the purchase of food and other type of goods (as well as the purchase of services to be described in Chapter 5) have been developed by the Sheraton Hotels organization and the Hilton Hotels Corporation.

Cycle Billing. The exact date on which the bill is expected to be paid has been somewhat complicated by the introduction in the early 1940's of the practice of cycle billing. Instead of sending all bills on or around the first of the month, the names in the credit files are divided systematically and statements are rendered to a different group of customers each working day of the month. Thus in stores using a cycle-billing system the statement "accounts are due and payable the tenth of the month following purchase" does not strictly apply; instead, full payment is ex-

FIG. 4–1

THE FIRST, LARGEST, AND MOST COMPREHENSIVE

CREDIT CARD CHARGE SYSTEM



Only with this Diners' Club Credit Card can you "Charge It" at over 17,000 member establishments and receive just one itemized monthly statement...conveniently pay for all charges with ONE MONTHLY CHECK.

Gives you an itemized record of expenditures and travels through your Diners' Club monthly statement–supporting proof of legitimate business expenses for tax filing purposes.

Eliminates the need for large sums of cash and dozens of other credit cards when you travel.

OVER 900,000 CARDHOLDERS NOW ENJOY THESE PRIVILEGES

ONLY $5 A YEAR

All this credit, convenience, and prestige costs you just $5 a year for 12 full months from the date your card is issued. And for only $2.50 each, authorized members of your firm or family can be added on the same account.

THIS IS YOUR APPLICATION FILL OUT AND MAIL TODAY

ANSWER ALL QUESTIONS - TYPE OR PRINT

FOR OFFICE USE

FULL NAME _____

HOME ADDRESS _____ (STREET) _____ (CITY) _____ (ZONE) _____ (STATE)

Phone _____ Rent home _____ Own home _____ Years at present address _____

COMPANY NAME _____ Nature of business _____

Address _____ (STREET) _____ (CITY) _____ (ZONE) _____ (STATE)

Phone _____ Years with above firm _____ Position _____

BANK NAME & ADDRESS _____ (IF COMPANY ACCOUNT DESIRED, INDICATE COMPANY BANK)

Reg. Checking ☐ Spec. Checking ☐ Savings ☐ Loan ☐

CHARGE ACCOUNTS AT _____

CHECK ONE ONLY

- COMPANY ACCOUNT ☐ Bill sent to office address
- PERSONAL ACCOUNT ☐ Bill sent to home address
- PERSONAL ACCOUNT ☐ Bill sent to office address

Have you held a Diners' Club card previously? _____

If addition to existing account, show number _____

$5 FEE: ENCLOSED ☐ BILL ME ☐ covers 12 months' membership from date card is issued (includes one year's subscription to Diners' Club Magazine at 60¢)

Card holder assumes individual responsibility with company applicant

SIGNATURE OF INDIVIDUAL APPLICANT _____

AUTHORIZATION FOR COMPANY ACCOUNT _____ (SIGNATURE OF EXECUTIVE) _____ (TITLE)

WORLD-WIDE *Charge Services* include

- **RESTAURANTS**
- **HOTEL, MOTEL, INN** and **RESORT** accommodations
- **NIGHT CLUBS**
- **TRANSPORTATION** via Air, Rail, Bus, Steamship
- **TOURS** and **CRUISES**
- **AUTO RENTALS** and limousine service
- **GIFT** and **FLORIST SHOPS**
- **LIQUOR STORES**
- **GASOLINE** and Automotive Repair Services
- **OVERSEAS CABLES**

...plus many others

FIG. 4–2



We are pleased to bring to your attention a new comprehensive, world-wide Credit Card, to be inaugurated October 1, 1958

The 108 year old American Express Company is uniquely qualified to introduce such an all-inclusive credit instrument because

400 American Express offices provide the most complete travel service world wide

Millions of people depend upon American Express Travelers Cheques, spendable anywhere, with prompt refund if lost or stolen

The American Express Credit Card is the logical extension of this unrivaled combination of travel and financial service

Services covered by the american express credit card include

- Accommodations, meals and other facilities at many hotels and motels throughout the world
- Food, beverages and entertainment at a wide selection of restaurants, clubs and inns
- Purchases at florists, gift shops and specialty stores
- Drive-yourself and chauffeur-driven car rentals
- Purchase of air, rail, steamship and bus tickets at any American Express office in the U S and overseas
- Cruises, tours, sightseeing and other travel services at the Company's world-wide offices

Additional services, as they become available, will be added to make the card as comprehensive as possible

For either business or pleasure, this plan will provide you with a complete record of your expenditures, *with all charges included in a single, monthly billing* Cardholders will receive a signed receipt at the time each charge is made

A wallet-sized Directory of the services and participating establishments will be issued with each Credit Card to be mailed during September.

- **Annual charge for the American Express Credit Card will be $6.00. Additional cards billed on the same account will cost $3.00.**

pected approximately ten days after receipt of statement. The cycle-billing technique has proved extremely valuable to the larger retail establishment, which otherwise would be faced with a tremendous work load on the first few days of each month, thus creating the problem of efficient utilization of personnel during the slack period. Examples of two cycle-billing systems are shown in Figure 4–3.

Repayment Period. The words "30-day" have been used to describe the so-called normal charge account. It should be recognized, however, that in actual practice bills are outstanding on an average of 45 to 80 days, depending upon general economic conditions, the season of the year, the type of store involved, and the type of customers to which the store caters.

Carrying Charges—to Use or Not to Use? This delayed payment has given rise to a problem that has troubled retail merchants for years—and continues to bother them—that of whether to charge a fee on accounts that are not paid by the end of the normal 30-day period. Undoubtedly most of the stores would prefer to add such a fee, but competition has proved in most areas to be a limiting factor. Also, simply

FIG. 4–3. Cycle billing systems.

A	28
A	1
B	3
C	5
D-E	8
F-G	10
H	12
I-J-K	14
L	17
M	19
N-O-P-Q	21
R	23
S	25
T-U-V	28
W-X-Y-Z	30
Special Budget Accounts	28
* * * * *	
A thru D	8
E thru K	16
L thru R	24
S thru Z	Last day of month

Courtesy of Miller & Paine Department Store and Magee's Clothing Store, both of Lincoln, Nebraska

because a store threatens to add a carrying charge if accounts are not paid within a certain specified time—often 60 days after receipt of statement —there is no guarantee that such a policy will be indiscriminately enforced. Many stores carefully screen their overdue accounts and are very careful not to offend their "good but slow" customers by imposing charges and by writing collection letters. An insert used by one department store to explain its policy is shown in Figure 4–4 (p. 73).

Who Pays the Cost? It cannot be denied that the retail charge account involves a store in certain costs that are not found when a cash sale is made. These costs are of several varieties. Bad debt losses occur

FIG. 4–3—*Continued*

1 What Is Cycle Billing?

Under the old plan of sending bills to monthly charge customers, all customers received their bills at the same time during the first few days of each month. Under the modern plan, called Cycle Billing, a certain number of bills are mailed out to customers each day of the month This new plan has been adopted to make your bills as accurate as possible and to permit us to handle any questions you may have rapidly and efficiently. Instead of having to rush out many thousands of bills in a very few days, our office people now send out a relatively few each day Instead of all customer inquiries being received within the few days after the old type bill was received, inquiries are spread out over the entire month.

2 What Is Meant by "Bill Closing Date"?

On a certain date each month, all of the information about your charges, credits and payments is taken out of your personal file in our office, so that our office people can make up your bill This date, which is always the same date each month, is your 'Bill Closing Date." Many other customers will have the same date as yours Many more customers will have different dates during the month Since all of the information from your file has been removed to make up your bill, no charges, credits or payments made after your bill closing date, which is the same day of the month always, can be included in your bill for that month For example

Payments you make on your account on your closing date can be shown in that month's bill, if they are made in person at the store and the top half of your bill is included. Payments not including the top half of your bill, or sent by mail on or just before your closing date, cannot be shown in that month's bill. Time has to be allowed for mail delivery and looking up your account Use of the upper portion of your bill avoids delays and errors

Returns of merchandise made in person at the store prior to your closing date will, in all probability, be included as a credit on that month's bill However, **if the store has to pick up the merchandise at your home, or if a complication arises,** the credit cannot be included until the next month's bill.

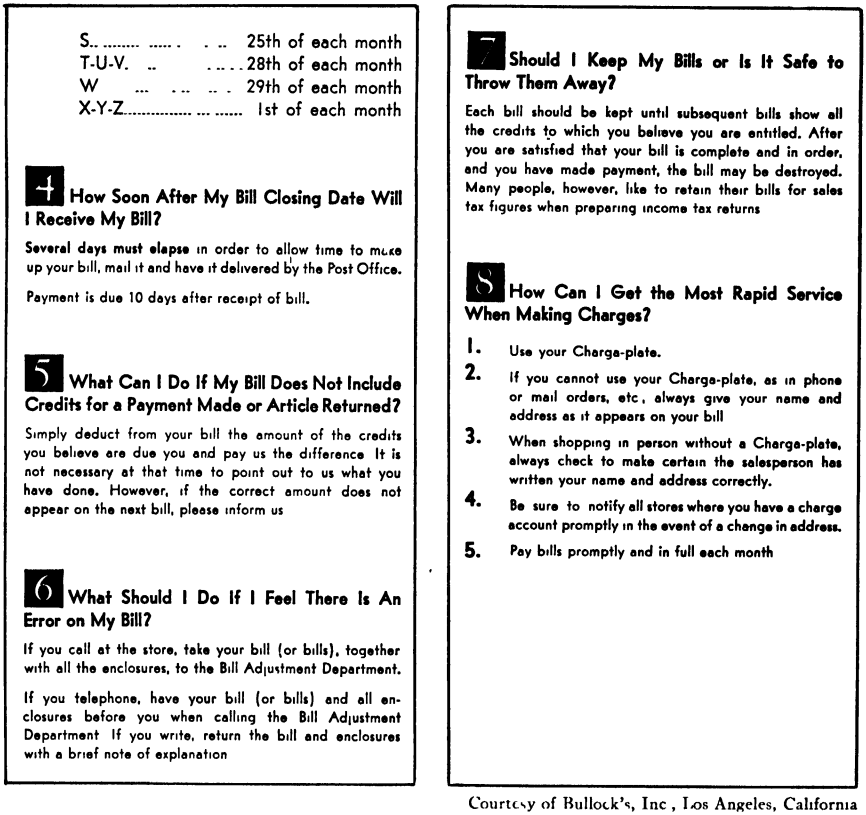
3 How Do I Know My Bill Closing Date?

Your bill closing date is printed on your bill, either in the upper portion or as the heading for one of the columns For your convenience, Bullock's bill closing dates are on the following chart

Names Beginning with	Bill Closing Date
A	1st of each month
B	2nd of each month
C	5th of each month
D	7th of each month
E-F	8th of each month
G	10th of each month
H	12th of each month
I-J	14th of each month
K	15th of each month
L	16th of each month
M	18th of each month
N-O	21st of each month
P	22nd of each month
Q-R	23rd of each month

despite the efforts made by most merchants to weigh the risk involved in increasing sales versus the possibility of nonpayment of the account. The retailer who accepts credit thus must walk the tightrope, deciding whether the acceptance of a certain account will add increased profits through increased sales while debating whether the risk is sufficiently good to offset the danger of expanding uncollectible accounts. In many stores, however, and in smaller stores in particular, the pressure of personal friendship, the lack of knowledge of general and local economic conditions, the inadequate facilities to obtain and even the lack of knowledge of how to secure credit information, the pressure of other duties, and the lack of adequate record keeping—all these factors have combined to make retail credit acceptance a more careless operation than in any other type of business in which credit plays such a dominant role. Another cost factor involved is the payment for personnel, equipment, and space to carry on the credit activities. If the proprietor devotes a share of his time to this function, it is apparent that he is limited in the

FIG. 4–3—*Continued*



S.. .... 25th of each month
T-U-V. .. ..28th of each month
W ... ... 29th of each month
X-Y-Z..... ... . 1st of each month

4 How Soon After My Bill Closing Date Will I Receive My Bill?

Several days must elapse in order to allow time to make up your bill, mail it and have it delivered by the Post Office.

Payment is due 10 days after receipt of bill.

5 What Can I Do If My Bill Does Not Include Credits for a Payment Made or Article Returned?

Simply deduct from your bill the amount of the credits you believe are due you and pay us the difference. It is not necessary at that time to point out to us what you have done. However, if the correct amount does not appear on the next bill, please inform us

6 What Should I Do If I Feel There Is An Error on My Bill?

If you call at the store, take your bill (or bills), together with all the enclosures, to the Bill Adjustment Department.

If you telephone, have your bill (or bills) and all enclosures before you when calling the Bill Adjustment Department. If you write, return the bill and enclosures with a brief note of explanation

7 Should I Keep My Bills or Is It Safe to Throw Them Away?

Each bill should be kept until subsequent bills show all the credits to which you believe you are entitled. After you are satisfied that your bill is complete and in order, and you have made payment, the bill may be destroyed. Many people, however, like to retain their bills for sales tax figures when preparing income tax returns

8 How Can I Get the Most Rapid Service When Making Charges?

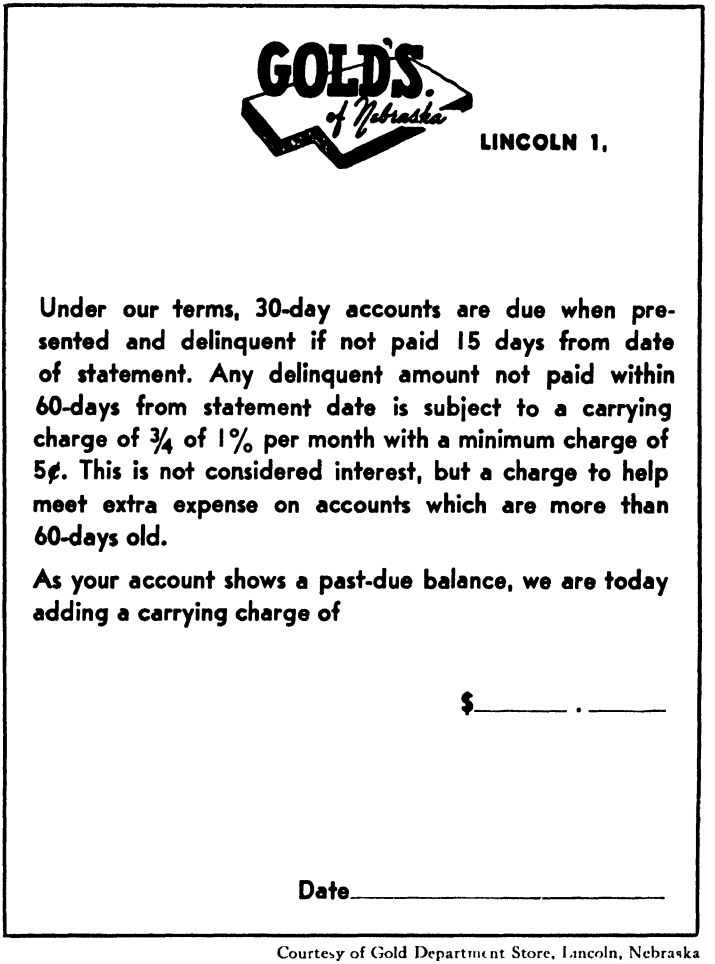
1. Use your Charge-plate.
2. If you cannot use your Charge-plate, as in phone or mail orders, etc., always give your name and address as it appears on your bill
3. When shopping in person without a Charge-plate, always check to make certain the salesperson has written your name and address correctly.
4. Be sure to notify all stores where you have a charge account promptly in the event of a change in address.
5. Pay bills promptly and in full each month

Courtesy of Bullock's, Inc., Los Angeles, California

time that he can devote to buying, selling, and other administrative duties. Another factor to consider is the cost of additional merchandise returns which a charge account customer has come to look upon as a special privilege. In addition, since the store must wait anywhere on the average from 45 to 80 days to secure full payment, the interest on the money tied up for this period is still another cost item to consider here.

All of these cost factors—and some stores consider additional other factors as well—lead to the question of who pays the added costs involved. It is often claimed that the store which accepts credit must charge more for its goods to cover these additional costs. This is not necessarily true, however. If these costs are spread over an increased volume of sales, the dollar amount of net profit may be larger without any increase in the selling price of the merchandise. In those instances where the price of the goods sold must be higher because of the involvement of credit, the customer should and usually does realize that he is paying

FIG. 4–4



Courtesy of Gold Department Store, Lincoln, Nebraska

this extra amount because of the added service which he is receiving.

How Accounts Are Financed. It has been pointed out previously that the introduction and expansion of the use of the charge account involves the need for additional capital. This capital may be furnished by the store's reinvestment of earnings or by the investment of added funds secured from loans from commercial banks or other types of financial institutions. Either of these methods usually enables the retail merchant to carry his own charge accounts until payments are received from customers.

The loans obtained from commercial banks may be based solely upon the unsecured credit position of the store, may be secured by the

store's putting up certain assets as collateral for the loan, or may be obtained by the store's selling its account receivables outright to the bank. In the latter instance, the store may continue to collect the account and the customer generally is unaware that his account has been sold, or the bank may notify the customer that the store has sold his account and that future payment should be made directly to the bank. It should be understood that these receivables that are described here are the result of previous credit transactions approved and established solely by the store.

The practice of selling retail charge account receivables is not as common a practice as it is in commercial credit transactions, although the introduction and growth of charge account banking has provided many retailers with a means of operating on a "cash" basis while still offering to accept the credit of their customers. Charge account bank plans,[4] then, should be considered as another means available to retail stores to obtain the necessary funds to carry on their credit activities.

Bank Charge Accounts

Charge account banking plans are new. Very little mention of them is found prior to 1950. When they were springing up rapidly over the country during the early 1950's, there were many who believed that it would be only a question of time until banks handled the major portion of retail charge account activity. That such has not proved to be the case does not detract from the progress made by some of the banking organizations that started and developed charge account banking techniques and procedures.

The basic idea of this type of plan, of which there are variations, of course, was aptly described by Mr. J. C. Gilliland, past president of the Charge Account Bankers' Association:

> In brief, we screen the credit of consumers who apply to the bank, or to a member merchant, for a charge account. If approved, we issue a Charge Account Identification Plate to the consumer. With this plate, the consumer can buy on a charge basis from any merchant who displays our membership emblem. The merchant writes up the sales on sales checks furnished him by the bank. If the sale amount is less than the floor limit, he can give out the merchandise on the strength of the plate alone. If over the floor limit, the merchant telephones the bank for approval. With modern authorizing methods, we can give such approval in a matter of seconds.
>
> At the end of the day, the merchant endorses the charge sale tickets, assigning the sales to the bank. He then deposits the sales checks in his checking

[4] In addition to banks, there are special finance companies which make a practice of purchasing these accounts receivable from large department and other retail stores and operate plans similar to the bank plans which are described in the following section.

FIG. 4–5. Advertisement of charge account banking.



Courtesy of National Bank of Commerce, Lincoln, Nebraska

account at our bank We give him immediate credit for the total amount of sales, less our service charge.

He has assigned the sale to us without recourse, so the merchant is now out of that picture. Once a month, on a cycle-billing basis, the bank bills the consumer for all charges she has made through our member merchants The prices

charged her are the regular cash prices. She pays the bill at the bank. If she does not, we have the job of collecting. If we fail to collect, we take the loss.

. . . . . .

The service fee charged by the bank is usually 5 per cent on the regular 30-day sales, or 6 per cent on two- or three-payment budget sales.[5]

Advantages. It appears that three main advantages are potentially available to a merchant participating in such a bank charge plan.

1. Increased Sales. The bank plan has enabled many "cash" stores to adopt a credit policy for the first time, thereby opening the door to a new field of customers. By far the greatest number of merchants enjoying this initial credit opportunity are smaller businessmen who have been limited to a cash operation because of a shortage of personal working capital and an inability to fill such a need from other sources. Thus, it appears that to some degree these charge plans are enabling smaller businessmen to compete (as far as a credit policy is concerned) with their larger, more powerful, and better-financed competitors. A second group of merchants involved is store members who previously did a limited amount of credit business due to a shortage of capital or fear of loss but who now may actively promote their charge account business to authorized customers.

The development of neighborhood and outlying shopping areas is closely tied in with this phase of bank plan operation. It appears that in many localities these merchants are primarily the smaller type of business concerns that are often able to give only a limited amount of credit to a select group or to sell strictly on a cash basis. In attempting to continue to attract customers to their stores, many have been faced with the competition on a credit basis from the downtown department stores and their outlying branches. Bank charge plans have in many cases enabled these neighborhood stores to compete actively with their larger competitors and to hold new customers and to attract new ones because of the credit-granting opportunity heretofore unavailable, thus enabling some stores to maintain their position in some instances and to increase sales in other instances.

2. Conversion of Charge Accounts into Cash. One of the main advantages of these charge plans is the immediate cash returns for all charge account sales, less the bank service charge. Thus, in a sense, the

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[5] J. C. Gilliland, "Bank Charge Account Plans," *Credit World*, November, 1953, pp. 14–15.

(Authors' note: These service fees will vary to some degree from bank to bank depending upon the length of time the individual charge is scheduled to run and upon whether the bank has a schedule of rebates to participating members based upon the volume of business routed through the bank.)

member stores can do a credit business on a cash basis. The merchant who handles all of his credit transactions through a bank has none of his money tied up in receivables and thus is in a better position to expand his capital in taking cash discounts and on improving the quantity and quality of his goods and services offered.

3. Freedom from Credit Department Detail. In those stores that have never had a credit department or that have discontinued it upon joining the plan, this factor becomes of major significance. There is no need for the establishment, equipping, and development of a credit office, for the determination of credit and collection policies to follow, and for the hiring and satisfying of operating personnel. It is possible, however, that in many instances this advantage is overstressed. Most of the stores that have joined these plans are smaller concerns. The credit problems involved, if the stores were to handle their own credit, would be conducted usually by the owner or his wife. Thus, the need for an elaborate, well-equipped credit office simply does not exist in such stores.

Disadvantages. It should be realized that these plans entail important disadvantages which have been factors preventing as widespread adoption of this type of credit arrangement as was anticipated when the plans were first introduced.[6]

1. Cost of Bank Service. The bank service charge usually varies, depending upon whether we are talking about 30-day charges, 60- to 90-day charges, or revolving credit accounts. It appears that there was no scientific method used in determining what the service charge should be and as long as the first banks established a rate somewhere between 5 and 8 per cent, the other banks adopted approximately the same percentage of the credit sales figure on a follow-the-leader basis. By far the most commonly used percentage figure for 30-day charges is 5 per cent, although some banks use a graduated scale, depending upon the volume of credit business a retailer furnishes the bank.

Most of the plans are offering 30-day credit along with 60- to 90-day credit terms. The choice of which length of time to use is often predicated on the amount of the customer's purchase (the smaller amounts being allowed only under the 30-day arrangement in many cases). The merchant should realize that one of the main reasons for the 60- to

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[6] The decision in 1958 of New York's Chase Manhattan Bank to enter the charge account banking field gave this type of plan a renewed importance among other banking observers. In turn, the Bank of America expanded its pilot charge account program to include most of California, and many other banks over the country are seriously considering adopting or have already adopted some similar arrangement.

90-day arrangements is to permit him to "trade-up" the customer by suggesting additional merchandise or better merchandise at the time of sale. Because he is able to offer the customer an extended period for payment on the larger purchases, he is able quite often to make the larger sales.

2. Loss of Store Traffic. This point appears to trouble a great many of the participating merchants and also is a strong factor in the decision of many stores not to join a plan. The importance of this factor varies by line of business and by type of customer served. If a store caters to a group that charges and pays primarily by check, then this factor is of little consequence. If payment is normally by cash within the store itself, then a distinct disadvantage of the bank charge plan appears, because the store loses the opportunity of making additional sales while the customer is within the confines of the store.

3. Other Disadvantages. In some localities, it has been found that many of the individual customers simply refuse to participate in such a plan. Some dislike letting the bank know all of their intimate credit dealings; others prefer to deal individually with the store of their choice; others do not like the methodical billing and follow-up procedure used by the bank but prefer the more informal approach between merchant and customer.

It also should be recognized that all participating stores are subject to the standard credit policy of the bank and do not have the freedom of selecting their own risks. If stores do not maintain their own credit departments and certain marginal credit customers are refused credit by the bank standards, then such customers are lost to the store unless they can be converted into cash customers.

Another objection often raised by merchants who have completely eliminated their own charge activities upon joining the plan or who have continued to carry both their own and the bank charge activities is the fact that under the bank plan they are sharing their customers with all other charge plan members. No longer does the customer feel that she belongs to a certain store where she has a charge account. Instead, she may feel only that she belongs to the XYZ Charge Plan.

There are indications that this type of plan will probably not appeal to the following types of stores: those operating on the supermarket technique because the markup is too low; chain stores which for the most part do not go along with the plan because it requires changes in their established operating policies; larger department-type stores that already have an established credit department and credit customers; and stores that are presently extending credit and are requiring weekly pay-

ments in the store or terms longer than those normally given under such plans.

Divided Payment Accounts

It is debatable as to whether divided payment accounts should be classified as charge accounts or as installment accounts. Most retail merchants have recognized the fact that although their charge account terms are theoretically 30 days, in actual practice the customer takes on the average of 45 to 80 days to make complete payment. As a result, some retailers have used this situation as a sales promotional device and have informed their customers that they may charge goods and make payments of one-half the amount owed in 30 days and the remaining half in 60 days. Thus, the term "60-day account" came into existence. Likewise in some stores payments of one third in 30 days, one third in 60 days, and one third in 90 days are allowed. Thus came into being the 90-day account. In most of these arrangements, no down payments are required, nor is any service charge made to the customer. Thus it appears that these arrangements are properly classified under the charge account category rather than under the installment account regardless of the fact that installment payments are involved.

Such arrangements have proved advantageous to stores desiring to promote sales of merchandise, the price of which is too high for the average customer to attempt to pay in 30 days. Often, the privilege of such divided payment is given only to those regular charge customers who have proved dependable and steady patrons of the store.

Scripbook Accounts

Another variation of the regular open charge account is the plan which provides customers with scrip or coupons which are used to purchase merchandise within the issuing store. This plan, which was originally put into operation by Halle's Department Store in Cleveland, is used for the purpose of encouraging sales on the one hand and of controlling the amount that a customer may purchase on credit on the other. In most stores in which the plan has been placed in operation, new scrip is supplied to the customer each month in an amount equivalent to his previous month's remittances.

SUMMARY OF CHARGE ACCOUNT CREDIT

Today the retail charge account has acquired many variations and innovations as compared with the open account credit found on the books

of the retailers operating in the post-World War I period. More than ever, merchants are adapting their credit policies and arrangements to fill their customers' needs in order to meet the increasing pressure of competition. Some stores are offering so many varieties of credit that the credit manager often has to choose the "correct" one for the customer rather than have the customer choose the one he or she desires. Nevertheless, the regular 30-day account still remains the backbone of the credit picture for vast numbers of retailers—primarily the smaller establishments—who accept the credit of their customers on open account.

REVIEW AND DISCUSSION QUESTIONS

1. What is a retail charge account? Be careful to note all of the characteristics normally found in the retail charge account.
2. What factors should a merchant consider in deciding whether to adopt the retail charge account in his business? Which factor do you think is the most important? Why?
3. Do you agree with the statement that consumer credit is a post-World War I development? Why or why not?
4. Using the data in Table 4–1, discuss and analyze the changing importance of charge account credit.
5. Explain cycle billing and why it is used today in many retail establishments.
6. Discuss the differences between the Diners' Club and the American Express credit plans.
7. Do you believe carrying charges should be used with regular charge accounts? Why or why not?
8. Who pays the cost of credit in a retail store? Support your answer with statements from leading merchants in your town.
9. What are the characteristics of charge account banking plans? Does your town have one? If so, secure some promotional data on the plan and present the information to the class.
10. What are the advantages of charge account banking?
11. What are the limitations of charge account banking?
12. If you were a retailer, would you join such a plan? Why or why not?
13. Distinguish between divided payment accounts and regular 30-day charge plans.
14. What are scripbook accounts?
15. What do you believe is the future of the retail charge account?

CHAPTER 5

Types of Consumer Credit—Retail Revolving Credit and Service Credit

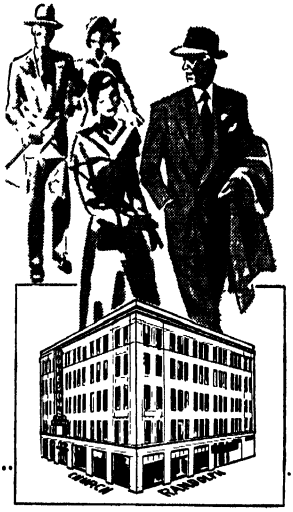
As we have noticed in the previous chapter on charge accounts, credit is a persuasive salesman. In an economy such as ours there is an ever-increasing array of goods and services which continuously fight for the consumer's attention—and pocketbook. Whereas sellers for cash must bring about buying when consumers have the funds in hand, sellers for credit can tempt their clientele at any time and in many ways. Two vitally important developments in this expanding credit picture are the retail revolving credit plans and the credit accepted by persons and firms performing services for the consumer.

RETAIL REVOLVING CREDIT

The first revolving credit plan offered in the United States for the sale of soft goods to the consumer was introduced in 1938 by Wanamaker's of Philadelphia. This plan, which was quite different from the revolving credit plan commonly in effect today, called for complete liquidation of the account in four monthly payments, and no service or extra charges were posted to the account. Shortly thereafter, Filene's in Boston, Bamberger's in Newark, and Bloomingdale's in New York introduced plans of their own that offered terms with a service charge added each month on the unpaid balance. During World War II, Regulation W, in requiring down payments on all purchases over $10, acted as a strong deterrent to the expansion of this type of retail credit, but

FIG. 5–1

PAGE TWENTY-FOUR THE NEWS-GAZETTE SUNDAY MARCH 13, 1955



Another FIRST at Robeson's

Now... when you come to shop at Robeson's

You can INCREASE

Your PURCHASING POWER

12 TIMES MORE

Than You Could Normally Afford!

Now... You Can
NAME YOUR OWN TERMS
in Robeson's new...

CONTINUOUS CREDIT PLAN

HERE'S HOW EASILY THIS PLAN WORKS...

1. You can now have 12 TIMES MORE BUYING POWER at ROBESON'S with **NO DOWN PAYMENT!**

2. You decide how much you want to pay each month . . AND Robeson's will extend you the corresponding continuous credit . . . . . .

$5	$10	$15	$20	$25
$60	$120	$180	$240	$300

* These are suggested terms but actually you can NAME YOUR OWN TERMS!

3. It's Easy-to-Buy! It's Easy-to-Pay! . . . with Robeson's new CONTINUOUS CREDIT PLAN!

4. Come to our Credit Office, balcony . . . and make arrangements for your "R-C-C-P" Now!
(Robeson's Continuous Credit Plan)

5. You establish your own credit limit. Say you set $120 as your limit . . . all you pay is $10 per month. BUT, you can have a continuous balance of $120 at Robeson's! Any time your account balance is less than the maximum credit you have established for yourself . . . you can make additional purchases up to your account limit, (1) without any extra visits to our credit office, (2) with NO MONEY DOWN, and (3) without increasing your established monthly payment! With this Plan you receive our CREDIT PLATE. (One per cent service charge with this plan).

CONTINUOUS CREDIT PLAN is in addition to our established Credit Plans...

30-DAY CHARGE
Save shopping time . . . no need to carry money. Your Credit Plate is all you need. You will receive a monthly statement complete with your original sales checks and credits.

BUDGETED PAYMENT PLAN
Designed for you to enjoy the use of major purchases such as appliances or other home furnishings. No down payment is required and you can take as long as two full years to pay. Small carrying charge included in monthly payments.

LAY AWAY PLAN
Here you can select any item you desire and with a small deposit have us hold your choice until you are ready for it. Choose when stocks are at their peak pay when you're ready

Note This advertisement of Robeson's Department Store of Champaign, Illinois, appeared in the March 13, 1955, issue of the *News-Gazette*

with the lifting of this regulation, department and specialty stores—both large and small—have become interested in this plan.

"Basic" Revolving Credit Plans

Known by various names but generally called "revolving credit," the type of plan that is commonly found in retail stores today is a hybrid between the open charge account and the installment account. Under this plan the customer who is afforded the opportunity to buy primarily apparel and other soft-goods items (although hard goods may be charged under some plans) on a deferred-payment basis can determine the monthly payment best suited to his needs. This monthly payment multiplied by the number of months that the store chooses to run its revolving credit plan determines the credit limit that is established for this customer. A service charge which usually is based on the brought-forward balance is added to the account and is payable along with the regular monthly payment. Some stores, however, follow the practice of including the service charge as part of the agreed monthly payment, rather than considering it as an additional amount due. Illustrations of revolving credit plans in several retail organizations are shown in Figures 5–1 and 5–2. The advertisement displayed in Figure 5–1 shows the initial introduction of a basic plan, while the illustrations in Figure 5–2 show the promotion of "flexible" revolving credit plans after they had been in effect for some time.

A simple illustration will demonstrate how the plan operates. Let us

FIG. 5–2

Ayres' flexible charge account

The flexible plan enables you to buy the things you want and need right now, and spread the payment over several months as determined by the ***flexible payment schedule*** below. This plan is very helpful in handling seasonal buying needs such as Christmas, back-to-school and vacation wardrobes. You determine your own credit needs!

You receive a Charga-Plate. A complete record of purchases and credits are included with your monthly statement. (Small service charge included in payments.)

If your monthly balance is:	$10 to $60	$60 to $90	$90 to $120	$120 to $150	$150 to $180	$180 to $200	$200 & over
Your payment for that month is:	$10	$15	$20	$25	$30	$35	1/5 of statement balance

Courtesy of L. S. Ayres and Company, Indianapolis, Indiana. The flexible charge, or revolving credit plan (six months), was started in August, 1950.

FIG. 5–2—*Continued*

The greatest credit help you ever had!

filene's BCA *budget charge account**

**formerly PBA*

on which you pay just a little every month

BCA allows you to buy as much as you need each month. You pay only a part of the full balance each month according to the chart listed below.

When you pay, you rebuild your credit and you may charge more at anytime, raising or lowering the total to suit your needs.

A small service charge is included in the balance of each monthly statement.

If you pay your bill in full before your next billing date, there will be no service charge.

The Filene BCA charge plate you will receive is usable at all Filene stores . anywhere except the Bargain Basement.

Note . . . a regular Filene charge account is payable in full, when you receive your statement. We give you a Filene charge plate or will notch, for Filene's, the one you may have.

Fill out the two forms below

(application AND the agreement)

(. . . detach on perforation
. . . moisten and seal . . . return postcard
will show outside . . . no postage required)

This is your Filene Budget Charge Account agreement

If my application to Wm Filene's Sons Company, a Division of Federated Department Stores, Inc., for a Budget Charge Account with the budget bonus feature is accepted and in consideration of the extension of credit by Filene's for purchases made by me or members of my family from time to time, I agree

1 that all purchases made and charged to this account, including mail or telephone orders, shall be evidenced on a form prescribed by Filene's, and all such purchases shall be governed by and payable in accordance with this agreement,

2 to pay $10 each month on receipt of my bill so long as anything is due on my account, provided my balance does not exceed $100

3 in those months when I vote myself a budget bonus and each month that my balance exceeds $100 to pay, on receipt of my bill, the monthly payment due as shown on the BCA budget bonus chart attached,

4 to pay as part of my required monthly payment, credit charges on the unpaid balance of the total purchases in accordance with the Budget Charge Account terms generally in effect at the time of each purchase

5 to use the BCA Charga-Plate on all BCA charge purchases,

6 to surrender on demand the BCA Charga-Plate given me by Filene's, which remains its property,

7 that if I fail to pay my bills as I agree Filene's may ask me to pay the entire balance I owe, immediately,

8 that Filene's or I may terminate this agreement at any time upon notice to the other, but my existing obligations will not be affected.

WHEN YOUR ACCT BALANCE IS	YOUR PAYMENT FOR THAT MONTH WILL BE
UP TO $100	$10
101 to 120	15
121 to 140	20
141 to 170	30
171 to 200	40
201 to 240	55
241 to 280	70
281 and over	¼ of balance

The Finance Charges Provided Herein are NOT Regulated by Law They are a Matter for Agreement between the Parties.

DATE:..... Name .....

WM FILENE'S SONS COMPANY

By ..... Address .....

Courtesy of Wm Filene's Sons Company, Boston, Massachusetts

assume the store and the customer agree to a $10 monthly payment and that the store is operating under a six-month plan. Thus the credit limit is established at $60. As soon as the customer charges a purchase to the revolving credit account, the $60 credit limit is reduced by the amount of that purchase. Thus if the purchase is $15, the "open-to-buy" of the customer is reduced automatically to $45 until the first payment of $10 is made. As soon as the $10 payment (plus the service charge) is made, the "open-to-buy" increases to $55 ($60 − $15 + $10 = $55).

FIG. 5–2—*Continued*

Here's how Bullock's Personalized Budget Account works:

Mrs. Jones found the right coat at $95; suitable accessories came to $45. With the flexible PBA her first bill will be $140, the total of the amount purchased. The payment schedule shows that her payment due is $25 leaving a $115 balance. With no further purchases the second bill to Mrs. Jones will call for a payment of only $20. Her monthly payment has dropped automatically with the decreasing balance. If Mrs. Jones should make new purchases the monthly payment would automatically increase with the balance as indicated in the Flexible Payment Schedule.

FLEXIBLE PAYMENT SCHEDULE

When your monthly balance is:	*Your payment for that month is:*
$ 10 to $ 60	$10
$ 61 to $ 90	$15
$ 91 to $120	$20
$121 to $150	$25
$151 to $180	$30
$181 to $200	$35
$201 to $500	1/5 of Statement Balance

See Credit Office for amounts over $500.

Just one call at the Credit Office of any Bullock's store is all it takes. Then you can enjoy the Personalized Budget Account Plan.

Courtesy of Bullock's, Inc., Los Angeles, California

Additional purchases, of course, reduce the "open-to-buy" as of any moment of time, just as additional payments increase it. It should be recognized that no monthly payment is due, unless the customer actually has an amount owing the store. There has been some confusion in the minds of some customers to the effect that the agreed-upon monthly payment is due regardless of whether or not goods are purchased. This is not true of any revolving credit plan, as the stores are not establishing themselves as bankers for their customers. The following table illustrates one of these plans commonly in effect today:

Table 5–1

A TYPICAL "BASIC" REVOLVING CREDIT PLAN

If the customer agrees to pay monthly*	$10	$15	$ 20	$ 25	$ 30	$ 35
Then the credit limit is	$60	$90	$120	$150	$180	$210

* Plus carrying charge

This basic type of revolving credit plan holds a tight rein on the buying activities of a customer. However, some stores that have such a plan in effect have somewhat relaxed this restricted credit for peak season buying—as at Christmas, Easter, and back-to-school purchasing in September—and have permitted their customers (sometimes on a selective basis) to expand their credit beyond their fixed limits. These customers usually are expected, however, either to pay the above-limit amount in

FIG. 5–2—*Continued*

Plan No. 3 **DEFERRED PAYMENT ACCOUNT** *offers you greater shopping convenience and the easy budgeting of payments on major purchases over $25*

DPA

We call it DPA for short, but it's really the *long*, convenient way to pay for major purchases that bite too big a chunk out of one pay check

how much credit do you want ? Your credit limit is arranged on your initial visit to our Credit Department, and is the amount you may owe Strawbridge & Clothier at all times, provided monthly payments are made promptly

how much do you pay each month ? Your monthly payments are based on the highest balance shown at any time on your account, not on your credit limit. The amount of your monthly payment will appear on each bill For example, if the highest balance shown on your account is $330, your monthly payment would be $17

additional purchases can be made without increasing your monthly payments providing your unpaid balance, including the new purchase, is not more than your highest previous balance When additional purchases increase the amount of your monthly payments, you will receive a slip in your bill, notifying you of this change

your DPA is easy to add to ! No need to wait until your first purchase is completely paid for before you use your DPA again Once your account is opened, it becomes a continuous account, and you may add articles priced at $25 and more with No Down Payment

S&C sends you a bill each month showing amount of each purchase, payment and your balance Your sales checks and credit slips will be enclosed with your bill, which is mailed in alphabetical order The date you get your bill will depend on the first letter of your last name

Is there a credit service charge ? Yes, to help cover the cost of handling DPA accounts, a small carrying charge will be added to your statement each month

larger payments reduce your carrying charge ! If you choose, you can make larger payments than the required amount, and in this way reduce the amount of the service charge On accounts paid in full within ninety days of date of purchase, all carrying charges will be credited

bring your statement when making payments in person at any of our four stores

mail the top portion of your statement showing your name and address when paying by mail Always use checks or money orders when paying by mail.

DEFERRED PAYMENT ACCOUNT SCHEDULE

amount of purchase	*monthly payment*
$25 to $60	$ 5
$61 to $80	$ 6
$81 to $110	$ 7
$111 to $150	$ 8
$151 to $200	$10
$201 to $250	$12
$251 to $300	$15
$301 to $350	$17
$351 to $400	$19
$401 to $450	$21
$451 to $500	$23
$501 to $600	$27
$601 to $700	$32
$701 to $800	$37
$801 to $900	$40
$901 to $1000	$45
$1001 to $1500	$67

Larger amounts than those shown here may be scheduled by special arrangement

Courtesy of Strawbridge & Clothier, Philadelphia, Pennsylvania

the following month or to make bigger monthly payments for a few months until the predetermined credit limit is regained.

"Chart" and "Flexible Limit" Plans

In an attempt to correct some of the shortcomings of this so-called "basic" revolving credit account, many retailers over the country recently have adopted what has been commonly called in the trade as the flexible or the chart plan of revolving credit. Under this type of credit arrangement, the flexible account of a customer has no agreed-upon ceiling; the terms are not standard among merchants; and some merchants are offering carrying terms to individual customers, depending

Table 5–2

A TYPICAL "FLEXIBLE" OR "CHART" PLAN

If a Customer's Balance Is—	*Then the Monthly Payment Is—**
Under $50	$ 5 00
Between $50–$75	7 50
$76–$100	10 00
101–125	12 50
126–150	15 00
151–175	17 50
176–200	20 00
201–225	22 50
226–250	25 00

* Plus carrying charge

upon the credit risk involved. One reason often given for the necessity of some type of flexible plan is that stores have discovered that their customers, instead of asking for higher limits as their open-to-buy disappears under the basic plan, shift their buying to another store to boost their available credit. (See Figure 5–2.)

Often under this type of arrangement, the customer is given the option of paying the monthly bill within 30 days without the addition of any service fee. The plan, of course, also provides a schedule of payments for amounts carried beyond 30 days. For each range of unpaid balances —as for example, under $50, $50–$75, $76–$100, and so on—there is a specific monthly payment of $5, $7.50, $10, and so on due. The service charge is added to this monthly payment. The payment that is due is predicated on the balance owing, thus providing for reduced monthly payments as the balance outstanding declines. A typical flexible or chart plan is shown in Table 5–2.

An examination of the payment schedule shown in Table 5–2 reveals that the store that has such an arrangement in effect would be operating under a 10-month plan. Also it should be pointed out that if the balance

due falls below $5, then the exact amount owed is the amount that the customer is expected to pay.

Modifications or Variations

As to be expected, no one plan or series of plans ever exactly meet all of the specifications desired by retail stores. Nor does any one plan provide the same degree of sales promotion advantage for a competing store. Thus, as to be expected, there have appeared many variations of the basic and of the flexible plan. While it would be impossible and of little

Table 5–3

MONTGOMERY WARD'S BASIC REVOLVING CHARGE PLAN

If each month the customer wishes to pay*	$10	$15	$20	$25	$30
Then he may charge up to	$100	$150	$200	$250	$300

* Plus carrying charge

value to describe all of them, it is worthwhile to view a few to see what variations are being used to attract customers to buy on revolving credit.

Let us consider the plan that Montgomery Ward introduced into some of its retail stores as of August, 1957. First, Ward's worked on a basic plan and adopted the following payment schedule as shown in Table 5–3.

Ward's, however, included the following notation in their promotional question-and-answer material describing the plan:

May I buy more than my agreement limit? Yes, a special occasion such as Christmas, Easter, or back-to-school shopping may create a need for a temporary increase in account limit. Perhaps at such a time you want to charge an additional $50 or $100. Ward's Revolving Charge plan includes a flexible payment scale that gives you up to 4 months to pay out this temporary "bulge." Then you return to your regular monthly payment. For example:

If your account exceeds agreement limit by—	*You pay that month agreed payment plus—*
up to $40	$10
$41 to $80	$20
$81 to $110	$30
$111 to $140	$40
Amounts over $140	1/3 of amount over agreed limit

The flexible chart plan has become the answer for many stores because this plan is believed to be more adjustable to the customers' needs. It also, more or less, puts the responsibility for control of the account

with the customer. Many stores were gratified with this new aspect of revolving credit because it decreased credit office traffic and increased credit sales. But there were disadvantages to this plan also. The average outstanding balances increased which resulted in more capital being tied up in accounts receivables. Also, control of accounts was sometimes more difficult. As a result, many credit observers predicted that soon many stores would adopt a One-Account or All-Purpose account which would replace the two, three, or four types of credit offered by stores. It is interesting to note that in May, 1956, J. L. Hudson's Department Store adopted the 30-Day Account with Optional Terms.

Briefly, Hudson's 30-Day Account with Optional Terms provides for repayment in full in 30 days without service charge or the customer may pay as little as one fourth of the balance each month with a minimum monthly payment of $10.00 if the balance is $50.00 or less. Thus, all of their 30-day accounts and revolving charge accounts have been converted to their new account.

According to the Hudson officials, there are several distinct advantages in the Option account which certainly must be considered in the adoption of this type of credit. The advantages include the following: increased sales, simplified billing, convenience to the customer, increased service charge income, uniform collection procedure, and savings in supplies.

How Revolving Credit Compares with Open Charge Credit

Revolving credit is similar to open charge credit in that the customer ordinarily makes a series of purchases under both arrangements—in fact the retail store would consider its sales promotion program faulty if such was not accomplished. Likewise, there is no down payment under either arrangement, and the type of goods—apparel and other soft goods items—purchased under each plan is almost identical.

Revolving credit has some characteristics, however, that distinguish it from open charge credit. For example, in revolving credit, recurring payments are made over a period of time; whereas in open charge credit, payment is expected in one lump sum, usually 10 days after receipt of the bill by the customer. No service or carrying charge is usually found in open charge credit, although there is an increasing tendency for retail stores to make an additional charge on a selective basis if the account is not paid in 60 days. Under revolving credit arrangements, the customer is almost always charged a carrying fee which is based on the balance due on the revolving credit account. In addition, under revolving credit, title to the merchandise purchased sometimes remains with the

store until the customer has paid the purchase price thereof in full. Any risk of loss of such merchandise by fire or otherwise is generally assumed by the customer.

How Revolving Credit Compares with Installment Credit

Previously it was mentioned that revolving credit was a hybrid between open account credit and installment credit, being similar in some respects to each and likewise differing from each. The two main points of similarity between revolving credit and installment credit are as follows: first, under each there usually is the establishment of a schedule of payments over a period of time; and second, there is also the cost of a carrying charge levied on the consumer by the retail store.

The two plans differ considerably, however, in that no down payment is required under the revolving credit plan, whereas such an action is usually customary, although not always requested, under an installment transaction. Under the revolving plan, it is hoped that the customer will purchase a series of articles—usually of fairly low unit value—and will continue to make such purchases on a recurring basis. In installment transactions, however, the goods involved are primarily those of a high unit value, durable, and of substantial repossession value. These purchases are backed generally by a conditional sales contract or a chattel mortgage, as a means of minimizing the seller's risk and thus assuring repossession. Likewise, the installment sale is usually for only one such article and is not established to cover recurring purchases. Exceptions to this are the stores that have recently started to permit "add-on's" in installment transactions up to some predetermined limit.

It should be recognized that in many classifications revolving credit has been considered as simply a modified form of installment selling. In fact, the statistical data on consumer credit that appear in the monthly issues of the *Federal Reserve Bulletin* include the revolving credit sales volume as part of the installment credit sales. For this reason, it is not possible to arrive at the national importance of this type of credit. However, because of the rapidly expanding use of this type of credit, primarily in the department-store type of retail store, it has been considered advisable to consider it as a distinct and separate form of credit activity.

Factors Affecting the Determination of a Merchant to Sell on Revolving Credit

It should be recognized that in his decision to adopt a revolving credit plan, the merchant must take many factors into consideration. The most

important of these factors include effect on profits, amount of capital, competition, type of goods, size of community, type of community, and desires of customers. Let us examine each of these factors separately.

Effect on Profits. Whether or not to introduce or to expand revolving credit activities depends primarily upon the effect on profits that the merchant expects such an action to have. Despite all the other factors that were enumerated and that will be discussed subsequently, unless a merchant believes that increased sales accompanied by increased profits will result, he will not introduce or will not attempt to expand his revolving credit activities.

Amount of Capital. Revolving credit may necessitate a much larger capital investment than open charge credit because of the time that is involved before an article is paid for completely. It should be recognized, however, that a retail store which conducts its open charge activity in a highly lenient manner and does not insist on payment close to the agreed-upon 30-day terms and as a result gets 80 to 90-day payments is often in a worse financial squeeze than the store that receives a small payment (plus a carrying charge) each month under a revolving credit plan. If a store is receiving fairly prompt payments from its open charge accounts, the amount of capital needed to carry these accounts is less than the amount needed to carry an equal dollar volume of revolving credit accounts. In addition, since revolving credit also results usually in increased credit sales, this of itself calls for a larger capital investment. Another item to consider is that in those instances in which the store finds itself in need of funds more quickly than payment is expected from the customer, the assignment of a revolving credit account is not nearly as accepted a practice as is the case with installment accounts.

Competition. This factor has been especially important in revolving credit, because the first department store in a community that adopts such a plan seems to derive an important and often lasting competitive advantage with some customers over similar stores which may introduce such a plan in the future. Once a customer has signed a revolving credit agreement with one store and has committed herself to a predetermined or flexible monthly payment, she may find herself unable financially to meet payments for additional credit at other stores. Thus, if the store has a successful sales promotion program and keeps the customer buying, this buying may be heavily concentrated at this one store in which the customer first opened a revolving account. This is the hope of the store, of course, and can be accomplished only if the customer remains satisfied with the merchandise sold, the prices charged, and the services rendered.

Regardless of this possible initial advantage, competing stores often believe—and rightly too—that they should offer equivalent credit opportunities, and thus they too install a revolving credit arrangement. Their potential market for revolving credit customers includes people who have not opened a revolving account at the first store, as well as people who are members of the first store's plan. Of course, being a member of a plan does not automatically mean that you will make regular use of your revolving account in any one store.

Type of Goods. This factor plays an important role in the decision of many stores as to whether to adopt a revolving credit plan. If a store handles primarily "big-ticket" items (such as appliances, furniture, and similar consumer durables), a successful revolving credit plan must provide for a sufficiently long repayment period to permit reasonable monthly payments. It also should be recognized that with this type of goods regular recurring purchases are not customary. Thus in most instances the installment type of credit arrangement has proved more suitable for these types of goods. If the goods handled are of such a nature that they would be consumed, such as groceries, before they are completely paid for under a revolving credit plan, the characteristics for successful operation are not present.

In fact, the department store, with its wide variety of semidurable merchandise carried, has been the primary proving ground for revolving credit plans.

Size of Community. The size of a community, in itself, is no determinant of the success or failure of a revolving credit plan. To say that a plan automatically will be a success in a city of 100,000 persons and a failure in a town of 10,000 is failing to recognize the importance of the size of the store itself, the type and price of merchandise carried, the selection of goods available to customers not only in this particular store but also in competing stores in the same town and in towns attracting trade from some distance, and the availability of credit data on prospective customers.

Experience has shown, however, that stores in the larger communities have been the ones most often introducing such a plan, although more careful attention might be given by smaller-town merchants to this credit arrangement as a possible means of holding more trade in the local area and of preventing regular customers from widely dividing their patronage. To accomplish this, the smaller-town merchant will, of course, have to offer merchandise of quality, assortment, and price comparable to his larger-community competitors. Revolving credit alone will not prevent a customer from "shopping around" for the best buy.

Type of Community. The success of a revolving credit plan is based primarily upon regularly recurring purchases on the part of customers and regular monthly payments as agreed upon between the store and the customer. Thus, another factor to be considered by the store contemplating the introduction of such a plan is the type of community in which it is located. Is the town one in which the inhabitants generally have a regular weekly or monthly source of income, relatively free from the seasonal income feature found in some agricultural areas and not subject to the irregularity of work due to strikes, layoffs, and cutbacks in industrial activities? This is not to say that such a credit arrangement is impossible in such communities, but it is imperative that in these areas merchants give long and careful consideration as to whether their customers—present and future—will be able to meet their regular monthly payments. This problem also exists, of course, in installment sales but is involved only to a limited degree in open charge transactions.

Desires of Customers. Again the desires of the customers must be considered, as they are in open charge and installment credit. Simply installing such a plan is no guarantee of greater sales and higher profits, unless the customers actually wish to purchase under such terms or can be persuaded that this arrangement is to their advantage. For example, it is impossible to imagine customers ever agreeing to such a plan in their buying of groceries, although the 30-day charge form of credit has proved to be a major factor in the success of many smaller grocery retailers in competing against their larger cash-carry competitors.

Benefits and Pitfalls of Revolving Credit

To introduce a revolving credit plan is not an automatic assurance of higher profits. The store must give careful consideration to the factors just discussed and should weigh the advantages and pitfalls of such a credit arrangement. It should be recognized also that many of the advantages for the store become the reverse—that is disadvantages—for the customers.

To the Customer. The customer who decides to purchase goods under a revolving credit plan is usually in the position of being able to charge a larger dollar volume of goods than under a regular 30-day arrangement because of the extended period of time over which payment may be made. Knowing the monthly dollar payment that has been agreed upon with the store under the so-called basic plan, the customer also is in a better position to allow for this definite payment in any budget planning that may be done. In addition, once the revolving credit account is established and a basic limit set, the customer then is free to buy

at any time up to that limit without the need of having his credit rechecked with each purchase as is the case with the usual installment buying. Even more freedom is afforded the customer under the flexible or chart plan, in that enlarged payments automatically permit larger purchases.

Despite the advantages, the customer encounters certain pitfalls when deciding to buy under such an arrangement. For one thing it may be too easy for the customer to buy, and thus he may find himself continually in debt to the store. In fact, it has been discovered that in some areas in which revolving credit has been actively sold to customers, these families have come to look upon revolving credit payments in the same light as income tax and other types of deductions.

Another factor for the customer to consider is, of course, the carrying charge involved in revolving credit. Thus, the customer is the one directly paying for the use of this privilege of continuous buying. With the most commonly used carrying charges running at either 1 per cent or 1½ per cent per month on the unpaid balance, the customer is paying a true annual rate of 12 or 18 per cent.[1] It is interesting to wonder whether the average customer actually knows the carrying cost in terms of percentages, as in many cases the monthly carrying charge is explained to the customer by the store in terms of dollars and cents rather than percentages. Some stores are furnishing their customers prepared tables, showing these predetermined carrying charges. Such a table appears in Table 5–4. Of course, the actual dollars and cents figures are much more meaningful to many customers than a stated percentage figure. As previously mentioned, some stores have introduced the following statement into the description of their plans: "There is no monthly charge. A small handling charge is added to each purchase." Although this handling charge is usually in the neighborhood of 6 per cent and it is this 6 per cent figure that is used in the sales promotional material furnished the customer, it would be interesting to know how many customers actually realize that a $100 item purchased on a 6 per cent-six month plan carries with it a true rate of 20.57 per cent.[2] As an offset to these carrying charges of 12, 18, and 20 per cent, it should be mentioned that the customer under the federal income tax law is permitted to list as a deduction on his Form 1040 interest paid by him "equal to

[1] This rate will vary to some degree depending upon the time that the service charge is levied; that is, is the carrying charge added before giving credit for the current monthly payment and for returns and allowances, or after such credits are made to the accounts?

[2] Using the formula $R = \frac{r(2n)}{n+1}$ where R is true annual rate at simple interest, r is the nominal annual rate, and n is the number of installments.

6 per cent of the average unpaid monthly balance under the contract" with the store.

Another factor of importance to the customer—but often overlooked by him—is the statement that appears in many of the revolving credit agreements between customer and store. Typical of such a statement is as follows:

> Title to merchandise purchased on this account shall remain in you until I have paid the purchase price thereof in full. I assume and shall be responsible for all loss or damage to said goods after receipt.

Such a statement, and the hundreds of others similar to it, raise the question as to when merchandise bought under a revolving credit agreement is actually paid for completely and in full. Of course, there is no

Table 5–4

CHART PLAN FOR PLANNED BUDGET ACCOUNT SERVICE CHARGE

Previous Balance		Monthly Charge	Previous Balance		Monthly Charge
From	Up to		From	Up to	
$10 00	$ 15 00	$ 20	$55 01	$ 60 00	$ 87
15 01	20 00	27	60 01	65 00	.94
20 01	25 00	.35	65 01	70 00	1 02
25 01	30 00	42	70 01	75 00	1 09
30 01	35 00	.50	75 01	80 00	1 17
35 01	40 00	57	80 01	85 00	1 24
40 01	45 00	65	85 01	90 00	1 32
45 01	50.00	72	90 01	95 00	1 39
50 01	55 00	.79	95 01	100 00	1 47

problem involved if an account is completely paid and there is no balance owing. Under such a condition, it is obvious that title passes to the buyer. But the point in question does arise if the customer keeps a continuous balance owing to the store and if at any time the customer defaults in payment. In such a situation, just what goods if any has the customer paid for in full? In the soft-goods line such a question is generally more theoretical than practical since the advantage of and ability to repossess soft merchandise is obviously little. But the issue assumes greater importance as revolving credit arrangements are made available for hard-goods purchases.

To the Store. The primary purpose that a store has for introducing revolving credit into its operations is to increase sales and in turn profits. If this type of credit arrangement is not productive in this man-

ner, then the store should seriously reconsider this phase of its credit policy. Closely connected with this primary objective is the added income available to the store from the carrying charge levied on the customer. Another related advantage is the meeting of competition offered by other stores with similar plans, as well as the hope that through this plan customers of the store will be encouraged to make more of their purchases in this one retail establishment rather than divide their buying among many competing institutions. Many stores also have adopted this policy in the hope of decreasing bad-debt losses, in that customers can not only purchase more but can pay off the resulting amount owed much easier through small but regular monthly payments.

While the store may benefit in the ways just described, it still experiences certain limitations in the use of revolving credit. This type of arrangement generally calls for more capital investment, in that payment is made over an extended period of time. Because of this time factor, some stores have found that bad-debt losses may tend to increase because of "skips." Thus the type of clientele which may change with the introduction of revolving credit may call for more careful and most costly credit investigation. It should be recognized that "calling for" a different type of investigation and actually "making" this more detailed analysis of the credit risks are two entirely different things. Thus some stores have continued to accept revolving credit on exactly the same basis as they accept regular charge account credit. Another point worthy of comment is the additional bookkeeping, billing, and other related tasks that accompany revolving credit and add to the costs of its operation.

Soon after a basic revolving credit plan is established, the store discovers that it has a very perplexing and serious problem—overlimits. The biggest problem in the overlimit situation is that the good customers feel they should stay within the agreed-upon limit, and it is these very customers that the store would like to see buy more, whether they request a raising of the limit or just go over the limit. It is the poor risk that owes a store $300 or $400 on a $120 account and gives the store a big collection problem. This problem has been the cause for the adoption of the flexible plan and its variations in many retail stores over the country.

This problem of limitations of a revolving credit plan from the point of view of a store has been well expressed by A. Leonidas Trotta, Manager, Credit Management Division, National Retail Merchants Association:[3]

[3] A. Leonidas Trotta, "New Developments and Analysis of Revolving Credit," *Credit Management Year Book 1955–1956* (New York: Credit Management Division, National Retail Merchants Association, 1955), pp. 165 and 169.

Let me make it perfectly clear that in spite of my obvious enthusiasm, I do not regard revolving credit as a panacea. To be sure there are problems—known and unknown, but if you offer or contemplate offering the plan, the problems and questions you want answered are:

1. How profitable are these accounts?
2. What are the most efficient operating procedures?
3. How do operating costs compare with those for other accounts and at other stores?
4. How much of revolving credit business is plus business?

Before you can answer these questions, you will have to find the answers to other questions, such as

1. How much does it cost to open and maintain a revolving credit account?
2. What are the average yearly purchases per account?
3. How active are these accounts?
4. What do bad-debt losses amount to?
5. How important is service charge income to the maintenance of these accounts?
6. How do these factors and costs compare with those for monthly accounts?

In addition, Mr. Trotta called attention to the following questions:

1. Policy, such as
   a) Can a customer have a monthly and revolving account concurrently?
   b) What will be your maximum maturity?
   c) What rate of service charge will be made and how does this compare with competitive charges?
   d) How will the plan be publicized?
   e) How will your credit extension requirements differ from monthly accounts?
2. Equipment and procedures
   a) Housing equipment and physical filing arrangement;
   b) Billing equipment,
   c) Procedures involving forms, letters, notices, and employee training and supervision,
3. Cost and method of financing accounts receivable.

The expanded use of the flexible revolving credit is also a step closer toward the credit plan that has been called "the one standard account." Under this standardized plan, a store will have only one type of credit account. Once a customer is accepted for this type of credit, he may pay any incurred indebtedness within 30 days of purchase without any carrying charge. If the account runs over 30 days, it is automatically switched to a flexible revolving credit arrangement (similar to the one previously described). If the amount the customer wishes to charge runs above the customary limit established by the store for revolving credit accounts, the customer then is asked to set up a schedule of payments with the credit department with a monthly carrying charge on this ex-

tended payment period usually the same as that of the basic revolving credit plan.

It should be apparent that revolving credit is in its infancy. Only one thing is certain—revolving credit in some form will continue to be a major factor in credit sales of the future!

INTEREST CHARGE OR SERVICE CHARGE?

The overwhelming rule throughout most of the United States has been that a business firm may sell its goods and services at one price for cash and at a higher price on time without violating the interest and usury laws. The reason for this view arises from the generally accepted idea that a sale of goods and services is involved and that a loaning of money is not connected with the transaction. Thus, interest and usury laws have been interpreted as applicable only to the lending of money. Carried one step further, it has been accepted in most instances that the sale of an installment or time payment contract by a business firm to a finance company or banking institution does not involve the interest and usury laws.

Recent legislative and court actions in various parts of the country, however, have raised highly pertinent questions as to the applicability of interest and usury laws to the sale of goods and services on a time basis. Toward the end of the 1959 legislative year, some 30 states had statutes, special or regular, related in a direct and material way to spelling out in detail the cash price-time price concept.[4] In the other states, the fundamental issue still involved is simply whether a finance charge or service charge is to be considered an interest charge. If it is to be considered an interest charge, does the usury law in the state apply? If it does, will it be found that the financing charge in most of the transactions involved is in excess of the interest rate allowed under the usury law?

It is clearly evident that this cash price-time price problem strikes at the very heart of our entire credit system.

Connection with Revolving Credit Plans

Especially pertinent is this problem in connection with the sale of goods under the relatively new revolving credit plans found in most of the leading department stores throughout the country.

It will be noticed that in all these plans, regardless of type, a carrying charge is involved. This charge generally is quoted[5] at ¾ of 1 per cent

[4] See Appendix B.

[5] Robert H. Cole, *Revolving Credit* (Urbana, Ill : Business Management Survey No. 6, Bureau of Business Management, University of Illinois, 1957). *Credit Management Year Book—1957–1958* (New York: National Retail Merchants Association, 1957), p. 39.

per month on the unpaid balance (9 per cent true annual rate), or at 1 per cent per month (12 per cent true annual rate), or at 1½ per cent per month (18 per cent true annual rate). It should be noted also that under most revolving credit plans customers have not been told what the exact time price of a good will be but have been told only the cash price and the carrying charge involved.

Recent State Action. Seven states—Arkansas, California, Florida, Nebraska, New York, North Dakota, and Ohio—have taken significant action in relation to the revolving credit and installment transactions. So significant in fact that retailers, lawyers, legislators, and a few consumers are closely following the repercussions and the impact upon legislative and court actions in other states.

The Supreme Court of Arkansas, in a decision[6] on December 23, 1957, held that an installment sale contract by Sears, Roebuck & Co. was usurious and void. This Sears case put Arkansas in the unique position in which merchants of the state must restrict their time price of goods to no more than the legal rate of interest above their cash price of the goods. In this particular case the contract showed "Total cash price $393.98" plus "Carrying charge $37.17." The total of $431.15 was payable in monthly installments of $22, and the carrying charge exceeded the maximum interest rate of 10 per cent established by the Arkansas Constitution. The Constitution provides that "all contracts for a greater rate of interest than 10 per cent per annum shall be void." In its decision the court noted that Sears has

> . . . a splendid reputation for its dealings with the public; . . . but if we should hold that this contract is not usurious, it would be a precedent by which all the sellers of merchandise of every kind and description could add any amount to the cash price as interest, carrying charge, differential or what not, that those whom the Constitution and statutes were designed to protect would of necessity agree to pay. And Art. 19, par. 13, of the Constitution, prohibiting usury, would amount to nothing more than a scrap of paper.

Insofar as the cash price-time price concept in connection with the sale of goods is concerned, it would appear that at the present time there is nothing left of the rule in Arkansas.

A decidedly different action has been taken in New York State. The New York Retail Installment Sales Act,[7] which went into effect October 1, 1957, recognized that retail stores have different problems in handling revolving credit accounts, as opposed to 30-day open charge accounts for example. The New York Act regulates the charges that can

[6] *Sloan* v. *Sears, Roebuck and Co.* (Ark. Sup. Ct., Dec. 23, 1957) 308 S.W. (2d) 802.

[7] New York Retail Installment Sales Act, Personal Property Law—Ch. 41, Art. 10, as added by Laws of 1957, Chapter 599, approved April 17, 1957.

be levied on revolving credit accounts, setting the limit at 1½ per cent per month on the first $500 unpaid balance of an account and at 1 per cent per month on amounts in excess of $500, with a minimum of $1 per month where the computed charges are less. No time price need be quoted, but the contract must "state the entire agreement of the buyer with respect to the subject matter of the credit agreement." Until passage of this legislation, considerable uncertainty existed in New York State concerning the validity of carrying charges on revolving credit accounts. The retail stores thus have avoided the possibility of having the usury laws of New York apply to their revolving credit transactions.

During the 1959 legislative year, laws were enacted in California, Florida, Nebraska, North Dakota, and Ohio regulating revolving credit transactions in retail stores. In other states, this question is being debated also. For example, in Wisconsin revolving credit in department stores has become the subject of attention and interest of the Supervisor of the Division of Consumer Credit, State Banking Department of Wisconsin. Writing in the Spring 1958 issue of the *Personal Finance Law Quarterly Report,* John F. Doyle, Supervisor of the Division of Consumer Credit, made the following pertinent statement:

> . . . Revolving credit plans are not time sales and cannot be considered as such, unless the retail seller has an established time price for each sale as well as an established cash price, and further, that the purchaser must sign a time sales agreement which sets forth the cash price as well as the time price when the merchandise is purchased. They attempt to justify their operations by saying that it is a new method of doing business and therefore it is legal. . . .
>
> . . . . . .
>
> . . . It is my opinion that these plans are in violation of the small loan law, as well as being in violation of the usury law, and if the court were to hold that they were in violation of the small loan law, the department stores could not collect the principal, the interest or any charge in connection with the transaction.[8]

Influence on Other States

Obviously the actions being taken in the states that have passed time sales (cash price-time price) laws and revolving credit laws are simply forerunners of similar inquiries, investigations, legislative enactments, and court interpretations in the other states. If the other states adopt the extreme view of Arkansas there will be nothing left of the cash price-time price concept in connection with the sale of goods and all contracts

[8] John F. Doyle, "Charges for Revolving Credit and Charge Accounts, Subject for Scrutiny, Wisconsin Supervisor Suggests," *Quarterly Report,* Vol. XII, No. 2 (Spring, 1958), pp. 33 and 67.

for a greater rate of interest than the usury rate of the states shall be void, unless specific legislation relating to revolving credit and time sales is passed.

Connection with Other Credit Transactions

It should be apparent that the minute the legislatures and the courts introduce and adopt the idea that usury laws apply to the credit sale of goods and services as well as to the lending of money, they have opened the door to many problems and legal entanglements. Can it rightly be said, for example, that the usury laws apply to one type of retail credit practice and not to the practices of thousands of other businesses in which cash versus credit prices enter into their day-to-day operations?

In reference to the extreme view of the Arkansas Supreme Court, the question might be raised whether this decision can affect, for example, the long-established practice of many firms to grant terms of 2/10, n/30 to their business customers. If the cash discount is not taken, this is equivalent to a firm's paying a charge of approximately 36 per cent per year for the use of money for 20 days. Likewise, some newspapers grant a discount of 10 cents per column inch for display advertising if paid by the 15th of the month following. Thus if the bill is not paid until the 30th of the month, the advertiser has paid approximately 48 per cent for the use of this money. In addition, on many heating gas bills there is a net price of so much if paid by the 10th of the month following and 10 per cent additional if paid after the 10th. This amounts to an interest rate of 3,650 per cent a year if the bill is paid on the 11th and to a 180 per cent rate if paid on the 30th.

Such a condition calls for a prompt and clear redetermination on the part of each state as to the exact status of the finance charge involved in not only revolving credit transactions and time sales contracts but in all credit sales of goods and services to individual consumers and to business concerns.

SERVICE CREDIT

Although service credit is recognized as an important segment of the total consumer credit picture, it is a subject that has been practically ignored in the consumer credit literature. While the subjects of retail credit and cash loan credit have been closely followed and analyzed by consumer credit observers, only lip service has been paid to service credit. It has been considered sufficient to say that there is such a thing as service credit—even though the American consumer owes in

excess of $2½ billion for services he has received and has agreed to pay for.

In the statistics reported monthly in the *Federal Reserve Bulletin* (see Table 5–5), service credit has been defined as "the amount owed by individuals to professional practitioners and service establishments."

Table 5–5
SERVICE CREDIT
(*In Millions of Dollars*)

End of Year	*Amount of Service Credit**
1929	$ 579
1930	567
1931	516
1932	477
1933	454
1934	438
1935	459
1936	505
1937	541
1938	508
1939	518
1940	553
1941	597
1942	660
1943	712
1944	794
1945	845
1946	1,014
1947	1,166
1948	1,284
1949	1,388
1950	1,580
1951	1,784
1952	1,867
1953	1,927
1954	2,003
1955	2,127
1956	2,366
1957	2,593
1958	2,800
1959†	3,037

* Noninstallment credit only.

† Includes data for Alaska and Hawaii beginning with January and August, 1959, respectively

Source Board of Governors of Federal Reserve System.

Problems of Professional Credit

Credit is a customary method of doing business with members of the medical and dental profession. Under normal conditions, almost all private practitioners and clinics accept some credit from their patients, and most of them expect to collect the greater part of the amount due them for these services. It should be recognized, however, that in some instances fees for some patients are entered as receivables on the books,

even though it is known by the practitioner that the recipients of the service will be unable to pay at any time in the future.

In the *Physicians and Dentists Credit and Collection Manual* published in 1953 by the National Retail Credit Association, the following pertinent observation was made:

> Medical and dental credit has lagged behind other consumer credit in use, and also in public regard No exact figures are available, as they are with other business classifications, as to the losses sustained by physicians and dentists, through the slow and nonpayment of accounts. All available evidence shows they are considerable. The traditional attitude of "pay the doctor last" still lingers sufficiently to cause him troublesome financial problems. Happily, this is being slowly overcome, but we still have a long road to travel before professional credit is taken out of the mists of uncertainty.
>
> . . . . . .
>
> There is need for a more enlightened public attitude to the importance of prompt payment of professional bills. There is equal need for professional men themselves to put into operation in their offices sound principles and procedures of consumer credit management. Medical credit is a business arrangement based on the ability and willingness of the patient to pay bills according to the agreement. Professional credit granting, just like commercial credit, therefore, should follow correct procedures.[9]

Whereas the 30-day form of account is the most common type of credit involved in the medical and dental profession, it is also often advisable for the professional man to encourage those of his patients who so prefer to arrange installment payments for protracted treatments or services.

Credit arrangements also are found in the legal profession, in which services are rendered for a client who is billed at some later date for this professional service.

The vast growth of hospital, medical, and surgical insurance plans has permitted millions of people to take care of their vital health needs on a "cash basis," by having paid in advance for this protection and thus being able to shift the financial burden—or a large part of it—for the services rendered to the insurance companies with which they have such arrangements.

Credit in Service Establishments

Basically we must say that credit in a service establishment is like credit in an establishment that sells goods. In many instances it is difficult or practically impossible to separate the two, as there are thousands of retail concerns that sell goods on a credit basis and are at the same time

[9] *Physicians and Dentists Credit and Collection Manual* (St. Louis: National Retail Credit Association, 1953), pp. 2 and 3.

offering repair and similar services that may be received by the customer at the present time and paid for in the future. In a department store, for example, a person may buy a watch and charge it to his open charge account. Some time later if repairs are needed, the person may return the watch to the watch repair department of the store and have the cost of the service performed charged to this same account.

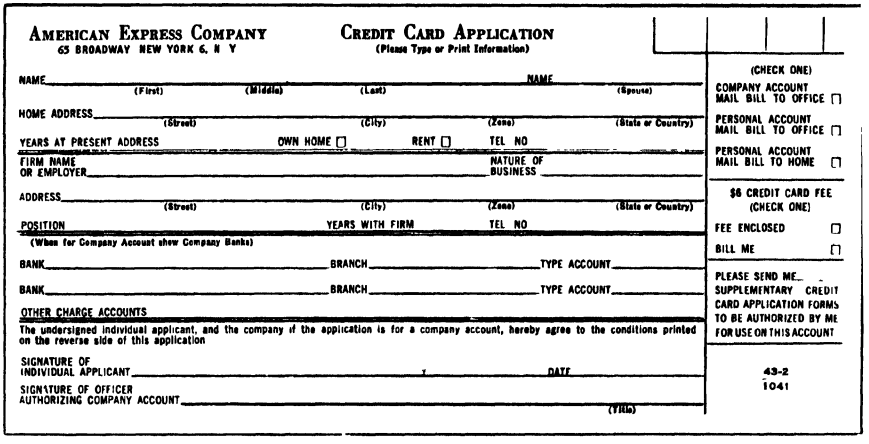
It should be clearly understood that when the word "service" is used it does not mean the various devices employed by a store to attract and hold customers, such as delivery of goods, credit arrangements, parking lots, baby-sitting, and all the other sales promotional devices found in retail establishments today. Rather the word "service" refers to an establishment that is providing some need for the person himself or is performing some operation or task on goods belonging to the customer. The term "service" may also apply to the individual who does not have a so-called "place of business" but who is handy with tools and has an ability for fixing things. This service person may operate from his own car or truck and establish a series of regular customers for whom he performs certain services and sends his bill at the end of the month for services rendered.

The number of these service "establishments" that cater to the consumer has been increasing rapidly over the years, and a large segment of this total is conducting its business on a credit as well as on a cash basis. It should be recognized that when a person heats his home with gas during the winter months and receives a bill for this service at the end of the month during which the service was received, credit is involved just as much as if this same customer had walked into a department store, bought a suit of clothes, and charged it on his 30-day account. Again, as in the medical and dental profession, it is a customary method of doing business. True, the credit time involved is usually short, and the installment method of repayment is not as commonly used in consumer service credit as it is in retail credit.

A great deal has been written on the "credit-card boom" in this country since the close of World War II. Observers have pointed out that millions of Americans are riding a magic carpet called the credit card and are using a pencil instead of cash to obtain food and drink, shelter and clothing, sleep and entertainment, gas, oil, tires, and so forth, even travel to faraway places. This was referred to in Chapter 4, in which the discussion centered on the obtaining of goods, not the securing of services on credit. Of course, it is difficult if not impossible to separate the two as thousands of concerns are offering goods on credit to customers at the same time they are giving services under some credit arrangement.

Reference was made in Chapter 4 to the Diners' Club plan, the American Express Company plan, the Hilton Hotel "Carte Blanche" credit plan, and the Sheraton Hotel plan. These are only a few among many, and mention could be made of the Air Travel Card, sponsored by the Air Transport Association and the International ATA. More than 50 railroads honor the cards issued by the Rail Travel Credit Agency of Chicago. Hertz Rent-a-Car System has its own charge cards. Telephone credit cards, especially valuable for long distance calls while away from home, are being issued. Applications for credit cards of three companies are illustrated in Figure 5–3.

FIG. 5–3. Credit card application forms.



AMERICAN EXPRESS COMPANY
65 BROADWAY NEW YORK 6, N Y

CREDIT CARD APPLICATION
(Please Type or Print Information)

NAME _____ (First) (Middle) (Last) NAME (Spouse)

HOME ADDRESS _____ (Street) (City) (Zone) (State or Country)

YEARS AT PRESENT ADDRESS OWN HOME ☐ RENT ☐ TEL NO

FIRM NAME OR EMPLOYER _____ NATURE OF BUSINESS _____

ADDRESS _____ (Street) (City) (Zone) (State or Country)

POSITION YEARS WITH FIRM TEL NO

(When for Company Account show Company Banks)

BANK _____ BRANCH _____ TYPE ACCOUNT _____

BANK _____ BRANCH _____ TYPE ACCOUNT _____

OTHER CHARGE ACCOUNTS

The undersigned individual applicant, and the company if the application is for a company account, hereby agree to the conditions printed on the reverse side of this application

SIGNATURE OF INDIVIDUAL APPLICANT _____ DATE _____

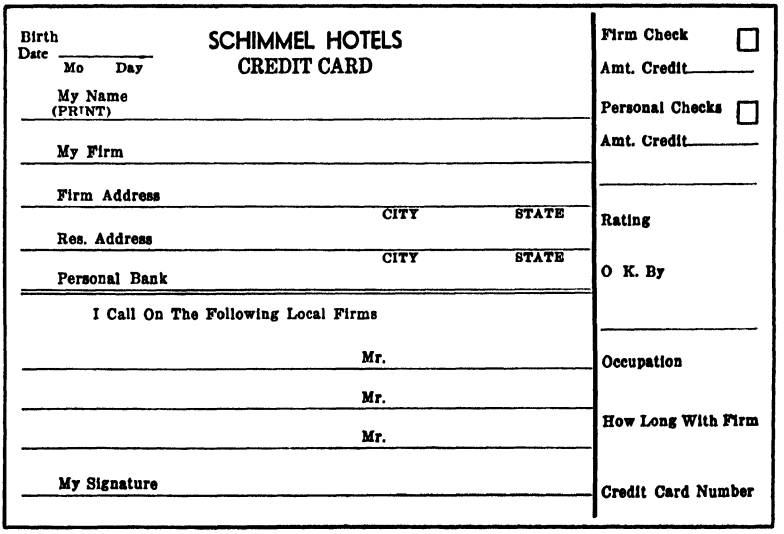
SIGNATURE OF OFFICER AUTHORIZING COMPANY ACCOUNT _____ (Title)

(CHECK ONE)
COMPANY ACCOUNT MAIL BILL TO OFFICE ☐
PERSONAL ACCOUNT MAIL BILL TO OFFICE ☐
PERSONAL ACCOUNT MAIL BILL TO HOME ☐

$6 CREDIT CARD FEE (CHECK ONE)
FEE ENCLOSED ☐
BILL ME ☐

PLEASE SEND ME _____ SUPPLEMENTARY CREDIT CARD APPLICATION FORMS TO BE AUTHORIZED BY ME FOR USE ON THIS ACCOUNT

43-2
1041



Birth Date _____ Mo Day

SCHIMMEL HOTELS
CREDIT CARD

My Name (PRINT) _____

My Firm _____

Firm Address _____ CITY STATE

Res. Address _____ CITY STATE

Personal Bank _____

I Call On The Following Local Firms

Mr. _____

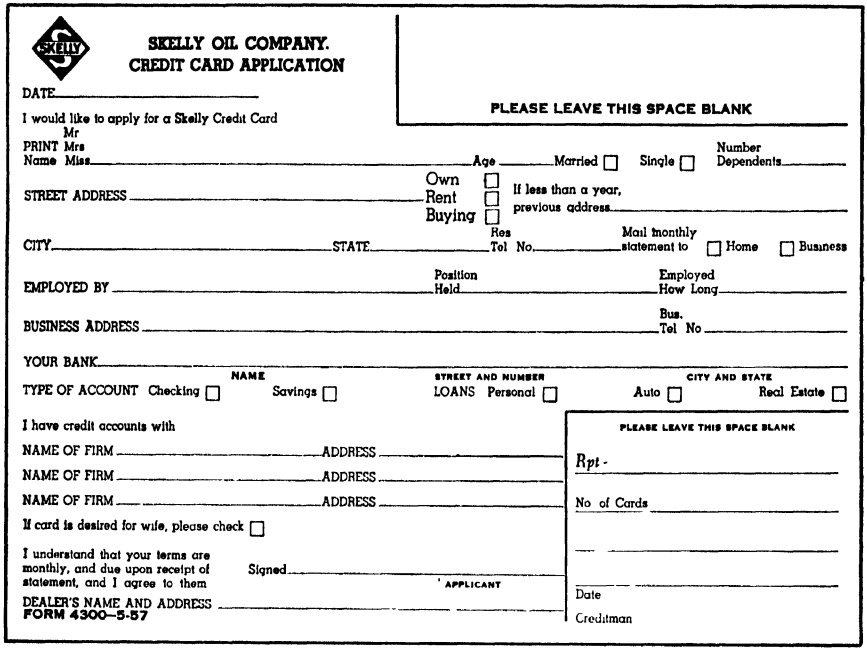
Mr. _____

Mr. _____

My Signature _____

Firm Check ☐
Amt. Credit _____
Personal Checks ☐
Amt. Credit _____
Rating
O K. By
Occupation
How Long With Firm
Credit Card Number

FIG. 5–3—*Continued*



SKELLY OIL COMPANY.
CREDIT CARD APPLICATION

PLEASE LEAVE THIS SPACE BLANK

DATE

I would like to apply for a Skelly Credit Card

PRINT Mr / Mrs / Miss Name — Age — Married ☐ Single ☐ Number Dependents

STREET ADDRESS — Own ☐ Rent ☐ Buying ☐ If less than a year, previous address

CITY — STATE — Res Tel No. — Mail monthly statement to ☐ Home ☐ Business

EMPLOYED BY — Position Held — Employed How Long

BUSINESS ADDRESS — Bus. Tel No.

YOUR BANK — NAME — STREET AND NUMBER — CITY AND STATE

TYPE OF ACCOUNT Checking ☐ Savings ☐ LOANS Personal ☐ Auto ☐ Real Estate ☐

I have credit accounts with

NAME OF FIRM — ADDRESS

NAME OF FIRM — ADDRESS

NAME OF FIRM — ADDRESS

If card is desired for wife, please check ☐

I understand that your terms are monthly, and due upon receipt of statement, and I agree to them Signed — APPLICANT

DEALER'S NAME AND ADDRESS

FORM 4300—5-57

PLEASE LEAVE THIS SPACE BLANK

Rpt -

No of Cards

Date

Creditman

It has been just in the post-World War II period that advertisements such as "Now . . . Fly Abroad . . . And Pay Later" have encouraged the American tourist to pay for his travels on an installment plan of repayment after his trip has been completed. Credit has become popular, especially with the group of people to whom traveling is a necessary part of their business life, in the purchase of "sleeping" services in hotels and motels, and in the buying of "transportation" services on railroads, planes, and buses. This credit is accepted generally through the use of credit cards similar to the ones commonly employed for the purchase of gasoline and oil from automobile filling stations.

Various experiments have been made with what has been called the "universal" credit card. The American customer today finds that he may be carrying a wide variety of credit cards—one for gasoline purchases[10] (and a different one for each oil company from which he may buy his gasoline), one for credit purchase of meals in selected restaurants, one for hotels (again different hotel chains have their own credit cards), one for plane service (again different airlines have their own separate credit

[10] The gasoline credit card is at times abused by a small segment of the American consuming public. Cards have been used to "buy" cash. This is accomplished by the station operator simply adding to the charge slip items that are not given to the customer, but cash is given in their place.

arrangements), and so forth. To attempt to eliminate the necessity of a customer establishing his credit over and over again with every service concern with which he might care to do business, attempts have been made to establish one credit clearance which would permit the issuance of a card that would allow the acceptance of this person's credit by every firm belonging to the organization sponsoring the "universal" plan. While at the present time, this arrangement has not proved highly successful, undoubtedly some similar plan in the future will accomplish the objective, thereby eliminating much duplication of credit investigation, bookkeeping, billing, and collection follow-up.

REVIEW AND DISCUSSION QUESTIONS

1. Explain the differences between the retail open charge account and the retail revolving credit account.
2. Check with the local retail stores to see whether they have adopted any type of revolving credit plan.
3. What is the basic revolving credit plan? How does it vary from the flexible or chart type plan?
4. Explain the Hudson's 30-Day Account with Optional Terms plan. What are the advantages of this plan to the store and to the customer? The disadvantages?
5. How does revolving credit compare with installment credit?
6. In his decision to adopt a revolving credit plan, the merchant must take many factors into consideration. What are these factors? Which one or ones do you believe are the most important? Why?
7. If you were the customer, how would revolving credit benefit you?
8. How might it harm you, the customer?
9. Why might a store want to introduce revolving credit into its operations? Why not?
10. Explain the difference between interest charge and service charge. Why is this difference important?
11. Discuss the actions taken by Arkansas, New York, and Wisconsin in relation to the interest charge versus service charge controversy.
12. What is the cash price-time price concept? Explain fully.
13. What is service credit, and why is it important that it be recognized and fully understood?
14. Explain the term "buying" cash.
15. Discuss the recent trend in the use of credit cards to obtain goods and services.

CHAPTER 6

Types of Consumer Credit— Retail Installment Account

THERE IS little doubt that consumer installment credit has played an important role in our expanding economy. This is but one of the several types of consumer credit. It is this type of credit, however, which is responsible for facilitating the possession of durable consumer goods and hence contributing to the material comfort and convenience of the American people. The rather recent adoption of installment credit by many service institutions will undoubtedly bring their higher-valued services within the reach of the mass of middle-income families. In particular, sea and air travel trips to any part of the world are not out of reason for the vast majority of the American people. As consumer markets for goods and services are expanded in the future, and the American people further increase their enjoyment of life, there is little reason to believe that consumer installment credit will not continue to expand. In fact, if the production and distribution trends of today are to continue, an even greater growth in the use of installment credit must of necessity occur. Installment credit as a sales promotional tool has been so completely effective, that today it is firmly rooted as a permanent part of our retail structure. And, it is rapidly becoming an important device in the marketing of those services which demand a large expenditure of funds.

FACTORS AFFECTING THE DECISION TO SELL ON INSTALLMENT CREDIT

The decision to sell goods and services on installment credit is a major policy decision. This is so because any seller of goods or services who

adopts the installment method of financing customer purchases cannot ignore the implications of this decision on his merchandising operations. His financial requirements, promotion policy, and services to customers are vitally affected by such a decision. The seller's personnel requirements become an immediate problem. Personnel who have a complete understanding of this type of credit are necessary in order to avoid many of the internal problems which can develop in the offering of this credit. To ease the impact of this decision, careful consideration should be given to the factors which influence the sale of goods and services on installment credit.

Financial Requirements

When a vendor adopts a credit policy, greater financial resources are required to offset the time element inherent in accounts receivables. A nominal strain on financial resources occurs when the vendor sells only in the open-account type of credit. The turnover of accounts receivable is quite obviously more rapid when the accounts receivable are made up entirely of retail charge accounts. A different situation confronts the vendor when he adopts an installment credit policy. Larger sums and longer periods are involved in installment sales. Consequently the vendor's accounts receivable will turn relatively fewer times; and without additional working capital, it is quite probable that a shortage of working capital may occur.

Additional working capital may be provided by the owners of the business or by institutions which specialize in financing installment sales. Since their origin, sales finance companies have regarded the "buying" of consumer installment contracts as one of their major functions. In more recent years commercial banks increasingly have become more interested in accepting this same kind of business. Many vendors find it necessary and sometimes preferable to sell their installment contracts to one of these institutions. When this is done, the retail institution is free to channel its resources into its merchandising activities. A more detailed discussion of retailers financing their installment sales is reserved for another section of this chapter.

Type of Goods

The degree to which the type of goods influences a vendor's decision to adopt an installment credit policy is difficult to measure. It is known, however, that the kinds of goods typically sold on installment credit have not been drastically altered in several decades. For example, before and during the early 1900's, household furniture was one of the lines of

merchandise which was adapted to installment selling. By 1920 the automobile and a few household appliances were being sold on installment credit. Today, approximately one half of the total installment credit volume is made up of automobile paper, while the remainder represents household furniture, numerous household appliances, and some of the so-called "soft" goods.[1] An examination of the characteristics of these goods will bring one to the conclusion that the vast majority of goods sold on installment terms are *durable,* of *high unit value,* and frequently possess some *repossession value.* Goods which possess these characteristics lend themselves more perfectly to installment selling than do other types of goods. There is little logic to proposals which would expand installment selling to goods which are of a temporary nature, for immediate consumption, or of low unit value. These articles lend themselves more clearly to payment from current income or other types of consumer credit. Another point of emphasis is the fact that repossession value is not a factor in many installment sales. While an automobile usually typifies all three characteristics, wearing apparel is seldom of repossessable value. When this third factor is not present the creditor will place more emphasis on the worthiness of the credit risk. In the sale of services on the installment basis, such as airline and ship travel, only one characteristic is evident, that of high unit value. In this instance even greater emphasis may be placed on the credit worthiness of the debtor.

Competition

The policies adopted by competitors will most certainly influence other vendors' decisions. Credit service to customers is one of the most important services rendered by retailers. When this service is offered by the competition, retailers without credit service are in a weakened competitive position. The offering of durable goods to consumers without an installment credit service represents a merchandising method contrary to the way in which such goods are commonly bought. The American consumer *expects* this service—and chances are that he will buy his high unit valued items from those retailers who can satisfy this requirement. Retailers when expanding their merchandise lines to include durable, high-ticket goods have set the stage for their sale by adopting an installment credit policy. In this way they can compete with other retailers who offer the credit service.

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[1] Slightly over 6 per cent of the 1959 total installment credit volume is made up of repair and modernization loans. Fluctuation of this ratio from year to year is quite nominal (see *Federal Reserve Bulletin*).

Other Factors

The preferences of customers, certain sectional differences, and the size of a community may also influence the adoption of an installment credit policy. These, as contrasted with the foregoing factors, are not primary factors in the decision. At one time these factors were more important, but as our travel and communication systems developed, the concept of what is *local* has changed. The size of communities and the economic differences of some sections have greatly diminished in the past few decades. No longer are many communities in the United States isolated from the economic trends which have swept the nation. It is only a minority of American consumers who do not find installment credit service available to them throughout their lifetime.

DEVELOPMENT OF INSTALLMENT CREDIT

The development of all types of consumer credit was traced in Chapter 3. In many ways the evolution of installment credit parallels the developments of other types of credit. It differs, however, in two important respects. First, installment credit as a business practice may have an earlier origin than other types of consumer credit. At least this type of credit transaction is more easily identified as a business practice in early literature. Second, in recent years this type of credit has registered a growth which is out of proportion to the other types. Its post-World War II expansion is greater than the combined growth of all other types of consumer credit.

Origin and Early Use

Installment selling is indeed of very early origin. It is known that the Babylonians and Phoenicians financed marine insurance in this way. Another very early form of installment credit has been found in connection with real estate. Researches into the past reveal this device in the sale of real estate in ancient Egypt and Rome. Plutarch writes that Crassus made a profitable venture of buying up many houses in Rome during periods of conflagration and in turn selling them on the installment plan.[2] In the United States this method of financing purchases is known to have been applied to horses, carriages, and farm equipment during the 1780's.[3] One of the first retailers in the United States to

[2] E. R. A. Seligman, *Economics of Installment Selling* (New York: Harper & Bros., 1927), Vol. I, p. 10.

[3] Rolf Nugent, *Consumer Credit and Economic Stability* (New York: Russell Sage Foundation, 1939), ftn., p. 54.

adopt an installment credit policy was the Cowperthwaite and Sons firm, founded in 1807. Nugent writes that this is ". . . reputedly the first specialized furniture store in the United States, [and it] began immediately after its organization to sell goods on instalment terms."[4] Within a few years pianos, sewing machines, household organs, and stoves were sold on installment terms. It is significant to note that American retailers and door-to-door agents were early to recognize the shortcomings of any other type of credit if they hoped to sell durable goods in volume.

Prior to the Civil War, merchants who were selling high-priced durable goods devised special credit arrangements. They found that they could not expect their customers to pay for high-priced goods under the terms of the open account. Instead installment terms were encouraged to ease the impact of the debt burden and still liquidate the amount due within a reasonable period. However, prior to the Civil War installment terms were short, down payments high, and only those who enjoyed an excellent credit reputation qualified for this "privilege."[5]

It remained for the post-Civil War period to witness the relaxed standards that permeated the installment device. Installment sales expanded in this period as merchants required smaller down payments, lengthened the contract terms, and began selling to the more marginal credit risk. The variety of goods which were sold on installment terms was also expanded. The automobile appeared to be doomed as a commonplace purchase by the early 1920's. Again installment credit came to the rescue of the American consumer, as increasing numbers of customers enjoyed private transportation on the time payment plan. Nugent contends that the expansion of installment sales of automobiles tended to reduce some of the stigma attached to this type of selling.[6] It appears logical that anything as dominant as the automobile in the American economy could have facilitated this change. With much of the stigma of installment sales removed, installment selling was expanded to additional lines of merchandise, and merchants who had at one time professed negative reaction began to adopt this method of selling. Installment credit today is a firmly established, respected, and volume-producing instrument of the retailing industry.

Increasing Frequency of Use

It goes without saying that installment credit is important in our economy today. It is important in a number of distinct ways. This is evi-

[4] *Ibid.*

[5] Nugent, *op. cit.*, pp. 55–56.

[6] *Ibid.*, p. 96.

dent to us because of the ratio of total installment credit to the total volume of consumer credit. Installment credit alone is more than three times greater than all other types of consumer credit. The Federal Reserve System statistics for the end of 1959 show installment volume of $39.5 billion while single-payment loans, charge accounts, and service credit totaled $12.6 billion. Automobile paper accounted for more than $16 billion of the installment credit volume. From these data we can surmise that millions of consumers are using this device to satisfy their material wants; and large numbers of vendors are offering this service. To what factors can we attribute this rapid growth in installment credit? It is believed that three primary factors account for the installment credit climate we see today. First, the productive genii of American industry have been successful in continually expanding the variety of consumer products which are particularly adaptable to installment selling; second, a changed attitude among consumers with respect to this type of credit. And, third, retailers have changed their attitudes with respect to this powerful selling tool.

Expanded Variety of Consumer Goods. To illustrate the degree to which durable goods have expanded since 1941, Table 6–1 was con-

Table 6–1

THE SMALL AND LARGE APPLIANCES OF 1941 CONTRASTED WITH THE EXPANDED LINES IN 1959

1941 Appliances	*1959 Appliances*
Vacuum cleaners	Vacuum cleaners
	Air conditioners
	Dehumidifiers
	Clothes dryers
	Food waste disposers
	Food freezers
Irons	Irons
Ironers	Ironers
	Automatic dishwashers
Radios and phono combination	Radio and hi-fi combination
	Radio (clock)
	Radio (portable)
	Television
Gas and electric range	Gas and electric range
	Wall ovens
	Counter cooking units
Washing machine (conventional)	Washing machine (conventional)
	Automatic washer
	Washer-dryer combination
	Floor polishers
Water heaters	Water heaters
	Automatic coffee makers
Food mixers	Food mixers
	Blenders
	Automatic frypans
Refrigerator	Refrigerator

structed. This is only a partial listing of the small and large appliances offered in 1941 as compared with 1959, but it illustrates the variety of new products developed in a short span of years. Even though some of the appliances in the 1959 column were manufactured in 1941, they did not become important lines for vendors until after World War II. Similarly plumbing and heating equipment, siding, insulation, roofing, and many other types of building materials are now typically offered on installment terms. Again, it was post-World War II before building materials were introduced to a mass market of "do-it-yourselfers." The increased leisure time of Americans has opened the way for a greatly expanded market in sporting goods of all types. Installment credit sales of outboard motors, water craft, and companion equipment are commonplace today. New markets and opportunities for installment credit sales open up as rapidly as basic economic changes occur. All of this implies that manufacturers are alert to new market opportunities and have found success in developing markets as soon as favorable market climates develop.

Increased income, home ownership, more leisure, larger families can mean only one thing—an expanded variety of goods. We have only touched the surface in indicating the dramatic changes which have taken place since World War II, but they are sufficient to tell the story of the need for an increasing use for installment credit.

The Changing Attitude of Consumers. Throughout the early development of installment credit, the sales techniques used by some vendors were damaging to the good will created by installment sales. Exaggerated claims, misunderstandings between vendor and customer, and threats of force to accomplish collections contributed to the stigma which was associated with this type of selling. It was not until this stigma was removed that installment buying became commonplace for the majority of middle- and upper-middle-income groups. Fortunately the early abuses were short-lived, and industry recognized the good will of its customers as essential to its success. The advent of the automobile in the 1920's did much to gain respectability in the installment finance industry. Automobile manufacturers either controlled or were associated with sales finance companies, and a forthright effort was made to guard the good will of the customer. Since the good will of customers could be in jeopardy and hence the sale of automobiles, manufacturers exerted an influence to avoid the repetition of earlier practices. As a consequence, the competition of the major sales finance companies forced adherence to higher standards by the smaller offending companies. There are still isolated instances of installment credit abuses by a few vendors and a

few local sales finance companies. These damaging acts occur in regions where the lower-income groups lie easy prey to an unprincipled company or individual.

Changing Attitude of Retailers. Paralleling the changing attitudes of consumers is the changing attitude of retailers. Many retailers had built up the same prejudice against installment selling as consumers had of installment buying. Retailers shunned this type of selling because of the prevailing low standards of the industry, and because they failed to recognize it as a productive merchandising tool. However, as the changing attitude began to register among consumers, so it did with retailers. They observed the adoption of high standards by the sales finance industry and soon were convinced of the sales possibilities of this type of credit. More and more retailers gained respect for this device and willingly they accepted the installment customers as a valuable and sales-producing group. While it had been the tendency to assume a durable-goods customer as a cash or open account buyer in the early 1920's, merchants soon changed their assumption so as to regard all customers as potential installment buyers. Retailers who had formerly rejected this type of credit offered it in the sale of their durable goods and high-priced soft lines. By the middle 1920's retailers could openly promote installment credit without fear of damaging the good will of their customers. The trend for retailers to adopt installment selling continues to the present day. Retailers of many types, chains and independents alike, are instituting installment plans to facilitate the sale of their expanded lines of merchandise. Without question, the retailing industry now regards this type of credit as a necessary requisite. The success with which they have been able to merchandise installment sales is such that the customer who does not buy in this way at some time in his life is coming to be the rare exception.

PRINCIPLES OF INSTALLMENT CREDIT

The foregoing sections of this chapter have pointed out some of the abuses of installment credit. These abuses came about because of a failure to exercise sound principles of management. It is not enough merely to adopt a credit policy and begin selling goods in exchange for credit. This activity, as other management decisions, must be governed by sound and proven principles of operation. One can observe these principles in action by a visit to a major retail establishment or by observation of the operating policies of many sales finance companies. Adherence to the following installment credit principles will successfully serve the vendor and the customer alike.

Type of Goods

Perhaps the first principle which may confront a vendor is the type of goods which he will sell on installment credit. It has already been shown that durable and high unit value goods are most susceptible to success. There is good reason to believe that installment sales should be confined to high-value lines. This means that any line of merchandise, whether hard or soft line, can be sold on installment credit provided it represents a major expenditure for the consumer. What is and what is not a major expenditure is a relative matter. A vacuum cleaner which sells for $79.95 may be a cash purchase for some families, but an installment purchase for others. In general, goods of high unit value are consumed over a relatively long period. Consumers who purchase these goods by means of the installment plan have many months or years of enjoyment from the item. Their tendency to regard their responsibility to pay their debt is greater when they see the benefits conveyed to them by the merchandise. On the other hand, goods which are immediately consumed, such as food and gasoline, are more logically reasonable purchases from current income or by means of an open charge account. Long-standing obligations on goods immediately consumed place the vendor in a more difficult position from the collection standpoint. It is also believed that the vendor-customer relationship is greatly enhanced when installment payments are made for things being enjoyed. The adoption of this principle will help to safeguard the good will of the retailing firm.

Down Payment

The next principle of use and value to both the vendor and customer is the amount of the down payment. An accepted principle is that the down payment should be sufficient to create a sense of ownership. A sense of ownership creates pride of possession in the customer's mind and provides a safety margin for the vendor. Customers who have a considerable sum invested in their mortgaged possessions are more likely to maintain them and to protect them from loss or destruction. When a sense of ownership is lacking, there is always the danger that the customer will become discouraged, hateful, and passive with regard to his obligation. While today there is a small minority of installment vendors who offer merchandise at "no money down," this policy is considered a violation of good business practice.

The amount of the down payment will of course vary with the type of goods financed. The customary down payment on new cars is from one fifth to one third of the original purchase price. Lower down pay-

ments are frequently available to those with excellent credit standings. Household furniture and appliances and many automobile accessories have a usual down payment of 10 per cent. Some stores, rather than require a definite percentage down, state their requirements in dollars. For example, Sears, Roebuck and Company requires a $5 down payment on appliances ranging in price from $50 to $200, and $10 down on purchases in excess of $200. Home furnishings have the same requirements. For clothing and other family needs, 10 per cent down on any purchase of $20 or more is Sears' policy. Down payments of some respectable amount also provide for the initial depreciation of the item. If the down payment is sufficient to do this, the payments can be somewhat lower but still adjusted to provide for more investment in the goods than depreciation. This matter is discussed in the next principle.

The Amount and Schedule of Payments

The amount and schedule of payments are important in two particular ways. First, the amount to be paid must be relative to the income and other outstanding obligations of the customer. Second, it should be set up so that the unpaid balance is no greater than the resale value of the goods. In other words each payment should be sufficient to keep the unpaid balance below the resale value of the goods. Admittedly it is frequently impossible to apply this latter function to the apparel lines. In these instances other factors may complement this deficiency. With durable goods, however, it is a relatively simple matter to adjust the payments so that the unpaid balance is always less than the resale value of the goods. It has been mentioned that the amount of payments should be relative to the customer's income and other obligations. A point of emphasis is necessary here. The amount of the payments should not be in excess of what is judged to be reasonably and prudently possible for the customer to meet, nor should the time of payment be set when difficulty in meeting the payments may occur. It behooves the credit practitioner to correlate the time of payment with the receipt of income. If the customer is paid twice a month and he has a home mortgage and other obligations to meet on or about the first of each month, it would be well to charge additional installments to the income not so heavily obligated. The same procedure holds when the purchaser is paid weekly. When receipt of income is on a monthly basis, a date in the week following the receipt of income would be the logical choice.

Installment Terms

Installment terms and the amount and schedule of payments are closely related. The principle that *the unpaid balance should not*

more than the resale value of the goods is also a function of installment terms. Not only is this principle affected by the amount of payments, but it becomes a reality as the terms are adjusted in view of the useful life of an article. Terms covering the sale of apparel will, therefore, be extended over a shorter period than terms covering an automobile. When terms are extended too far into the future, there is always the prevailing possibility that the owner's equity in the purchase will be too small and the item may be worth less than the amount owed on it. This presents a great risk to the vendor in that a few customers may want to be relieved of their obligation and simply surrender the article to the store. Avoidance of this risk may be brought about by adjusting the terms to a point within the useful life of the purchase. Twenty per cent down on a woman's winter coat with terms no longer than four to six months would tend to overcome the problem under discussion. On the other hand, a new automobile may have terms of one third down and 24 to 36 months to pay. In each instance, barring destruction of these articles, the useful life and enjoyment of the purchase can continue beyond the terms of the contract. If this is so, the resale values of the articles are perhaps high enough to encourage the customer to complete the obligation. In the last analysis, the terms of the contract must end before the psychological or intrinsic value disappears.

In general, the terms of an installment contract should be as short as possible. When installment contracts are made to run for long periods of time to build interest income, even though the customer could pay in a shorter time, an injustice is done the customer. Hence, each installment contract might be adjusted to the characteristics of the customer. The amount and schedule of payments as well as the terms of the contract are functioning at their best when they have been set relative to the customer's income and his other outstanding obligations.

Carrying Charges

Carrying charges should be reasonable and adequate to defray the costs of installment transactions. The cost of an installment business varies according to the size of the average sale and the volume transacted. In general, this is a decreasing-cost activity, inasmuch as the greater the volume, the lesser the unit cost. The well-known nominal rate of 5 or 6 per cent to finance high-priced durable goods can hardly be applied to merchandise lines where the average sale is quite nominal. It may be that 10 or even 15 per cent is necessary to help defray the cost of small transactions. Some firms have a nominal minimum charge of one or two dollars which appears to be an exorbitant rate when calculated

against a small purchase. The principle here is that the carrying charge should be sufficient to offset at least some of the costs, and that the customer gains the impression that he is "paying his own way." Without some carrying charge the suspicion is created that cash customers carry this burden.

The exact carrying charge[7] should be expressed to the customer so that no misunderstanding develops throughout the relationship. Some firms have found it advisable, and the writers agree, to state their carrying charges in dollars and cents as well as percentage figures. Furthermore, the customer should be truthfully advised as to his prepayment privileges and the refund rates if the balance is paid before maturity. Above all, a conscientious effort should be made by the seller to inform the customer of all aspects of the installment transaction.

Credit Investigation

The credit investigation is of unique importance in installment credit transactions. Installment credit accounts usually represent a high average-sale figure and are extended over a relatively long time. In contrast with the retail charge account, a single-installment transaction results in the assumption of a sizable risk by the vendor or financing institution. In the sale of new automobiles the sum to be financed is quite large. The mean price paid by new car purchasers in 1958 was almost $3,000, and the mean price paid for used cars was more than $800. After making allowances for the trade-in or down payment, the mean net outlays are in excess of $2,100 and $650 respectively.[8] The average sale of other merchandise lines adaptable to installment sales is also high. This fact alone accounts for considerable contribution to the risk factor. In addition, however, installment terms are frequently over long periods. It is commonplace that automobiles are sold on terms up to 36 months; and a large proportion of household furnishings and appliances are sold on terms of 12, 18, or 24 months. Extended terms are available when the size of the sale warrants this consideration. The large amount of the average sale combined with the terms presents a risk peculiar to this type of credit. The principle created by these conditions is that the credit investigation should be so thorough in extent and penetration as to diminish the inherent risk. The large average amount financed and the long terms must be relative to the credit qualities of the purchaser. Even though it is sometimes true that the right of repossession offers considerable protection to the creditor, it must be remembered that profit in

[7] See Chapter 5, page 94.

[8] *Federal Reserve Bulletin,* July, 1959, p. 718.

installment sales is really dependent on completion of the payments. Repossessions can be costly and even disastrous if they occur too frequently. It seems best to rely on the quality of the risk as revealed by the credit investigation rather than on other contingent factors.

It also should be recognized that frequently the resale or repossession value is lower than the amount of the note remaining at the time repossession is necessary. For this reason credit often is not granted on the basis of the value of the security at the time of necessary repossession and resale, but rather some credit personnel regard the value of the good itself as a psychological factor which keeps the customer paying on the debt. So long as this value is greater than the debt which the customer owes, the purchaser is motivated to maintain his equity. However, when the buyer's equity drops below what he owes, he too frequently feels he is paying for a "dead horse" and is quite willing to permit the retailer or financing institution to repossess the item.

CHARACTERISTICS OF AN INSTALLMENT ACCOUNT TODAY

An installment account results when a consumer purchases an article for immediate use but promises to pay for it over a series of weeks or months in partial payments. It is an arrangement whereby the customer usually pays part of the purchase price at time of the sale. He agrees to a continuous series of equal payments at stated intervals, and he signs a written agreement as evidence of his intention to fulfill his obligation. These steps in the transaction will readily be recognized as the down payment, the amount and schedule of payments, and the installment contract. In addition to these characteristics the purchaser will pay a larger sum for this privilege than had he paid cash for the article. This differential is known as the finance charge, carrying charge, or interest charge.

There are many variations in installment accounts. Retailers offer this type of credit under names ". . . such as Deferred Payment Plan, Divided Payment Account, Budget Account or Budget Plan, Extended Payment Account, Revolving Credit Account, Time Plan, Coupon Account, Convenient Payment Account or simply Installment Account."[9] Some of the above are merely different names for the same thing. In some instances actual variations from the installment account as described do exist. The principal differences lie in the lack of the requirement of a down payment and relatively short installment terms. Install-

[9] Clyde William Phelps, *Using Instalment Credit* (Baltimore: Studies in Consumer Credit, No. 4, Commercial Credit Company, 1955), p. 11.

ment terms as short as 60, 90, or 120 days are not uncommon in the wearing apparel field. Many of the above are in reality installment accounts, whereas others are a hybrid of other types of consumer credit with one or more characteristics of installment credit. The essential point is that all are credit accounts exemplifying the elements of a credit transaction—futurity and risk.

Forms of Installment Contracts[10]

One of the essential characteristics of an installment account is the written agreement or contract accomplished by the parties to the transaction. The relatively large amount of credit and the long period of time involved create the need for some form of written agreement. In an attempt to minimize some of the risk, the sale may be made either on a conditional sales contract or chattel mortgage. In many respects the two contracts are similar, but certain important differences are to be noted. It is general practice to use the conditional sales contract in connection with the sale of goods by retailers and chattel mortgages in connection with cash loans whereby the property of the borrower is used as security in the repayment of the loan. The use of one or the other depends to some extent upon the nature of the installment credit business and the state laws in effect.

The *conditional sales contract* (see Figure 6–1) provides for the retention of title by the seller of the goods, and title will pass to the buyer only upon full compliance of the terms of the contract. In most states the contract is valid only when it is in writing, signed by both parties, and filed and recorded according to statute. In a few states the validity of the contract does not hinge on these requirements, but oral contracts have been held to be valid. Most conditional sales contracts provide for the right of repossession of the article. While this is a forceful collection device, many merchants do so reluctantly. Depending upon the terms of the contract, the seller may repossess the property either with or without legal process. The right to repossess the property is provided for in the event of default by the buyer. Most sellers appear to waive the right of repossession by accepting payments after they are due. This conduct may, in the case of future attempts to repossess, nullify the creditor's right to do so as he may have difficulty in proving default. The National Association of Credit Management cautions its members to use extreme

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[10] For a detailed and authoritative account on the subject of the forms of conditional sales contracts, the reader is referred to the *Credit Manual of Commercial Laws*, prepared and published annually by the National Association of Credit Management. Much of the discussion in this section is based on the material appearing in this publication.

FIG. 6–1. Example of conditional sales contract.

PLEASE READ YOUR CONTRACT

CONDITIONAL SALES AGREEMENT

THIS AGREEMENT, made and entered into at Minneapolis, Minnesota, by and between Borg & Powers Furniture Co., of Minneapolis, a Minnesota Corporation, hereinafter designated as the SELLER, and _____ hereinafter designated as the BUYER,

WITNESSETH, that said undersigned buyer has purchased and received in good condition from, and as warranted by, the seller, all of the goods, chattels, and personal property described and enumerated on the reverse side hereof for a total TIME PRICE of _____ Dollars ($_____) to be paid at the times and in the manner specified in the statement of items covering the buyer's obligation, subject to the terms and conditions herein contained, which said "statement of items" is on the reverse hereof, and is hereby made a part hereof by reference.

IT IS HEREBY AGREED that said sale and delivery of possession of said goods is subject to the following conditions, to-wit:

1. That the title and right to possession of all the enumerated and described property shall be and remain in the seller until all of said purchase price thereof shall have been paid in full, when, but not until then, title to said goods shall vest in said buyer.

2. That said buyer will use said property carefully and suffer no one else to obtain custody or control thereof; that he will not abandon said property; that he will keep said property at the address to which the same is delivered and will not remove the same therefrom or otherwise dispose of same without the written consent of the seller; and that he shall neither cause nor suffer any injury or damage to said property, ordinary wear from careful use alone excepted.

3. That if said buyer shall fail to pay said purchase price, or any installment thereof as herein provided, or interest thereon, if interest be agreed upon, when same shall become due according to the terms hereof, or in case default be made in any of the promises, covenants, and understandings herein contained on the part of the buyer to be kept, done, and performed; or should the buyer remove, dispose of, or encumber, voluntarily or involuntarily, any of said personality or chattels otherwise than as herein provided and hereby contemplated and intended; or in case said seller shall at any time deem itself insecure as to said property or said purchase price thereof, by reason of failure to keep the terms and conditions hereof by said buyer; or any other reasonable cause; then, thereupon, and thereafter, said seller hereby retains and shall have the absolute right to take immediate possession of all of said property, without notice, and to retain all sums which shall then have been paid hereunder, as liquidated damages and for the use of said property, and the buyer hereby authorizes the seller, its successors and assigns, or its authorized agents, to take possession of said property wherever same may be found, and for that purpose may enter upon the premises of the buyer with or without process of law, and to take possession thereof; or, at the seller's option, to declare all of the then remaining unpaid purchase price to be immediately due and payable and to proceed to recover the same, and the necessary costs and disbursements of so doing, including a reasonable attorney's fee should the seller employ an attorney for such purpose.

4. That no act or omission on the part of the seller shall constitute or be deemed a waiver of any terms or provisions hereof, and no oral statement made by the seller, its agents or employes, either before or after execution of this agreement, shall be binding upon the seller or affect the provisions hereof; and this instrument shall be and remain the sole agreement between the parties hereto, unless hereafter modified in writing.

5. All deferred balances from time to time remaining unpaid under this contract shall bear interest after maturity at the rate of six per cent per annum, until paid.

6. That after six (6) days following delivery of the property herein specified, the buyer shall not be entitled to any adjustment or service of said merchandise if he be in default hereunder.

7. The said buyer hereby further agrees, at his sole expense, to insure, and keep fully insured, said personal property against loss or damage by fire, and said policy of insurance shall indemnify, and be made payable to, the seller as its interest may appear, and in case said insurance is not procured by said buyer as above provided, the seller may, at its option, procure such insurance, and the cost therefor shall be and become a debt payable under this contract.

FOR AND IN CONSIDERATION of delivery to the buyer of said property, said buyer hereby agrees to purchase and to pay for the same as herein provided and to keep and perform all of the conditions hereof, and hereby acknowledges that a full, true, and complete copy hereof has been received by him and specifically understands and agrees that the item of finance charges referred to on the reverse hereof shall not be construed as interest but shall constitute a part of the TIME PRICE hereinbefore specified to be paid, and that time is the essence of this agreement.

IT IS HEREBY FURTHER AGREED, by and between the seller and buyer, that their respective agreements herein contained shall be binding upon and inure to the benefit of their respective heirs, legal representatives, successors and assigns, and that if there be more than one buyer the use of the word "buyer" herein shall mean all buyers and their obligation shall be joint and several.

IN WITNESS WHEREOF, the parties hereto have hereunto set their hands and seals this _____ day of _____, 19____

Signed, Sealed, and Delivered
In the Presence of:

_____ _____
Witness

_____ _____
Witness Buyer

BORG & POWERS FURNITURE CO.
OF MINNEAPOLIS

Credit Dept.

Supplemental Memorandum of Agreement to Contract No._____

THIS SUPPLEMENTAL AGREEMENT WITNESSETH, that I have received from BORG & POWERS FURNITURE CO., of Minneapolis, the goods described on the reverse hereof in perfect condition and of the reasonable and agreed value and TIME PRICE of _____ Dollars ($_____), subject to, and upon the same terms, conditions and obligations, as specified in the hereto attached Conditional Sales Contract No._____ Dated _____ of which this Supplemental Agreement now becomes and constitutes a part, the same as if originally contained therein.

And I hereby agree to pay to said SELLER at its office in the City of Minneapolis, the amounts and at the times stated on the reverse side of this Supplemental Agreement, and hereby agree that a default in any of the terms and conditions of said hereto attached original memorandum of Agreement No. _____, or a default in any of the terms or conditions of this supplemental contract or memorandum of agreement, shall constitute and be deemed and be held to be a default in both said original and supplemental agreements.

And it is expressly understood and agreed that in consideration of the delivery of the said additional described goods covered by this supplemental agreement, receipt of which, in good condition, being hereby acknowledged, title to said goods described in both the original contract or memorandum of agreement No._____ together with the goods described in this supplemental agreement, shall be and remain vested in said BORG & POWERS FURNITURE CO., of Minneapolis, until all the terms and conditions of said original contract, and all the terms and conditions of this supplemental agreement, shall have been fully observed and performed by me.

I further acknowledge that I fully understand all the terms and conditions of this supplemental contract, and specifically understand and agree that the item of finance charges referred to on the reverse hereof shall not be construed as interest, but shall constitute a part of the TIME PRICE hereinbefore specified be paid, and hereby acknowledge that a full, true, and complete copy hereof has been received by me. I further understand that time is expressively made the very essence of this agreement.

IN TESTIMONY WHEREOF, I have hereunto set my hand and seal this _____ day of _____ A. D., 19____

Signed, Sealed, and Delivered
In the Presence of:

_____ _____ (SEAL)
Witness Buyer

_____ _____
Witness

BORG & POWERS FURNITURE CO.
OF MINNEAPOLIS

By_____
Credit Dept.

No._____ CONTRACT — OR — SUPPLEMENTAL CONTRACT WITH BORG & POWERS FURNITURE CO. of MINNEAPOLIS _____ EXECUTED _____ AMT. $_____

Courtesy of Borg & Powers Furniture Co., Minneapolis, Minnesota

care in retaking property and in particular when repossessing without legal process. Frequently, the conditional sales contract provides the seller with a preferred position in the event of bankruptcy or death of the debtor. It is necessary to examine the state statute, however, when and if these contingencies occur.

In the case of the *chattel mortgage* title passes from the seller to the buyer and immediately an instrument is executed conveying the title back to the seller. Title to the goods will pass to the buyer when all conditions of the mortgage have been met. This instrument is in common use when the title to the property was originally held by the buyer. In other words a borrower pledges his own property as security to the vendor. It has been held in some states that the vendor has only a lien against the property and title is still vested in the buyer. This is one essential difference between the instruments under discussion. The chattel mortgage must be in writing, signed by the parties, and filed and recorded In most states it must also be witnessed.

The use of the conditional sales contract or the chattel mortgage in installment sales is dependent upon the legal provisions applicable to these instruments in the state(s) in which the vendor is doing business. The chattel mortgage is in some ways the more cumbersome of the two, but in other ways it provides a larger margin of safety. The chattel mortgage can be used to cover additional property other than that sold. For example, in the purchase of a used automobile where the amount of risk is great and credit reputation of the buyer poor, the household goods of the buyer may be listed in the mortgage in addition to the automobile. Most states also provide for a deficiency judgment in the event that the sales proceeds from foreclosed property are not sufficient to satisfy the debt. The proceeds from a foreclosure sale must first be used to defray court costs, legal expenses, and fees and then the mortgage debt. Any amounts remaining after the satisfaction of these claims must be turned over to the mortgagor.

The legal interpretations and certain remedies of the seller using installment contracts may appear to be harsh. In a few cases it is necessary for the creditor to exercise his rights as outlined herein. When fraud and misrepresentation appear, the creditor would do well to enforce his remedies with the strongest kind of remedial action. In the vast majority of cases, merchants are known to be very lenient in interpreting the provisions of their contracts. Vendors, sales finance companies, and banks recognize that their continued profitable operations are dependent on their reputation and good will. Hence, great leniency prevails in most credit circles. Sickness, death, unemployment, and late payments are re-

garded as normal occurrences associated with the credit business. The failure of creditors to take drastic steps in forcing debt satisfaction has done much to improve their public relations. In general, the credit fraternity today observes a code of conduct which exemplifies an understanding and consideration of the contingencies of life.

Finance Charges

Another characteristic of an installment account is that some consideration will be paid for this privilege. Whether a consumer uses his credit to borrow funds or to purchase merchandise, the result is the same; a merchant, sales finance company, bank, or other financial institution is supplying the capital which makes the credit possible. In exchange for this service the firm supplying the capital charges a fee.

Finance charges and the actual cost of credit are seldom well understood by consumers. The failure of dealers in installment credit to quote accurate rates and clearly to inform the customer of the true cost contributes to a great deal of misunderstanding. The true cost of credit takes on significance for both the consumer and vendor, but for different reasons. Consumers should know the true cost of credit so as to evaluate the alternatives open to them. Is the true cost of the credit worth the enjoyment and service derived from this purchase? If the consumer knows this, he can accept or reject the installment credit or seek alternative ways to make his purchase. The vendor on the other hand must know the yield of his finance charge so that he is able to cover his costs and anticipated profit. The method used in computing the true cost of credit is known as the constant ratio method. The constant ratio method results in a higher true rate of interest than the rate computed by the actuarial method and the direct ratio method. It is used in this text because of its greater simplicity and wider use. As a practical matter, the differences in the results obtained by using one method over another are negligible.

Method of Computing True Rates of Interest

Whenever a consumer borrows funds or makes a purchase and agrees to repay the principal amount throughout a series of stated intervals, he is going to pay more than the quoted rate. The reason for this is that the quoted rate is very frequently the "nominal interest rate." We are all accustomed to the advertising of lenders which claim "6 per cent per $1000," "4½ per cent per $100," and the like.[11] The nominal interest

[11] A number of states do not permit companies to advertise "the rate as the nominal interest rate." They are permitted, however, to refer to the "6 per cent per $1000" as the finance charge which gives the impression that it is *the* interest rate.

rate does not take into account the fact that the debtor does not have use of the total principal for the entire duration of the contract. A debt of $1000 repayable in 12 monthly installments means that the debtor actually uses the principal for 6½ months. The formula for determining this is simply $\frac{n+1}{2}$, where n represents the number of installments needed to discharge the debt. Hence, an installment account repaid in 10 payments means that the debtor has full use of the principal amount for 5½ months on the average. Clearly, this explains the need for computing the true interest rate on installment purchases. Inasmuch as the debtor has full use of the creditor's principal for slightly more than one-half the total installment period, it may be already surmised that the true interest rate is approximately twice the nominal rate. This is true, and for many years in the finance field, the nominal rate per annum × 2 was a rule-of-thumb method of computing the yield or true rate per annum. The constant ratio method formula for computing the true interest rate is:[12]

$$R = \frac{r(2n)}{(n+1)}$$

R = true interest rate per annum
r = nominal interest rate per annum
n = number of installments to discharge the debt

Using the above formula, assume the purchase of a new automobile for $3250. The purchaser trades in his old car and receives $1750 trade in allowance which leaves a balance of $1500 to be financed. If the purchaser agrees to discharge the debt in 12 installments and a charge of 6 per cent is made for the financing service, the true interest rate becomes 11.08 per cent as follows:

$$R = \frac{6\%\,(2 \times 12)}{12+1} = \frac{6\% \times 24}{13} = \frac{144}{13} = 11.08\%$$

The illustration above is perhaps an oversimplification of the majority of installment cases. Frequently the credit terms are for less or more than one year. Some lenders assess a small service charge in addition to the interest rate; others may quote their charges in dollars and cents and not reveal a per cent figure; and many other variations seem commonplace business practice. To help the reader cope with some of the more difficult installment cases a model method for approaching each case

[12] This formula was developed by T. N Beckman and is used in his *Credits and Collections in Theory and Practice* (6th ed.; New York: McGraw-Hill Book Co., Inc, 1955), p. 98.

might be used. Such a model is presented below with an outlined step-by-step discussion. This form may be modified to the simplicity or complexity of individual installment cases.

a)	Cash price or principal borrowed	$_____
b)	Less: down payment or trade-in	$_____
	Equals. remaining balance	$_____
c)	Plus Insurance, other purchases, etc.	$_____
	Equals· balance to finance	$_____
d)	Plus. nominal interest and other carrying charges	$_____
e)	Equals. total amount of obligation or note	$_____

a) Determine the cash price or principal borrowed. The cash price of an article is the total amount that would be needed to buy the item outright. For example, $3250 is the cash price in the illustration above. In the event cash is borrowed from a lending institution this amount is the actual amount received. If $100 is borrowed from a bank and the bank deducts interest of $6.00 in advance, this leaves $94 as the principal actually borrowed.

b) A cash down payment or an allowance for a trade-in has the same result. This line is used only when one or the other occurs in the transaction. Hence, this line is left blank in the case of a cash loan. The down payment or trade-in reduces the amount of the cash price to a remaining balance, or if no other additions are to be made, it becomes the balance to finance

c) Add any insurance, other purchases, or "add-ons" which will increase the balance remaining so that a total balance to finance is arrived at. Insurance is a usual addition to an automobile installment account because this is a requirement of most financing institutions. Other purchases represent anything which the customer selects as an additional item to finance such as accessory items and other small purchases. Perhaps the most common addition in this instance will be insurance which is customarily financed the same as the automobile. This added to the former balance results in the total amount to be financed.

d) Arrive at the interest and other carrying charges in one of two ways. If the nominal rate of interest is quoted as a percentage such as 5 or 6 per cent merely multiply this figure by the balance to finance. Care must be exercised here so that one does not relate the nominal rate to the total amount of the obligation. It is the amount of credit used to which the interest rate and carrying charges apply. Before a dollar-and-cents figure can be inserted in this blank make certain that the amount is relative to the time element. If 6 per cent per annum has been used to arrive at the dollar-and-cent figure, it must be adjusted if the time element is less or more than one year. Simple arithmetic will accomplish this. The same note of caution holds when the per cent rate of interest has been derived from dollar-and-cent figures. The nominal rate of interest (r) must be on a per annum basis before it is used in the formula. If this is not done the value of comparison is lost. Interest is related to a time period and the most common period is one year.

e) The total amount of the obligation or value of a note is the balance financed plus the total interest. This figure is needed in order to set the amount to be paid in each installment. When the amount is not perfectly divisible by the

time factor, it is customary to make all installments equal except the first or the last. In this way there is less risk of customer confusion being created.

Referring back to our earlier example of the automobile to be financed in twelve months, assume an additional charge of $148 to insure the automobile against loss. The model suggested would appear as follows:

Cash price	$3250 00	
Less trade-in	1750.00	
Remaining balance	$1500 00	
Plus. insurance	148 00	
Balance to finance	$1648 00	
Plus interest	98 88	(6% × 1648)
Total obligation	$1746 88	

The true rate of interest per annum remains 11.08 per cent and now it is a simple matter to compute the amount of the installments which are one of $145.61 and eleven of $145.57.

To illustrate another complete installment transaction the following problem is stated: An automatic washer and dryer are sold by a department store for the combined cash price of $565. The down payment is 10 per cent of the cash price and installment payments are extended over *eighteen months.* A carrying charge of $61.02 is added to the conditional sales contract. What is the true rate of interest per annum? What are the monthly installments?

Cash price	$565 00
Less down payment	56 50
Balance to finance	$508 50
Plus carrying charges	61.02
Total obligation	$569 52

The first step toward solving this problem is to compute for r, the nominal rate of interest per annum, as follows:

$$\frac{61.02}{508.50} = 12\% \text{ (nominal rate)}$$
$$12 \times \tfrac{2}{3} = 8\% \text{ (nominal annual rate)}$$

The fact that this installment case had terms extending to eighteen months meant that the resultant 12 per cent had to be reduced to one year, or by two thirds in order to arrive at r. Substituting 8 per cent for r in the formula and 18 for n we have:

$$R = \frac{8\%(2 \times 18)}{18 + 1} = \frac{8\% \times 36}{19} = \frac{288}{19} = 15.21\%$$

The true interest rate is 15.21 per cent, and the monthly installments will be one of $31.66 and seventeen of $31.64. If the time element was less than twelve months in this case, similar adjustment should be made to arrive at the nominal rate per annum.

HOW RETAILERS FINANCE INSTALLMENT ACCOUNTS[13]

All consumer installment accounts originate with the purchase of goods from a retail outlet. The retailer, whether he carries his own paper or not, takes the customer's credit information, executes the conditional sales contract or chattel mortgage, and completes other forms and acts necessary to the establishment of the installment account. The retailer also will inform the customer as to the terms of the contract and remain ready to answer the customer's questions. Some retailers carry their own installment paper while others find it desirable to let a financial institution assume this burden. Earlier in this chapter the problem of the retailer carrying his own paper was confronted. It was shown that in order to do this he would have to provide the necessary capital to compensate for a decline in his working capital turnover. Additional capital also will be needed if the retailer is successful in increasing his sales volume by offering installment credit services. In either instance a greater investment is required. The retailer who wants a faster turnover of his own capital and desires to shift much of the credit risk burden, can sell his paper to a sales finance company, commercial bank, or other consumer finance institutions. When a retailer does this he transfers the credit function to specialists in the installment credit field and frees his own organization for greater participation in the merchandising task.

There is a greater tendency for retailers to carry their own installment paper when the amount of the average sale is small. Jewelry and clothing stores frequently carry their own paper. These lines of merchandise have shorter contract terms than the so-called "big ticket" items, and as a result many of these retailers seem inclined toward providing their own capital to finance their accounts.

Some indication of the relative importance of the installment paper carried by financial institutions as contrasted with the installment paper carried by retailers is shown in Table 6–2. It is interesting to observe that of the total volume of consumer installment debt, retailers were only

[13] Clyde William Phelps, *Instalment Sales Financing: Its Services to the Dealer* (Baltimore: Commercial Credit Company, 1953). The authors recommend this and other volumes by Dr. Phelps. This volume is a detailed account of this subject matter. Some of the material in this section is based on Dr. Phelps' study. The authors are indebted to him for his valuable and authentic contribution to this area of credit literature.

carrying 14.3 per cent of it. Department stores, furniture stores, household appliance stores, and automobile dealers actually carry a very small portion of the debt which they have been influential in creating. Consequently, this table indicates that while the origin of all installment accounts rests with retail outlets, they have a very great tendency to shift their credit burden to financial institutions. Commercial banks and sales finance companies are the dominant holders of installment paper, according to these data. The 37.8 per cent held by commercial banks represents paper which they have purchased from department stores, furniture stores, appliance dealers, automobile dealers, and sales finance com-

Table 6–2

INSTALLMENT CREDIT BY HOLDER, DECEMBER 31, 1959*
(In Millions of Dollars)

Financial Institutions						Retail Outlets				
Commercial Banks	Sales Finance Companies	Credit Unions	Consumer Finance Companies	Other Finance Companies	Department Stores	Furniture Stores	Household Appliance Stores	Automobile Dealers	Other	Total Installment Credit
$14,922	$10,145	$3,232	$3,764	$1,775	$2,298	$1,167	$295	$588	$1,296	$39,482
37 8%	25 7%	8 2%	9 5%	4 5%	5 8%	3 0%	7%	1 5%	3 3%	100%

* Includes data for Alaska and Hawaii beginning with January and August, 1959, respectively.
Source *Federal Reserve Bulletin*, February, 1960, p 198

panies.[14] While banks appear dominant in this field, sales finance companies in turn acquire their working capital by selling purchased paper to commercial banks.[15] Hence, the commercial bank position is inflated by the capital acquisition activities of sales finance companies. The paper held by sales finance companies is made up principally of new and used automobiles, major household appliances, and repair and modernization loans made to householders. The sales finance company plays such a unique and increasingly important role in installment credit that particular attention is warranted.

Development of Sales Finance Companies

The sales finance company is not to be confused with cash lending institutions such as small loan companies, consumer finance companies, and personal loan companies which are engaged in lending money directly to consumers and operate under special state legislation. The sales

[14] This figure also includes paper purchased directly from consumers or installment notes arranged directly by the customer with the bank.

[15] Sales finance companies do not always sell their paper to commercial banks. They may borrow unsecured or against the paper on a full recourse basis, as contrasted with selling where there is no recourse

finance company of today evolved in response to the growing demand for installment credit and the financing needs of automobile dealers. This institution is engaged principally in purchasing installment paper from automobile dealers and retail stores. It also provides financing services to automobile dealers and retailers; this service is referred to as "floor planning" or "wholesale financing." The origin of the sales finance company dates back to the early 1900's. The first companies supplied working capital to manufacturers and wholesalers by buying open accounts and purchasing drafts and notes receivable. It was not until the advent of the automobile that the sales finance companies, as we know them today, were organized. The Commercial Credit Company began in 1916 to purchase automobile paper, and since that time the development and growth of sales finance companies have been almost without interruption. The rise of the sales finance companies parallels the growth of the automobile industry, hence the great depression of the 1930's and World War II were two periods in which they declined in relative importance. The three largest and best known sales finance companies are Commercial Credit Company, C.I.T. Financial Corporation, and General Motors Acceptance Corporation. The combined capital funds of these three companies are about two-fifths as large as the combined capital funds of our nation's three largest banks. Each of the three largest sales finance companies has several hundred branches throughout the United States. In addition to this vast network, there are many large regional sales finance companies and many hundreds of local companies. The enormity and importance of a typical large sales finance company may be emphasized by stating that the sales finance subsidiaries of Commercial Credit Company operate in excess of 340 sales finance offices in 295 cities in the United States and Canada.

Growing Importance of Sales Finance Companies and Efforts to Control Their Activities

As consumer installment credit continues to expand, so will the sales finance companies. Consumer credit in all likelihood will expand with the growing population, the increased discretionary buying power of American families, and the expanded markets of American manufacturers. The trends of the past which have continued into the future mean an increasing amount of valuable and durable goods will be marketed. Sales of appliances, furniture, and automobiles which have become a part of our daily living through installment buying, have every indication of continued growth. Because of the past great success of the sales finance companies in financing consumer durables, it is only natural to look for their continued future expansion.

The dominance of the sales finance company in the installment credit business has been a factor in a rash of recent state legislative developments. The installment sales contract generally is not covered by banking and loan laws of the states, and much activity of the sales finance companies has been determined largely by competition. Today 30 states have legislation covering certain aspects of installment sales. Practically all of the legislation is of recent origin, although Indiana and Wisconsin enacted laws as early as 1935.[16] The state statutes on this subject are varied, but in most of them there are common provisions. (See Appendix B.)

Wholesale Financing

Sales finance companies are engaged in a variety of financial activities which serve the manufacture and distribution of goods in this country. Their commercial financing involves the purchase of accounts receivables from manufacturers, wholesalers, mills, and converters. Their principal activity always has been and still is the buying of installment paper from retailers, and in particular from the automobile dealer. This same institution provides what has come to be known as *wholesale financing* to durable-goods dealers. Inasmuch as this service was first developed for the automobile dealer and the fact that he utilizes it to a great extent, wholesale financing of the automobile dealer serves as an appropriate example.

Automobile dealers are required to pay cash for automobiles delivered to them by manufacturers. The manufacturer draws a sight draft on the dealer which is payable upon receipt of the automobiles. If dealers used their own capital to pay for the automobiles, many would have all of their working capital tied up in inventory, and would be seriously limited in the quantity of automobiles they could pay for. Sales finance companies *floor plan* or *wholesale finance* the shipments from manufacturers by paying the manufacturer for the dealer. In exchange for this financing, the dealer delivers to the sales finance company the security of a trust receipt, or other form of lien. By virtue of the trust receipt, title vests in the sales finance company and the dealer retains possession of the automobiles. It is usual practice that the dealer uses the automobiles for display, storage, and demonstration. When the dealer sells an automobile listed on the trust receipt, he must immediately or

[16] Thomas W Rogers, "State Instalment Sales Laws—1959," *Time Sales Financing*, September, 1959, pp. 3–29 and p. 32. The following states have special statutes affecting installment sales: California, Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, North Dakota, Ohio, Oregon, Pennsylvania, South Dakota, Utah, and Wisconsin.

within a stipulated period satisfy the sale finance company's lien. Sales finance companies charge a low rate of interest for this service, approximately 0.5 per cent per month, because the risk is relatively low and the turnover of their capital rapid. In reality, the sales finance company desires that when the automobile is sold, the customer's installment paper will be offered its way.

Purchase of Installment Paper from Dealers

When a dealer sells an automobile on the installment basis, the customer's installment contract is usually offered to a sales finance company. It is usual procedure for the sales finance company to perform the credit investigation, make certain that all documents are in order, and if acceptable make the purchase. The customer's account is then opened, and the customer usually is notified of the purchase by the sales finance company. The customer is informed of the conditions of the contract, the amount of his payments, and when and where they are due. It is customary for finance companies and banks to supply the customer with a payment book of coupons, which also indicates the amount of payments and the date each payment should be made.

The installment paper which dealers sell to sales finance companies come under three major classifications. Under the *nonrecourse* plan of purchase, the dealer is not contingently responsible for the credit failure of the customer. Should the customer default in his payments, the dealer has no responsibility. Under this plan the sales finance company buys the paper solely on the credit quality of the installment purchaser. In the event of repossession, the sales finance company assumes the full responsibility of retaking, reconditioning, and reselling the vehicle. Under the *recourse* plan of purchase, the dealer is contingently responsible for the credit failure of the buyer. Should the buyer default for any reason, the dealer is liable to the finance company for the balance due. The dealer may repossess the vehicle on approval of the sales finance company, or the sales finance company may retake and deliver the property to the dealer. In either event the dealer is responsible for the balance due, reconditioning, and resale of the automobile. A third plan with several variations is known as the *repurchase* plan. Under the various repurchase plans the dealer is responsible for buying back the property for the unpaid balance after it has been retaken from the installment buyer. The sales finance company must first find and repossess the vehicle before it can require the dealer to repurchase it. In many instances the sales finance company is expected to issue its check to the dealer immediately upon presentation of the paper. Thus, it may purchase the paper on the basis of the purchaser's statement, that is, without investi-

gation. Under each of three types of plans of purchase just described, the sales finance company usually has an understanding that it may ask the dealer to repurchase the paper within a specified number of days, if it does not wish to buy.

In sharing a contingent risk as under the recourse plan, the dealer is protected to some extent against losses by the dealer reserve. This fund, set aside by the sales finance company out of the finance charges, is held for refund to the dealer under specified conditions. The dealer reserve is used to cover expenses of repossession and other encumbrances against the vehicle. The reserve account is set up in the accounting records of the sales finance company. Surplus amounts which remain over and above the outlays are periodically declared earned and paid to the dealer.

Financing by Commercial Banks

The other important institution in the consumer installment field is the commercial bank. Banks were late to enter this field, but have rapidly taken an important place in the consumer finance structure. Earlier in this chapter, Table 6–2 revealed that banks held nearly 38 per cent of the total installment debt. Durable-goods paper, and automobile installment paper in particular, make up the major portion of their consumer holdings. Indirectly, sales finance companies holdings are financed by the commercial banking system, inasmuch as banks are their principal source of working capital. In addition to the sizable purchases of installment paper from sales finance companies, commercial banks have aggressively been building this phase of their business. In contrast with the sales finance company which seldom has direct contact with the installment buyer at the time of purchase, the commercial bank deals directly with the consumer. Its methods, contract forms, and procedures are similar in many respects to those covered for sales finance companies. The interest rates of commercial banks versus the rate of sales finance companies are highly competitive in many communities. In general, the rate is slightly lower at commercial banks.

BENEFITS AND PITFALLS OF INSTALLMENT CREDIT

Few would deny that installment credit has been a profitable and effective sales-building tool for retailers and a means of creating much enjoyment and satisfaction in the life of consumers. The real danger in installment credit, as in so many other things, is not in its use but in its abuse. Consumers must be aware of the ease with which it is possible to overextend themselves with this type of credit. The consequences of this are that the consumer will fail to appreciate fully what the prudent use

of installment credit can do for him. Numerous examples of the benefits of this type of credit are well known. The fact that 63 per cent of all new automobiles, 49 per cent of all television sets, 46 per cent of all household furniture, and 40 per cent of all refrigerators are purchased with installment credit is testimony to the material contribution of this type of credit to the American consumer. The vast majority of all of these articles was acquired by successful use of installment credit. There remains, however, a small number of consumers who have installment debts out of proportion to their ability to pay. This is damaging to the credit industry and presents a problem of consumer education in the use of their credit.

From the standpoint of the installment retailer, he must be aware that the credit qualities of the customer are more crucial elements to the risk than the lien retained upon the article sold. Even though we are able to cite evidence of group success with installment credit, it does not mean that the retailer can offer credit unwisely. Some customers are imprudent, some impetuous, while others are dishonest. Adherence to sound principles of credit management will do much to avoid the account which does not have the ability or character to pay.

REVIEW AND DISCUSSION QUESTIONS

1. Distinguish clearly between retail installment credit and retail open charge credit. Between retail installment and retail revolving credit.
2. What are the factors that affect the decision of a retailer to sell on installment credit?
3. Do you believe any one of these factors is more important than the others? Which one? Why?
4. Trace the development of installment credit in this country.
5. Tour one of your local department stores. Make a list of items that you believe would be sold on installment terms. Check this list with the credit manager.
6. What is meant by the "changing attitude of consumers" toward installment credit? The "changing attitude of retailers"?
7. Explain what is meant by an installment credit principle. List those principles that are recognized as being important.
8. What is the difference between a conditional sales contract and a chattel mortgage? Check your state laws in respect to each of these.
9. How may retailers finance their installment accounts? Which procedure would you recommend and why?
10. Trace the development of the sales finance company in the United States.
11. What is "floor plan" financing? Why is it important in the automobile industry?

12. Distinguish clearly between the sales finance nonrecourse, recourse, and repurchase plan of buying paper from retailers. Which plan is best for the consumer? For the retailer? For the sales finance company?

Cost of Credit Problems

In the following cost of credit problems, you are asked to compute the terms and the cost of credit as a true rate of carrying charge per year. It is suggested that the formula $R = \frac{r(2n)}{n+1}$ be used. In this formula, R is the true annual rate; r is the nominal annual rate; and n refers to the total number of installments in the transaction.

13. A new Chevrolet Impala convertible is advertised for $3,497. Mr. Martin purchases the car by trading in his used Plymouth for which he is allowed $1,097. He desires to pay the balance in 24 monthly installments. The transaction is accepted by an automobile finance company on its "6 per cent" financing plan. How much does Mr. Martin pay as a finance charge? What is the amount of the note he will sign, and what are his monthly payments? What is the true rate of carrying charge Mr. Martin is paying?
14. An appliance store sold Mr. Craycroft a freezer for $495. A down payment of 10 per cent of the sale price was made, and the payment period was set to cover 18 months. A carrying charge of $60 was added. What is the true rate paid by Mr. Craycroft?
15. Mary Wotawa is a cashier in a downtown restaurant and has just purchased a $139.50 "mink coat." She bought the coat under the following credit arrangement: $19.50 down payment and weekly payments of $2.50 for 48 weeks. The coat would have cost her $120, if she had paid cash. What is the true rate of carrying charge Miss Wotawa is paying? Would you say that this rate is excessive? What other ways might Miss Wotawa have used to obtain the coat?
16. The "University Special" clothing plan has been advertised by a credit retailer. The customer is encouraged to buy a topcoat costing $50. He is asked to pay $7.50 down and to make ten weekly payments of $5 each. What is the nominal rate the student is paying to buy under this plan? The nominal annual rate? The true annual rate?
17. The Cain family has just purchased a new television set. The cash price of the TV set is $300. The set was bought under the following arrangement: $30 down and a finance charge of 12 per cent of the balance. Payments are to be made over a 18-month period. What is the amount of the note and monthly payments that Mr. Cain should agree to? What is the true annual rate he is paying for the use of the credit?
18. Chester Thomas purchased a four-year-old Plymouth for $950. He paid $325 down and made arrangements with the local bank to finance the purchase by signing a note for $700. The note is to be paid in 18 monthly installments. The insurance for the car was handled between Mr. Thomas and an automobile insurance company, and the premium was paid in cash by Mr. Thomas. What true annual rate of interest is involved in this transaction?

CHAPTER 7

Types of Consumer Credit— Cash Loan Credit

ALL OTHER types of credit result in the consumer receiving goods and services in exchange for his credit, whereas cash loan credit results in his receipt of money in exchange for his credit. Cash loan credit then is credit in the form of money as contrasted with other types which are credit in the form of goods and services.

The borrowing of money by consumers is not of recent origin, but it has occurred in all ages. Before 1900 all types of consumer credit were of only nominal importance in the United States, but since that time the expansion of cash loan credit has been almost as rapid and dramatic as installment credit. The need to borrow money today is much greater than it was in the past, because the American consumer has come to be increasingly dependent upon his ability to use his credit to fulfill his varied wants and desires. Just as the several forms of consumer credit developed in response to the diversity of credit needs of the American consumer, so did cash loan credit become an important segment in the consumer credit field.

The system of financial institutions which has evolved is one which supplies most employed persons with a wide variety of types of cash loans, much as they are supplied various types of credit in their acquisition of goods and services. Supplying the various types of cash loans to consumers are commercial banks, consumer finance companies, credit unions, industrial banks, and a number of other institutions such as philanthropic organizations and illegal lenders. The major proportion of all consumer loans is made by commercial banks, consumer finance companies, and credit unions. Table 7–1 shows the relative position of each

Table 7–1

CASH LOANS OUTSTANDING AT FINANCIAL INSTITUTIONS, BY HOLDER
(Estimates. In Millions of Dollars)

End of Year or Month	Total Installment and Non-Installment Loans	Installment Loans					Noninstallment Loans (Single-Payment Loans)		
		Total (1)	Commercial Banks (2)	Sales Finance Companies (3)	Consumer Finance Companies (4)	Other Financial Institutions* (5)	Total (6)	Commercial Banks (7)	Other Financial Institutions (8)
1939	1,875	1,088	363	56	669		787	625	162
1941	2,167	1,322	471	66	785		845	693	152
1945	1,755	1,009	312	54	643		746	674	72
1946	2,618	1,496	546	92	858		1,122	1,008	114
1947	3,266	1,910	747	126	1,037		1,356	1,203	153
1948	3,669	2,224	839	166	1,219		1,445	1,261	184
1949	3,963	2,431	913	142	1,376		1,532	1,334	198
1950	4,635	2,814	1,037	162	1,615		1,821	1,576	245
1951	5,291	3,357	1,122	276	1,959		1,934	1,684	250
1952	6,231	4,111	1,374	341	2,396		2,120	1,844	276
1953	6,968	4,781	1,521	377	2,883		2,187	1,899	288
1954	7,800	5,392	1,676	402	3,314		2,408	2,096	312
1955	9,165	6,163	1,916	465	2,155	1,627	3,002	2,635	367
1956	10,216	6,963	2,118	567	2,500	1,778	3,253	2,843	410
1957	11,267	7,903	2,351	670	2,835	2,047	3,364	2,937	427
1958	12,216	8,570	2,612	750	2,928	2,280	3,646	3,156	490
1959–Oct †	13,625	9,575	3,060	844	3,038	2,633	4,050	3,466	584

* Institutions represented are credit unions, industrial loan companies, mutual savings banks, savings and loan associations, and other lending institutions holding consumer installment loans

† Data for 1959 include estimates for Alaska and Hawaii beginning with January and August, respectively.

Source Board of Governors of the Federal Reserve System

of the several cash lending institutions by the volume of cash loan credit held.

The Use of Cash Loan Credit by Consumers

The consumer who borrows money from any one of the consumer financial institutions does so mainly for the purpose of consolidating his existing debts into one lump sum, the payment of emergency services, or the purchase of merchandise and services. Loans made to cover these broad purposes may be used for payment of medical and dental expenses, the repair and modernization of homes, to meet annual tax payments, to pay for educational expenses, and the purchase of personal needs as well as household furniture, appliances, and automobiles. Individual consumers have not only varied needs and desires, but they obviously differ greatly in their ability to satisfy their wants. Some borrowers will need nominal sums of money; others will require larger sums. Some will be able to repay their loan in a matter of 60 to 90 days; others will need more lengthy terms. Some will prudently compare interest and service charges; others will regard the receipt of immediate cash as more important than cost. A number of borrowers will need security or a co-maker, while others will be able to borrow sums on their

signature alone. In addition to the varied characteristics of the consumer borrowers, they will differ in their ability to handle funds wisely. Consequently the cash lending industry of this country is confronted with a different set of circumstances each time a loan is made. The numerous and varied uses of cash loan credit combined with the different consumer characteristics explain to a great extent the need for a wide variety of different types of loans.

Some businessmen use cash loan credit for the purpose of obtaining short-term working capital for their businesses. These loans, made particularly to small businessmen on their signature or with collateral, are included in the Federal Reserve Board's loan statistics.

The question might be raised as to why consumers borrow money to purchase goods and services when other types of credit could be used to make these purchases. Many consumers will calculate the cost of other types of credit, compare this cost with a personal loan, and use the cheapest money available to them. Prestige or conventional association with a particular financial institution may provide additional explanation for this apparent duplication of credit facilities. Typically the professional and managerial groups have had long and pleasant associations with commercial banks, while these same services have not been as fully utilized by skilled and semiskilled workers until recent years. Consequently, individual preferences to deal with one financial institution and not another and the cost of money from one source versus another explain some of the apparent duplication of credit services. In many instances retailers themselves will suggest that the buyer arrange a loan from a financial institution rather than buy on the retailer's installment plan. Frequently retailers complete the necessary papers, take credit information incidental to a cash loan, and forward the papers to a financial institution for its acceptance and establishment of a loan. These procedures may be less formal from the retailer's standpoint than the selling of installment paper as carried on by some merchants. Furthermore, in the life of most consumers, there arises a number of opportunities and situations which cannot be met except by cash loans. Vacations, some types of travel, education, moving expense, tax and insurance obligations are some typical examples for which no other type of credit is available.

CONSUMER CASH-LENDING INSTITUTIONS

Commercial banks, consumer finance companies, credit unions, and industrial banks are the principal sources of cash loans made to consumers. Each of these institutions was originated either to serve a particular

consumer segment or meet some specific consumer needs not otherwise met by already existing credit facilities. The types of loans offered by the several lending institutions are so varied and numerous that relatively few American consumers have no ready source of cash credit. As the variety of cash-lending institutions is studied, it becomes readily apparent that they exemplify an effort to meet diverse consumer needs.

It may be well to regard the several cash-lending institutions as "sellers of money." This concept of cash-lending institutions clearly establishes them as *merchandisers* of credit whose problems differ only slightly from merchandisers of goods and services. The supply and cost of money to the cash-lending institutions have their parallel in the supply and cost of goods for retail firms; their building of a customer group which seeks cash loans and the same group which will return when the need again exists has its counterpart in the good will, promotion, and repeat sales to satisfied customers, so well understood by retailers of other commodities. Their interest rates and service charges represent the cost of money to the borrower as do prices of goods and carrying charges represent costs to the buyer of goods and services. Furthermore, the profit motive attracts capital, institutions, and personnel to this field as does this same motive lend impetus to most economic activity. Consequently sellers of money are confronted with many of the same problems as other types of merchandising establishments, and the degree of their success will frequently hinge on the same or similar merchandising methods used by successful merchandisers of goods and services.

Commercial Banks

Commercial banks were slow in adopting the practice of lending cash to consumers. Before 1930 commercial banks were active in the real estate loan field but made only a few consumer loans to individuals. The loans of this period were single-payment loans made to individuals with high incomes.

In late 1920's banks began to enter the field of consumer cash lending. By this time they were fairly well assured of the fact that consumer credit was a mature economic force, and more importantly they now could assay the profitable experience of the pioneering sales finance and consumer loan institutions. The National City Bank of New York opened the first consumer loan department in 1928. Gradually the early stigma of consumer credit diminished and cash lending to consumers became as accepted and commonplace as loans to businesses. Consequently other commercial banks adopted the practice. Today more than 12,000 commercial banks or about 85 per cent of all banks pro-

vide consumer credit services. Fewer than this number have separate consumer loan departments, but there is no reliable estimate of the number of banks so organized. The data in Table 7–1 show that commercial banks are dominant with regard to cash loan credit held, provided single-payment loans are combined with the volume of installment cash loans. From the standpoint of the actual number of loan transactions, consumer finance companies are dominant because the average size of loan made by commercial banks is almost double that of consumer finance companies.

Types of Loans. Cash credit, as offered by commercial banks, usually comprises two types of loans: single-payment loans and installment loans.[1] Each of these types of loans is made on either a secured or an unsecured basis, depending on the over-all quality of credit risk relative to the amount of the loan. The collateral pledged as security on these loans is usually in the form of government bonds and other securities and of the cash value of life insurance policies, savings accounts, automobiles, and other personal property that may readily be converted into cash in the event of default by the debtor.

The expansion of single-payment loan credit from $625 million in 1939 to over $3 billion by the end of 1958, as shown in Table 7–1, indicates both the absolute and relative importance of this type of loan to the loan portfolio of commercial banks. Single-payment loans are frequently made for 30, 60, or 90 days and longer periods such as six months, nine months, or even a year. The term "discount loans" is frequently used to describe these loans when the bank deducts the inter-

[1] Another type of cash loan that is gaining importance in commercial banks is the revolving check credit arrangement. With only a few banks offering this type of arrangement in 1958, by 1959 hundreds of banks had installed such a plan. The typical plan operates in the following fashion.

"The customer fills out an application stating the amount he can afford to repay each month. If the bank approves, this figure is multiplied by a fixed number of months—from 12 to 24, depending upon the bank's policy—to determine the maximum amount he may borrow. In other words, if it is decided that repayments of $50 a month can be handled and the bank's plan is for 20 months, the limit of the line is $1,000. The customer then receives a supply of checks which he may use just like any personal check. When one of these checks is written and comes back to the bank, it is charged to the revolving credit account and becomes a loan

"Monthly repayments begin once a debt is incurred They are usually in the predetermined size regardless of the amount borrowed, although a few plans provide for payments as a fraction of the outstanding balance. The customer may continue to write checks until he reaches his maximum line. Once repayments bring his debt below the limit, he may start borrowing all over again.

"There is no charge of any kind while the account is not in use. When the customer borrows, he must pay interest on the amount outstanding—generally around 1 per cent a month. Some banks also levy a service charge on each check." (Source: *Business Review* of the Federal Reserve Bank of Philadelphia, September, 1959, pp. 2 and 3.)

est from the principal amount at the time the loan is made. With some banks it is the policy to collect the interest on the maturity date of the loan when the single payment of principal is made. If the former arrangement prevails, the borrower pays a slightly higher true rate of interest because he has use of the amount borrowed less the interest charges for the duration of the time stipulated. In the event the latter prevails, a 6 per cent interest charge is also the true interest rate inasmuch as the borrower has full use of the principal for the entire period of the loan.

Table 7–2

INSTALLMENT CREDIT HELD BY COMMERCIAL BANKS BY TYPE OF CREDIT (1939–59)

(In Millions of Dollars)

End of Year	Total Installment Credit	Automobile Paper		Other Consumer-Goods Paper	Repair and Modernization Loans*	Personal Loans*
		Purchased	Direct*			
1939	1,079	237	178	166	135	363
1941	1,726	447	338	309	161	471
1945	745	66	143	114	110	312
1950	5,798	1,177	1,294	1,456	834	1,037
1951	5,771	1,135	1,311	1,315	888	1,122
1952	7,524	1,633	1,629	1,751	1,137	1,374
1953	8,998	2,215	1,867	2,078	1,317	1,521
1954	8,796	2,269	1,668	1,880	1,303	1,676
1955	10,601	3,243	2,062	2,042	1,338	1,916
1956	11,777	3,651	2,075	2,464	1,469	2,118
1957	12,843	4,130	2,225	2,557	1,580	2,351
1958	12,780	4,014	2,170	2,269	1,715	2,612
1959†	14,922	4,798	2,511	2,553	1,941	3,119

* Predominantly direct cash loans to consumer

† Includes data for Alaska and Hawaii beginning with January and August, 1959, respectively

Source *Federal Reserve Bulletin*, February, 1960, p 199

No data are available on the average amount of these loans, but it is known that the average is considerably larger than the average amount ($450) of installment loans by commercial banks. Many banks discourage single-payment loans of less than $100. When small loans of short duration are made, banks customarily make a flat charge rather than an interest charge. The flat rates for small amounts conform to bank policy and vary from $1 to $3 or more to defray the costs of the loan.

A full appreciation of the growing importance of commercial banks in the installment loan field cannot be gained from Table 7–1. In addition to the installment cash loans made to consumers for a variety of

purposes, other direct lending to consumers is encouraged. An examination of Table 7–2 will reveal that commercial banks make direct cash loans for the purchase of new and used automobiles and FHA Title I loans for home repair and modernization. It is apparent from data in Table 7–2 that commercial banks are purchasers of a large volume of automobile loans made by sales finance companies and other installment paper representing the sale of household goods, appliances, boats, and motors which have been sold by retailers. The column headed "other consumer-goods paper" represents purchased paper from retailers, sales finance companies, and some direct loans made for the purchase of such items. It is also apparent that most of these loans are secured loans made on the basis of a chattel mortgage instrument. Because of some intermingling of direct loans with purchased paper in the data, it is difficult to estimate accurately the net importance of banks in the installment cash-lending field. It is clearly indicated, however, that commercial banks have been successful in capturing an increasing share of the cash loan market.

Additional characteristics of installment loans as made by commercial banks were revealed by a recent study conducted by the American Bankers Association Instalment Credit Commission.[2]

The most common down payment, most common terms, and average terms reported by the study were:

Type of Loan	*Most Common Down Payment (Per Cent)*	*Most Common Term (Months)*	*Average Term (Months)*
Automobile—new	Approx 33	36	29
Automobile—used	" 33	18–30*	18–26*
Appliance	10	24	20
Television	10	24	19
Furniture	10	24	19
Food freezer	10	24	23
Boats—new	33	24	21
Boats—used	33	24	18
Modernization—own plan	—	36	31
FHA Title I	—	60	33
House trailer—new	33	60	—
House trailer—Used	33	36	—

* Used cars studied were from 1 year to 4 years old

The study further indicated the diversification of a bank's installment loan portfolio, the average loan size, and the estimated period of liquidation on all types of installment loans as follows:

[2] *Timely Notes on Instalment Credit* (New York Instalment Credit Commission, American Bankers Association, Bulletin No. 242, April, 1958), pp. 3–5.

Type of Loan	*Per Cent of Total*	*Average Loan*	*Estimated Period of Liquidation*
Personal loans	21 64	$ 446	7 90 Months
FHA Title I	11.88	797	17 04
Modernization—own plan	10.90	731	16 03
Automobile—direct	12 30	1,283	11 65
Automobile—indirect	16 58	1,464	12.98
Appliances . .	17.70	357	10.42
All other	9 00	1,902	13 28

Interest Rates and Service Charges. Commercial banks are generally bound by the "contract" rates of interest fixed by the usury laws of the state in which the bank operates. While the legal rate of interest may be 6 per cent, lenders may charge the contract rate of 8 per cent provided this rate is agreed upon by the parties involved in the credit transaction. Most state laws have fixed the legal rate at 6 per cent, but a few states have fixed the rate as low as 5 per cent and as high as 7 per cent. With the exception of four states which permit any contract rate agreed upon, the contract rate ranges from 6 per cent to 12 per cent, with 8 to 10 per cent being the most common rates set by state laws.

In general, nominal interest rates of from 5 to 8 per cent on installment cash loans are common. In a few metropolitan areas, where intense competition with sales finance companies for new car financing exists, nominal rates as low as 4 to 5 per cent are sometimes offered to "prime" credit risks. With nominal charges of 5 to 8 per cent per annum, the true rate of interest paid by the borrower will approximate 10 to 16 per cent. Some state laws either imply or permit additional charges commonly referred to as "service charges." Service charges, when permitted, defray the costs of investigation or may be levied to offset the expenses incurred when borrowers are delinquent in their payments. An interest rate quoted, such as 6 per cent by commercial banks on single-payment loans, approaches the true rate of 6 per cent. Whether or not the 6 per cent actually is the true rate is dependent upon the method and time of collecting the interest. As mentioned elsewhere, if the interest is discounted at the time the loan is made then the borrower has use of the principal *less* the interest; hence, the true rate will be somewhat higher than had interest and principal been paid on the maturity date of the loan.

The Changing Character of Commercial Banks and Their Customers. From the viewpoint of the customer, the commercial bank of today is a very different institution than it was two or three decades

ago. Historically, commercial banks have been an institution established to serve the financial needs of businesses for commercial purposes. In their dealings with businesses, fairly large sums of money are usually involved and the risk element can be rather accurately appraised. Banks' services to the needs of commerce are still their *raison d'etre,* and much change and adjustment to the modern needs of business are characteristic of their growth and over-all importance to our economy. Characteristically banks have been conservative financial institutions and are so regarded by most consumers.[3] The conservative nature of their management; the early stigma associated with consumer installment financing; the legal requirements in some instances and the reluctance to charge higher rates of interest so as to earn a profit from small loans; and, in general the bank's preoccupation with commercial needs—all these factors have tended to slow the entrance of banks into the financing of consumer needs.

By contrast, most present-day banks have accepted all kinds of consumer credit as a basic mechanism to our economy. In adopting the policy that consumer financing was sound and aggressively seeking consumer credit customers, they have gradually become one of the dominant sources for consumer installment loans. Much to their good for-

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[3] In connection with consumers' feelings toward banks, the following quotation from *The Hidden Persuaders* by Vance Packard (New York: David McKay Co, Inc., 1957), pages 66–67 is of interest

Our relationship with banks is another area where the depth probers have isolated a definite fear factor and have devised techniques for reducing that fear. An ad agency in Rochester, New York, turned to motivation research to try to find out how to broaden the clientele of a leading bank in that city. Its probers turned up in the people sampled a large variety of fears concerning banks· fear of being rejected for a loan, fear of the banker finding out how untidy their family financial affairs really are, or fear of disapproval. The agency concluded that people subconsciously see their bank as a kind of parent, a parent capable of scolding or withholding approval, and constantly scrutinizing With that subconscious cowering before the parent symbol in mind, the agency designed an ad for the bank, showing a man standing at the bank door saying "How I hated to open that door!" and then relating in the text his story of the warm welcome he got.

Dr Dichter is another prober who has looked into the problem of the banks in winning friends. His particular interest was in the paradox of the great growth of loan companies in spite of the fact most banks were offering personal loans at lower interest and were more lenient in accepting people for loans His conclusion was that the loan company's big advantage over the bank is its lower moral tone! The bank's big handicap—and here he concurs with the Rochester findings—is its stern image as a symbol of unemotional morality. When we go to a banker for a loan, he points out, we are asking this personification of virtue to condescend to take a chance on us frail humans. In contrast, when we go to the loan company for a loan, it is we who are the virtuous ones and the loan company is the villain we are temporarily forced to consort with Here, it is we, the borrowers, who do the condescending. Dr. Dichter explains: "This shift of moral dominance from borrower to lender changes completely the whole emotional undertone of the transaction " We shift from feeling like "an unreliable adolescent to feeling like a morally righteous adult. The higher cost of the loan is a small price indeed to pay for such a great change in outlook." He counsels banks seeking more business to soften their image of righteousness.

tune they have a large customer group which exemplifies stability and a low degree of risk.

Table 7–3 shows the relative importance of various occupational groups to the principal types of lending institutions. Commercial banks, according to these data, make almost 70 per cent of their installment loans to three occupational groups: craftsmen, foremen, and kindred workers; managers, officials, and proprietors; and clerical and kindred

Table 7–3

PERCENTAGE DISTRIBUTION OF INSTALLMENT LOANS MADE TO OCCUPATIONAL GROUPS BY TYPE OF LENDING INSTITUTION (1950–51)

Occupational Groups	Commercial Banks	Consumer Finance Companies	Credit Unions
Craftsman, foreman, and kindred	32 22%	22 73%	10 81%
Managers, officials, and proprietors	22 03	9 19	3 86
Clerical and kindred	13.40	8 20	20 01
Operatives and kindred	10 2.	30.46	51 96
Sales workers	8 80	3 51	2 26
Professional, technical, and kindred	5.27	2 83	.98
Service workers, protective, domestic, and others	2 96	7 23	4 07
Laborers	.84	11 86	6 01
Farmers, farm managers, and farm laborers	10	1 14	
Unemployed, pensions, or independent incomes	25	1 53	
Occupation not reported	3 92	.32	04
Total	100 00%	100 00%	100 00%

Source Adapted from W David Robbins, *Consumer Instalment Loans* (Columbus, Ohio The Ohio State University, Bureau of Business Research, 1955), Table 17, p 62

workers. Furthermore, commercial banks make the major proportion of all loans to professional and technical workers. These same occupations are least affected by seasonal receipt of income; they have considerable job stability and usually represent the middle-income, upper-middle income, and higher-income groups.

In expanding their present-day customer group, banks have had to compete against the other more aggressive consumer loan institutions. Much of the increase in bank customers was accomplished by adopting the sales promotion techniques which were known and proved to appeal to the masses. They adjusted their banking hours to conform with the convenience of the customer; they provided friendly, convenient, comfortable, and attractive loan quarters; and they used the most effective advertising media and techniques. The over-all effect of this changed ap-

proach has been its success in creating a very different image of banks and bankers than had formerly existed. The new customer impressions have resulted in a keener appreciation of what commercial banks can and will do for worthy cash loan customers. From the bankers' viewpoint, their entrance and success in the consumer credit field have resolved certain questions for them. Namely, can this type of credit be extended safely to large numbers of consumers? and, does consumer credit offer advantages and growth possibilities to commercial banks? The answers to these questions are no longer debatable issues among bankers.

Consumer Finance Companies[4]

Consumer finance companies (often referred to as small loan companies, personal finance companies, and licensed lenders) make loans to consumers under regulations enacted by state laws. The characteristics of their loans, their customers, their method of operation, and the state statutes under which they do business are the principal distinguishing features of these consumer lending institutions. Consumer finance companies are the dominant institution in the making of consumer installment loans. A large proportion of commercial bank loans is of the single-payment type, but consumer finance companies are almost exclusively installment loan institutions. These same companies are also dominant with regard to the number of transactions as the average size of their loans is considerably less than that for commercial banks.

A consumer finance business conducted under the Uniform Small Loan Laws may be an individual proprietorship, a partnership, or a corporation. The incorporated company was at first rare, but with the enactment of the Uniform Small Loan Law in most states since 1911,[5] the corporate enterprise has become dominant with such vast companies as the Household Finance Corporation. Typically, the large corporations operate on a national scale with licensed offices in hundreds of cities of all sizes. The smaller companies are usually regional in scope of operation, while the smallest firms with one or a few offices operate only on a local scale.

The rapid growth and present-day position held by consumer finance companies in the lending industry are a direct result of the small loan

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[4] For a very detailed and authoritative account of consumer finance companies, see M. R. Neifeld, *Trends in Consumer Finance* (Easton, Pa.. Mack Publishing Co., 1954).

[5] In 1911, Massachusetts enacted small loan regulatory laws based on the early recommendations of the Russell Sage Foundation. New Jersey followed with legislation in 1914, New York, Ohio, and Pennsylvania in 1915.

laws enacted by most states. Prior to enactment of state laws covering the operation of lenders of small sums, this business was characterized by deception with respect to interest charges and abusive collection practices. In 1907 and 1908 the Russell Sage Foundation, a philanthropic organization, financed studies that dealt with existing small loan conditions and the demand for loans of this type. These studies disclosed a large demand for small loans by wage earners and other consumers of small means, the need for legitimate lending agencies to supply the demand, and the necessity of subjecting the business to state supervision. In 1916, the Foundation in co-operation with a group of money lenders drafted a model small loan law which has come to be known as the Uniform Small Loan Law. Improved drafts of the model law have been made from time to time by the Foundation. This model regulatory act has served as the basis for legislation in most states.

The first Uniform Small Loan Laws tended to reduce the number of lenders subjected to regulation because some lenders found it unprofitable to operate at the interest rates permitted by law. It was not long, however, before lenders who formerly shunned this business were attracted to the small loan field and large numbers of new companies were organized to transact small loans under regulation. In all fairness to the small loan industry, it should be emphasized that the industry encourages state regulation as the basis for attracting personnel of high ethical standards and sufficient capital to meet the demand for small loans. The industry's support of the model Uniform Small Loan Law is testimony of its opposition to illegal lenders which today prey on wage earners and charge usurious interest rates in those states without effective legislation. Today the National Consumer Finance Association, a trade association of consumer finance companies, has assumed the role of promoting effective state legislation. This association's recommendations are based on the earlier model statute developed by the Russell Sage Foundation.

Provisions of an Effective Small Loan Law. An effective small loan law must provide for an interest charge which is sufficient to attract capital to the business and at the same time protect borrowers from abusive practices. Most states have enacted laws which meet this requisite, but unfortunately several states have either ineffective regulation or no small loan law. Arkansas, Montana, and North Dakota have no Uniform Small Loan Law. Most of the southern states, with the exception of Louisiana and Florida, have laws which are substantially ineffective for one reason or another.[6] Even though the Russell

[6] See *Small Loan Laws* (Cleveland, Ohio· Western Reserve University, Bureau of Business Research, 1958), Educational Pamphlet No. 2

Sage Foundation and later the National Consumer Finance Association recommend effective laws and provide a model Uniform Small Loan Law, many states have modified the model to suit local conditions or particular interests. In general, the following are the principal provisions of the Uniform Small Loan Law:

1. Interest Rate. The rate is generally 2½ per cent to 3½ per cent a month computed on the unpaid balance. In recent years some states have provided for the maximum rate to be applied to the first $100 or $200 of the loan and lower rates to loan balances in excess of these amounts. For example the rate of 3½ per cent may be on the first $100 or less and 2½ per cent on the remaining balance up to $300. In states where the maximum loan is more than $300 such as Pennsylvania, the statutory rates are 3 per cent on the first $150 or less; 2 per cent on the next $150; and 1 per cent on the remainder up to $600. Interest is charged only on the unpaid balance and cannot be deducted in advance.

2. Maximum Loan Size. $300 was the original loan size recommended by the Foundation. Today, however, this amount is regarded as too restrictive and the need for larger loans seems apparent. Many states have amended their law to permit maximum size loans to $500 or $1000. Several states have provisions for loans of larger amounts. California has the largest maximum loan size which is $5000.

3. License and Supervision. The lender must be licensed, and each office operated by a chain company must be licensed by the state in which the business is conducted. Each office is subject to annual and special examinations, must be bonded, and usually must submit to a test of ethical and financial fitness.

4. Evidence of the Loan and Security. The written instruments of the loan must disclose the amount of the loan, the interest rate, the security, and the payment schedule. Security may be a signed promissory note. Additional security may be provided by a chattel mortgage or a co-signer to the note.

5. Fees, Prepayment Privileges, and Penalties. No fees other than recording fees may be collected by the lender. The licensee must accept payment from the customer in advance of the due date, and interest charged can be only for the time the borrower has had use of the money. Civil and criminal penalties are provided for violation of the provisions of the Law.

While the above are the principal provisions of the Uniform Small Loan Laws, there are many other specific requirements of secondary importance. The states that have enacted small loan legislation have done so with variation from these provisions but essentially with the same fundamental objectives of effective legislation as cited earlier.

Some states prohibit any other business to be operated in conjunction with a small loan office; others permit insurance writing to minimize the degree of risk; and others have stipulated somewhat different methods of interest computation.

Character of Loans and Services Rendered. It is now apparent that the character and type of loans made by consumer finance companies are prescribed by the Uniform Small Loan Law of the state(s) in which the company does business. They make one type of loan—the cash installment loan. The state regulates the maximum loan limit; the interest rate charged and its method of computation; the prepayment privileges afforded the customer; and it requires written evidence of the transaction, citing the particulars of the loan, be given the borrower.

For the most part, loans made by consumer finance companies involve security of one kind or another. Dr. Neifeld's study of about seven million loans shows that 44.7 per cent were made on the security of chattel mortgages on household goods, 25.3 per cent were unsecured loans, 14.0 per cent were chattel mortgages on automobiles, 6.4 per cent on the security of wage assignments, 4.2 per cent had an endorser or comaker, and 5.4 per cent involved other types of consideration.[7] There is evidence that the value of security accepted by consumer finance companies is secondary to the character of the borrower. In this regard Dr. Neifeld found delinquency and bad debts no higher in Connecticut, where security is unlawful, than in those states where various forms of security are permitted.

The services of consumer finance companies are frequently more varied and of different character than that of commercial banks. The finance companies usually are located so as to appeal to the convenience of the customer. Their offices are frequently located in the so-called "high rent" districts so as to broaden their customer appeal. Such an office stands ready to accept loan applications, make investigations of the applicants, accept payments by mail and on the premises, and handle delinquencies and other necessary matters. Furthermore, it is usual that only a small loan business is carried on at any one location, hence the costs of operation are spread over relatively few operating functions as contrasted with the commercial bank.

The Consumer Finance Customer. Borrowers from consumer finance companies come from different occupational groups than do the borrowers from commercial banks. As shown in Table 7–3 more than 54 per cent of the loans of finance companies are made to two occupa-

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[7] Neifeld, *op. cit.*, p. 81.

tional groups: operatives and kindred workers; and craftsmen, foremen, and kindred workers. In other words there is a preponderance of the skilled, semiskilled, and unskilled workers comprising the customer group of these companies. They borrow funds for the same reasons that other occupational groups borrow, such as the consolidation of overdue bills, the refinancing of existing obligations, the payment of medical, dental, and hospital bills, and the meeting of other emergencies.

Individual customers of these companies borrow on the average smaller sums than do bank customers. The average size of loan now granted is in the neighborhood of $250. This is slightly less than one-half the average loan size granted by commercial banks. Variations in the average size of loan granted may reasonably be expected by virtue of the dominance of particular occupational groups. Historically, the small loan business has had as its customers wage earners and others of limited means. It is this group that this business has so successfully attracted and served. Generally the customers' income and occupational stability are less than the commercial banks' customers. Despite the fact that the customer groups of consumer finance companies and commercial banks have similar reasons for borrowing, the amount borrowed generally is in line with the borrower's income and other existing obligations. Consequently, one can reasonably expect the dominance of a few occupational groups to reflect the character and type of lending services offered by a particular cash-lending institution.

Changing Consumer Attitudes. The widespread change of consumer attitudes and the acceptance of consumer credit of all types during the first half of the 20th century brought with it the general acceptance of the small loan business. Most consumers, at one time or another, experience a temporary need for small loans when income and savings are exceeded by obligations. This need for small loans would exist whether or not the Uniform Small Loan Laws were in existence. Without such laws, however, experience has shown the need has been met by so-called "loan sharks" who loan money at usurious rates of interest. Most of the mistaken beliefs in regard to the desirability of borrowing from consumer finance companies revolve around the rates of interest permitted by law.

An individual who borrows $100 from a consumer finance company at a monthly rate of 3 per cent and repays the loan in twelve equal monthly installments will pay a total interest cost of $20.60, or 36 per cent true rate of interest. Admittedly, this amount appears high unless the cost of lending small amounts is clearly understood. The lender of small sums cannot lend money at the same interest charged by lenders

of larger sums. Furthermore, the cost of capital for these businesses is higher than the cost for commercial banks. The alternative to the Uniform Small Loan Law, which has attracted capital and businesses with high ethical standards to this field, is the fostering of the "loan-shark" and illegal lender. From the standpoint of social necessity, it appears desirable that the customer group served by the consumer finance companies be provided convenient and fair access to small loans rather than be subjected to the lending and collection methods of illegal lenders. It also must be emphasized that for many families the small loan company is their only available cash credit source, whereas the typical commercial bank customer could easily qualify and borrow funds from several sources. Consequently, if a state wishes to make small consumer loans available to its wage earners and lower-income borrowers, it must sanction interest charges to cover the high expenses of this kind of business. If it wishes this business to be conducted on a high plane, it must provide for effective regulation and supervision. These are the principal provisions of most state Uniform Small Loan Laws which have attracted the many ethical lenders to the field.

The phenomenal growth in both the number of lenders and the number of consumer borrowers is some indication of the widespread acceptance of the small loan business by the American consumer. Today there are consumer finance companies which range from the single-office company to the vast chains which operate hundreds of offices throughout the country. The largest of these, Household Finance Corporation, has 940 offices scattered through 39 states. There are presently 11,080 licensed small loan offices in the nation. It is claimed by the industry that these offices serve about one family in seven throughout a one-year period.[8] As shown by Table 7–1, more than $2.9 billion in installment cash credit was held by this industry at the end of 1958, and this is approximately 34 per cent of all consumer installment cash credit held by all consumer lending institutions.

Credit Unions

A credit union is an association of people who agree to save their money together and in turn make loans to each other at relatively low interest rates. In other words, it is a co-operative institution. A credit union is organized by people of a particular group. They may be employees working for the same employer; a group associated with a fraternal order or labor union; or those who live in a closely knit community.

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[8] *Ibid.*, p. 39.

At any rate some common bond or factor of homogeneity is characteristic of the members of a credit union. Today, there are more than 19,000 credit unions in the United States and its territories, with approximately 11 million members. Canada has in excess of 4,500 such organizations with approximately 2 million members. They had more than $3 billion in loans outstanding in the United States at the end of 1958. Assets are estimated to be in excess of $4 billion.

Origin and Characteristics of Credit Unions. The major impetus for the credit union movement came from Edward A. Filene, a Boston merchant and philanthropist. Even though credit unions had their origin in Germany during 1848, and the first credit union in North America was organized in 1900 at Levis, Quebec, it remained for an important United States business figure to head the movement in the United States. Mr. Filene first observed the beneficial aspects of co-operative saving and lending while on a trip to India in 1907. Upon his return to the United States he devoted much time and about a million dollars to the credit union movement. He was particularly successful in getting credit union laws passed and numerous credit unions organized. Much of the growth of the organized credit unions is directly attributable to Mr. Filene and to men whom he influenced to participate actively in the movement.

Today credit unions may be chartered under either state laws or the Federal Credit Union Act of 1934 and its subsequent amendments. Fifty-one per cent of the credit unions are chartered under state laws, while all others are chartered under federal law. The Credit Union National Association at Madison, Wisconsin, recommends that the organizing group consists of at least 50 persons. The common bond of membership may be by reason of employment, church affiliation, residence, labor union membership, and the like. Recently 32 per cent of all credit unions in the United States were owned and operated by manufacturing employees, about 14 per cent by governmental groups, 6 per cent by educational employees, 10 per cent by transportation and utility people, and 5 per cent were labor union groups. Others were comprised of church, residential, trade, and other common bonds.[9]

Credit unions, being essentially co-operatives, adhere to the basic principles commonly associated with other co-operative ventures. The saving and loan facilities are their main function, and they operate only for the benefit and use of their members. Capital is acquired from membership savings which are invested in credit union shares. Additional

[9] *The Credit Union Year Book 1959* (Madison, Wisconsin: Credit Union National Association, 1959), p. 8.

capital may be borrowed from commercial sources, but such borrowing is subject to legal limitations which are usually relative to the unimpaired assets of the credit unions. Shares are in $5 units and amounts deposited which are less than this are applied to the purchase of a share. In turn, a portion of the capital is available for loans to share-holding members. Each member, irrespective of his holdings in the credit union, is entitled to one vote in the election of its Board of Directors and its committeemen who manage the organization. Most state laws provide that a dividend not to exceed 6 per cent may be declared on members' shares after expenses are paid and legal reserves are set aside.

There is such great variance in state laws regulating the operation of credit unions that only the more common requirements and general provisions of the federal law can give an indication of their operating characteristics. The federal law and the state laws may be characterized as emphasizing protection of the members against imprudent management and still provide them with a ready source of cash credit at relatively low rates of interest. Loans to officers, directors, and members of committees are limited to the value of their shares in the organization. Further, such persons may not act as endorsers for borrowers. The accounting records of the credit union are subject to regular examination by government authorities. Further protection is afforded the members by surety bond requirements. The treasurer and each officer who handles money are required to be bonded. Most state laws provide for a maximum loan to members on their signature and another limit on secured loans. It is common for them to loan $400 on the borrower's signature, but larger amounts may be loaned to the borrower who pledges security. Under the federal law, interest on credit union loans may never exceed more than 1 per cent per month on the unpaid balance. Under the various state laws, the maximum rate may be 1 per cent per month on the unpaid balance, or 6 per cent per annum on the principal amount discounted in advance. In either case the true rate of interest on these loans is between 11 per cent and 12 per cent. The Bureau of Federal Credit Unions of the U.S. Department of Health, Education, and Welfare supervises credit unions operating under federal charter, and in most states the state banking commission supervises the credit unions under state charter.

Character of Loans. A credit union member is one who owns one or more credit union shares. Continuous membership may be had by merely holding one $5 share. This single share will earn interest and further entitles the holder to the lending services of the credit union. Applications for loans are made in writing, tell the purpose of the loan,

security offered, and other pertinent information. The Credit Committee, which is elected by the members, meets as often as necessary to approve and reject loan applications. One type of loan is granted—the installment loan which is to be paid in equal installments during the time schedule established by the organization. Small amounts may be repaid in 6 months, 12 months, or over longer periods depending on the amount and requirements of the borrower. Automobile loans typically are made for a maximum of 36 months. The borrower may repay the entire remaining balance of his loan at any time without penalty and hence save interest. As indicated earlier, no credit union loan can exceed 1 per cent per month on the unpaid principal balance. Credit unions write life insurance on the life of the borrower through their organization CUNA Mutual Services. The premium for this insurance is paid by the credit union out of earnings at no additional charge to the borrower. If the insured borrower dies before his loan obligation is fully met, the insurance pays off the remaining loan balance.

Who Borrows from Credit Unions and Why? More than 70 per cent of all credit union loans are made to two occupation catagories according to the data in Table 7–3. Operatives and kindred workers account for more than half of all loans made, while the next most dominant group of borrowers is clerical and kindred workers, who represent about 20 per cent of the total credit union customers. The average size of loan is approximately $475 for credit unions. The reasons for borrowing money from credit unions are essentially the same reasons that people borrow money from other sources: namely, to pay old bills, taxes, medical expenses, home repairs, vacations, automobiles, education, and take advantage of other financial opportunities.

Growth and Increasing Importance of Credit Unions. Since 1921 the growth of credit unions in the United States and Canada has been phenomenal. In each year, except the war years of 1943, 1944, and 1945, credit unions have advanced in number, members, and assets. The number of credit unions has risen from 190 in 1921 to more than 19,000 in 1958 in the United States alone. In Canada the number grew from 100 to more than 4,500 in the same span of years. In addition to the rapid growth of credit unions there has been a gradual increase in their services. The saving and personal loan feature of the business remains as its principal function, but in recent years the Credit Union National Association has ventured into the insurance field and offers life insurance under several plans in amounts up to $30,000. The most recent additional service is a major medical program now available to its members.

Much of the growth and present-day soundness of credit unions may be attributed to their relatively low rate of interest. This interest rate is made possible by its low cost of operation. Credit unions frequently enjoy the privilege of free office space provided by the employer; it is exempt from some taxes because of its co-operative nature; and frequently it receives the services of management (except for the treasurer) free, as elected officers serve voluntarily without pay. The very large credit unions which must maintain scheduled and longer hours of operation are staffed with paid employees. Further, many members regard the saving feature of credit unions most advantageous inasmuch as dividends paid to shareholders are frequently higher than interest on savings in commercial banks.

Despite the apparent advantages enjoyed by credit unions there are limitations to most ventures of a co-operative nature. It is very difficult to recruit spokesmen and workers for organizations of this type because of the voluntary and free expenditure of time and energy. Another limitation to credit union growth is the fact that 50 or more people with a common bond are required before a union can be organized. Groups of this size are not easy to organize in many professional, trade, and clerical fields. This requirement automatically nullifies development in the many thousands of small business firms in this country. Perhaps the greatest drawback in the credit union movement stems from the credit committee. This committee which screens all loan applications is frequently comprised of people closely associated with the borrowers. This fact violates the inherent belief among borrowers that their financial dealings are strictly confidential. Because of this, many credit union members may take advantage of the thrift and savings feature, but patronize other sources when a cash loan is needed. Even though there are these important limitations to the credit union movement, the important position it holds as a source of cash loans cannot be denied. In the short span of less than four decades another consumer finance institution has become an integral and important part of America's consumer credit structure.

Industrial Banks and Loan Companies

Industrial banks are one of the most complex consumer lending institutions because of the varied nature of their services which are governed by nonuniform state laws. In some states they are similar to commercial banks in many respects. In others, their services are restricted by law, and they operate similar to the small loan companies or the consumer loan department of commercial banks. The operation of indus-

trial *banks* is permitted by law in only seven states. In these states the firm may use the word "bank" in its advertising, contracts, and general literature. The laws of these states authorize the acceptance of deposits, the making of loans, and the banks may become members of the Federal Deposit Insurance Corporation. Eighteen states do not authorize industrial banks as such, but have legislation which permits the operation of industrial *loan* companies. In these states such firms are commonly known as "industrial loan companies," or "industrial credit corporations," and the use of the term "bank" is expressly prohibited. Industrial loan companies are not permitted to accept deposits and hence they take on most of the characteristics of other consumer lending institutions. The remaining states have no specific legislation covering these institutions. If they desire to conduct business in one of these states, they must be awarded a charter under the laws applicable to commercial banks or secure a license and comply with the Uniform Small Loan Act and operate accordingly.

Except in those states which authorize industrial banks to accept deposits, the use of "investment certificates," or "shares of stock," are used to circumvent usury laws. These institutions devised this method because state banking laws, as originally conceived, did not cover interest paid on loans which were repaid in installments. Such laws were predicated on the single-payment type loan still common with commercial banks. To earn a higher rate of interest and be within the legal interest rate limitations, a borrower from an industrial bank is required to subscribe to an equal amount of noninterest bearing investment certificates. The investment certificates are to be "purchased" by means of a schedule of deposits. When the amount of the deposits equals the value of the investment certificates, the certificates revert to the industrial bank and the loan is thereby paid off. Today industrial banks operate under one of the several methods suggested, depending on the legislative restrictions of the particular state. Some accept deposits from borrowers and nonborrowers and make loans for both consumer and commercial purposes. Others use the investment certificate device so as not to be accused of usurious interest rates. In some states industrial loan companies neither accept deposits nor use investment certificates, but lend money to consumers or businesses in a manner similar to other consumer lending institutions. Whatever the particular method of operation all industrial banks and industrial loan companies had their origin with Arthur J. Morris during the early 1900's. His original company has evolved into the largest group of industrial banks, now known as the Morris Plan Banks or Companies.

Character of Loans and Interest Rates. In addition to the acceptance of deposits by some of these institutions, another distinguishing characteristic is the amount that can be loaned to any one person. These companies generally can lend relatively large sums to any one person. It is not uncommon that the maximum loan may be up to $5,000, although it is slightly more in some states and somewhat less in other states. The installment type loan is characteristic of operations in the consumer field. However, there is great variation in the scope of their lending activities. In states which authorize widespread services and facilities, industrial banks are almost as diversified as commercial banks in their loan portfolio; making floor plan loans to automobile dealers, automobile loans to consumers, character loans, home improvement loans, mortgage loans secured by first mortgages, and commercial loans. Character installment loans are made directly to consumers in amounts ranging from $25 to $5,000. The average loan size among Morris Plan Banks is approximately $800, but this is believed to be considerably less with other industrial banks or companies. Payment schedules are similar to those of other lending institutions and are relative to the amount of the loan and the degree of risk involved.

The interest rates charged by industrial banks on consumer loans are typically from 6 to 8 per cent, plus an investigation fee of 2 per cent. The investigation fees charged to borrowers is sometimes provided for by statute, or may be assessed because of the implied right that a lender may charge the costs of investigation to the borrower. In view of the fact that their loans are installment loans and the borrower has use of the total principal for only slightly more than half the period of the contract, the rate is higher than appears. The true rate of interest is about 16 to 20 per cent. These figures include the investigation fee which is technically a cost of credit to the borrower.

Other Types of Lenders

There is no estimate of the volume of loans made by friends and relatives, philanthropic organizations, church societies, and fraternal orders, but the amount is believed to be sizable. Some persons have the distinct advantage of borrowing from friends and relatives, thereby enjoying less formal contractual arrangements and on most occasions strict secrecy. Some loans of this nature may involve nothing more than a "friendly agreement," but others may be made on a business basis with a promissory note given and even security pledged. The interest charge and enforcement of payment depend almost entirely upon the relationship and mutual trust between the individuals.

Philanthropic organizations, church societies, and fraternal orders make loans to individuals under special circumstances. These institutions function to provide financial assistance of a temporary nature to students and other deserving persons. Student loans are frequently made so that they are interest and payment free until such time as the student graduates from college. Some may take the form of an outright gift, while others are made with the full intent of enforcing the collection and interest option at some future date.

Illegal lenders operate in most of the states that have failed to enact legislation which would attract personal finance companies. In defiance of the state usury laws, illegal lenders are known to charge interest rates as high as 700 per cent. Typically, illegal lenders are more interested in earning exorbitant charges rather than actually collecting the principal. They prefer a victim who will obligate himself deeply and be submissive to their collection methods. Collections are enforced by threat of wage assignments, loss of employment, and even physical violence. The debtor is most frequently of limited means and "buys" off the threats, at least temporarily, by paying interest charges, but he seldom has enough to meet the full principal and exorbitant interest charges.

RELATIVE COSTS OF CONSUMER LENDING INSTITUTIONS

To appreciate fully the interest rates charged by the various consumer lending institutions, one must examine their costs of operation. Interest rates, or the "price of money," are usually relative to the costs of doing business and the degree of risk assumed by the lender. Costs of conducting a consumer loan activity may be quite high or relatively low. Whether the costs are high or low depends largely on the number and extent of functions performed. Furthermore, the relative costs of capital will importantly influence the rate of interest. Those factors which are believed to influence the costs of conducting a cash loan business are discussed in the paragraphs that follow. In these brief discussions no reference is made to the exorbitant rates charged by illegal lenders. Only the legal lenders are considered, and for that matter only the principal factors contributing to costs are explained.

Types of Risk Accepted

Making loans to wage and salary earners by consumer finance companies is a business in which the average loan is a modest amount. When the amount of the loan is modest, the dollar cost per loan of ac-

quiring customers and then servicing them is relatively high. The type of risk accepted by consumer finance companies is usually one of limited means and in general represents people who have a limited income and job instability. The greater risk incurred by these companies influences their ability to attract capital, their bad debt ratios, and costs of investigation. Commercial banks in particular and credit unions accept credit from more stable customer groups, and therefore less risk is incurred. Table 7–3 which shows the relative importance of various occupational groups to the three types of lenders under consideration also shows the degree of risk incurred, because occupation is frequently a measure of credit quality. Some occupations have greater income stability and also represent variations in the amount of income. The characteristics of the occupation groups attracted by banks and credit unions are qualitatively more acceptable from the credit risk standpoint. This factor alone contributes heavily to the higher cost of credit from consumer finance companies.

Investigation

The cost of investigation by commercial banks and credit unions is generally regarded to be less than the cost incurred by consumer finance companies. The types of risk accepted by the latter institution imply that those dishonest, and those who have neither the ability nor will to pay, must be screened out by investigation. The borrower's identity, stability, and general reputation must be verified. His income, expenses, and outstanding obligations must be established. On the other hand, commercial banks and credit unions frequently appraise applicants on whom prior knowledge exists. Each of these institutions accepts deposits, and in many instances the loan applicant is known by someone in the organization. Furthermore, each institution well realizes that the extent and intensity of investigation are governed by the apparent risk. Consequently, consumer finance companies will conduct rather extensive and costly investigations by virtue of the higher risk element characteristic among their customers.

Capital

The cost of capital for commercial banks, credit unions, and some industrial banks is less than that for consumer finance companies. The three former institutions accept deposits on which relatively little interest is paid. In each instance their deposits are several times as much as their own capital. In past years these same institutions have been able to attract capital more successfully because of the lower risk nature of

their lending operations. Consumer finance companies, on the other hand, cannot accept deposits and must rely on commercial banking facilities or other financial institutions from which to borrow or supply their own funds. Higher rates are thus paid for their capital irrespective of the source. For these same reasons, the operating net profit of these companies must be somewhat higher to attract some investors to the field.

Bad Debt Losses

The greater degree of risk incurred by consumer finance companies is reflected in higher bad debt losses. Conversely the nature of the risk incurred by commercial banks and credit unions results in almost negligible bad debt losses. Another factor which contributes to a high bad debt loss ratio for consumer finance companies is the low average size of loans. Even though a well-managed collection system is in operation, the cost of collecting nominal sums which are about to become bad debt losses is in all likelihood prohibitive. Furthermore, numerous legal actions against wage earners and others of small means would work against the social acceptance and good will which the small loan industry has built up. The threat of legal action by a commercial bank or credit union to collect somewhat larger average sums will most certainly bring forth settlement by their type of customers if for no other reason than to avoid embarrassment. The rate to be charged must take into account the relative amount and frequency of bad debt losses.

Collection Costs

The collection costs on an installment account are much higher than costs on a single-payment loan. Commercial banks, it must be remembered, have a large volume of single-payment loans, while consumer finance companies make only installment loans. Other installment lenders are not subject to the same expenses as consumer finance companies. In an effort to protect borrowers from abuse, the Uniform Small Loan Acts of the various states impose costly procedures on this type of business. Each installment account must be accounted for in detail; many individual calculations must be made; and detailed informative receipts must be given the borrower. The consumer finance company has its full share of accounts requiring "special handling." Again, the modest amount of their loans results in relative higher costs for the collection function. Obviously, the type of risk incurred by these companies is going to result in high collection costs because of a high delinquency rate commonly experienced by these companies. Delinquencies must be reme-

died by constant reminders, personal letters, and even personal contact with the debtor.

Services

Consumer finance companies, by the very nature of their business, establish offices for the convenience of their customers. These offices are not generally housed with another institution as are consumer credit departments of commercial banks and credit unions. The services rendered frequently involve more time and relatively more personnel. Most consumer finance companies have gone to considerable expense in establishing programs of debt amortization for their customers. Each borrower who needs this service presents different problems and the plan must be tailor-made to each borrower. This industry has long recognized that its type of customer needs council, advice, and education in managing their personal finance problems. The educational services that many of these companies offer is a notable service which is freely available to a very large number of American wage earners.

Recognition should be given to the fact that many, if not most, of the commercial banks have expanded their services to their customers. They have seen the need to advise and to counsel their customers on money matters, and have made arrangements for debt amortization on a competitive level with the other types of cash-lending institutions. The introduction of revolving check plans, for example, in commercial banks is an illustration of this recognition of the necessity of being more customer conscious.

In this chapter, the attempt has been made to clarify much widespread misunderstanding associated with particular types of lending institutions. Interest charges are simply a pricing matter, similar to the pricing problem confronted by merchandisers of goods and services. We must recognize that interest rates, the same as prices, must be sufficient to cover the total costs of operation and provide a net profit which is high enough to attract sufficient capital to the field. As the cash-lending industry continues to grow and aggressive competition continues to exist among legal lenders, greater efficiency and hence lower-cost methods of operation can be expected to contribute to the health of the industry in the future.

REVIEW AND DISCUSSION QUESTIONS

1. Distinguish between retail or merchandise credit, service credit, and cash loan credit.

2. Explain the statement: "Just as the several forms of consumer credit developed in response to the diversity of credit needs of the American consumer, so did cash loan credit become an important segment in the consumer credit field."
3. Why do some consumers borrow money to purchase goods and services when other types of credit could be used to make these purchases?
4. What are the principal sources of cash loans to consumers? Distinguish carefully between them.
5. When was the first consumer loan department in a commercial bank opened? Why did this occur at such a late date?
6. Distinguish between single-payment loans, installment loans, and revolving check loans.
7. Explain how a revolving check credit arrangement works.
8. Contact the commercial banks in your town to see what types of consumer loan plans are in operation.
9. Check the loans in your state to discover the interest rates that may be charged on cash loans to consumers.
10. Comment on the statement "The commercial bank of today is a very different institution than it was two or three decades ago." Do the banks in your town appear to have changed character in the last few years? On what do you base your opinion?
11. Review Table 7–3, noting especially the differences between lending institutions as to type of borrowers. Account for these differences.
12. What are the provisions of an effective small loan law? Check the law in your state and see whether it has these provisions.
13. How do you account for the changing attitude of consumers toward consumer finance companies?
14. Trace the development of the credit union movement in the United States. Is there a credit union at your school? Who may belong to it?
15. Explain the characteristics of the industrial bank. Are there any industrial banks in your town? If so, interview the president of the bank(s) and discover the policies and practices followed.
16. Explain the statement "To appreciate fully the interest rates charged by the various consumer lending institutions, one must examine their costs of operation."

CHAPTER 8

Home Mortgage Loans

GENERALLY speaking, when the term "consumer credit" is used, reference is being made to the short- and intermediate-term credit that has been accepted from consumers. These types of credit have been covered in Chapter 4 on the retail charge account, in Chapter 5 on revolving credit and service credit, in Chapter 6 on the retail installment account, and in Chapter 7 on cash loan credit.

There is yet another area of credit involving consumers that has not been covered—that of home mortgage loan credit.[1] Discussion of this type of long-term credit usually is found in books on the subject of personal finance, but is not covered generally in the books on credits and collections. However, it is believed that such an omission is regretable because the purchase of homes on credit has become an increasingly important factor in the budgets of the American family. With more than 60 per cent of American families now owning their own homes, subject to mortgage debts, a look into this form of consumer credit is important.

Decision to Buy or to Rent

Before the American family is concerned with the details of a home mortgage loan, it must have made the decision to buy or build a home

[1] Entire books have been written on the subject of mortgage lending, whereas in this book only one very short chapter is devoted to the subject. However, the authors believe that the student should at least be "exposed" to some of the most important aspects of home mortgage financing, as the majority of the students in the business administration curriculum do not study the field of personal finance.

It is suggested that the prospective home buyer, after having acquired some fundamental knowledge of this subject, rely strongly upon the expert advice of his experienced real estate agent, his banker, his savings and loan executive, his insurance agent, and other experienced executives in this field. Much grief can be saved by following the advice of experts in this complicated field.

rather than to rent. This old debate as to which arrangement is better has been surveyed by the Housing and Home Finance Agency of the federal government, and the replies received reveal at least a partial answer as to why home buyers decide not to rent. These answers appear in Table 8–1.

Table 8–1

REASONS WHY BUYERS DECIDE NOT TO RENT

Reasons	*Per Cent of Replies*
Buying is an investment	24
Rents too high, ownership cheaper	24
Ideal of ownership	22
Forced to buy, could find no place to rent	19
Desire for independence, security	11
"Found just the right place"	4
Other reasons	9

Source "Why People Buy the Houses They Do," *Housing Research* (Washington, D C. Housing and Home Finance Agency, October, 1952), p. 3

Increasing Volume of Home Mortgage Loans

Statistics appearing in the monthly *Federal Reserve Bulletin* reflect the steadily increasing volume of mortgage debt outstanding on 1 to 4 family nonfarm houses. Whereas the amount owed at the close of 1941 totaled $18.4 billion, by the close of 1959 this figure had increased more than seven times—to $131.2 billion. Of course, this increasing dollar amount of mortgage debt reflects to some degree the effect of inflation, but by far the greater influence is simply that more American families are buying homes. The data in Table 8–2 show the trend of mortgage debt outstanding for selected years. Also shown in Table 8–2 is whether the mortgage debt was FHA-insured, VA-guaranteed (GI), or a conventional type loan. Despite the growth[2] of VA-guaranteed and the somewhat lesser expansion of FHA-insured loans, it is important to note that conventional loans still accounted for approximately 59 per cent of the total outstanding at the close of 1959.

Before looking at the various sources of financial aid to borrowers, it is well to understand what is meant by the terms "GI loans" and "FHA insurance."

GI Loans (VA-Guaranteed). The original Servicemen's Readjustment Act was passed by Congress in 1944, extending housing benefits to the 19 million eligible veterans of World War II and the Korean War. This Act, which has been amended a number of times, guaranteed loans for any World War II veteran who served actively 90 days

[2] During the years 1958 and 1959, a decline was recorded in VA-guaranteed loans.

or more on or after September 16, 1940, and before the end of World War II, provided the veteran had an other than dishonorable discharge. Korean War veterans with service after June 27, 1950, are entitled to benefits under the amended Act up to February 1, 1965.

Despite a great deal of confusion and misunderstanding, loans under the Act are not made by the federal government. The government simply guarantees loans made by ordinary mortgage lenders (descriptions of which appear in subsequent sections), after the veteran has made

Table 8–2

MORTGAGE DEBT OUTSTANDING ON NONFARM 1 TO 4 FAMILY PROPERTIES
(In Billions of Dollars)

End of Year	Total	Government-underwritten			Conventional
		Total	FHA-Insured	VA-Guaranteed	
1941	18 4				
1945	18.6	4 3	4.1	2	14 3
1950	45.2	18.9	8.6	10 3	26 3
1951	51.7	22 9	9 7	13 2	28.8
1952	58 5	25.4	10 8	14.6	33 1
1953	66 1	28.1	12 0	16.1	38 0
1954	75 7	32 1	12 8	19.3	43 6
1955	88 2	38.9	14 3	24 6	49 3
1956	99 0	43 9	15 5	28.4	55 1
1957	107 6	47.2	16 5	30.7	60 4
1958	117 7	50 1	19 7	30 4	67 6
1959*	131 2	53 9	23 8	30 1	77 3

* Preliminary

Source *Federal Reserve Bulletin*, February, 1960, p 197

his own arrangements for the loan through normal financial circles. The Veterans Administration, which is charged with the carrying out of the Servicemen's Readjustment Act, then appraises the property in question and if satisfied with the risk involved guarantees the lender against loss up to 60 per cent of the loan, with a maximum guarantee of $7,500. In order to provide for small monthly payments to conform with the veteran's ability to pay, GI residential loans may be written for a maximum of 30 years and GI farm loans for a 40-year duration. Property cannot carry a GI loan, if it sells for more than the Veterans Administration appraisal.

FHA Insurance. As in GI loans, the applicant for the loan makes his own arrangements with a lending institution. This financial organization then may ask if the borrower desires FHA insurance on his loan or may insist that the borrower apply for it. The federal government,

through the Federal Housing Administration, investigates the applicant and having decided that the risk is favorable insures the lending institution against loss of principal in case the borrower fails to meet the terms and conditions of the mortgage. The borrower, who pays an insurance premium of ½ per cent on declining balances for the lender's protection, receives the benefits of a careful appraisal by an FHA inspector and of a lower interest rate on the mortgage than possibly would have been offered by the lender in case the loan were not so protected. The most important provisions of an FHA loan are as follows:

LOANS TO FINANCE PROPOSED OR EXISTING RESIDENCES
(Housing Act of 1957, effective April 1, 1958)

Maximum Loan: $20,000 on 1 or 2 family house, $27,500 on 3 family; $35,000 on 4 family. These amounts are for owner-occupied residences. If housing is not owner-occupied, maximums are 85 per cent of loan amounts shown

Down Payment: 3% of $13,500 value plus 15% of next $2,500 plus 30% in excess of $16,000. Figures are to be adjusted to $50 or $100 multiples.

Financing a Home

Of course, the safest and most desirable way to buy a home is to pay cash. But the typical American family is not in such an advantageous position, and thus it must make arrangements for financing its purchase. It probably will be in a position to make only a modest down payment, 25 per cent or less, and will be forced to secure the remainder of the purchase price by mortgage from some lending institutions. Of course, the larger the down payment the smaller the total interest payment over the term of the mortgage. Buyers are cautioned, however, not to use all of their savings for making the down payment, thus depriving themselves of any reserve on which to fall back if extraordinary expenses arise in the future or if income is reduced.

Sources of These Finances

The family seeking assistance in the purchase or construction of a home generally has several possibilities from which to secure the funds needed to complete the transaction. It should be pointed out, however, that the amount of the loan sought usually is less important than the ratio of the loan to the property value. At certain financial institutions, this ratio is a direct determining factor as to the eligibility of the applying family for the needed loan.

The sources from which a buyer or builder of a home may obtain financial aid includes savings and loan associations, life insurance com-

panies, commercial banks, mutual savings banks, mortgage companies, individual investors, and builders. In deciding upon the most advantageous source, a number of factors (such as the size of the loan needed, maturity of the loan, interest rate, method of paying off the loan, and other characteristics) should be considered before actually borrowing the money. For this reason, it is important to understand clearly the different characteristics of these potential sources of funds.

Savings and Loan Associations. The most important purpose of these institutions is to make mortgage loans on residential property. These organizations, which also are known as savings associations, building and loan associations, co-operative banks (in New England), and homestead associations (in Louisiana), are the primary source of financial assistance to a large segment of American home owners. As home-financing institutions, these associations not only give primary attention to single-family residences but also are well equipped to make sound loans in this area.

Some of the most important characteristics of a savings and loan association are:

1. It generally is a locally owned and privately managed home-financing institution.
2. It receives savings of individuals and uses these funds to make long-term amortized loans to purchasers of homes.
3. It has repayment protection through first mortgage security (see Figures 8–1 and 8–2).
4. It makes loans for construction, purchase, repair, or refinancing of houses.
5. Of the more than 6,000 savings and loan institutions, approximately 70 per cent are state chartered and 30 per cent are federally chartered.

From the data in Table 8–3, it is seen that the conventional type loan is much more important in mortgage activity of savings and loan associations than are the FHA-insured and the VA-guaranteed. At the close of 1958, conventional loans accounted for 80 per cent of the $45 billion loans outstanding, whereas VA-guaranteed loans were 15 per cent and FHA-insured were 5 per cent of the total. Loans made during 1955, 1956, 1957, and 1958 totaled more than $10 billion a year—thus accounting for the highest four-year activity in the history of savings and loan associations.

Life Insurance Companies. Another source of financial assistance to the consumer buying or building a home is the life insurance company. These companies have followed the practice of lending on real estate as one form of investment and have adjusted their portfolios from time to time in order to reflect changing economic condition. Formerly

FIG. 8–1. Illustration of savings and loan mortgage.

Know All Men By These Presents

THAT

of the county of and State of Nebraska, mortgagors, in consideration of the sum of DOLLARS,

the receipt whereof is hereby acknowledged, do hereby SELL AND CONVEY to The State Savings and Loan Association of Beatrice, Nebraska, mortgagee, the following described real estate, situated in County, State of Nebraska, to-wit:

TO HAVE AND TO HOLD the premises above described, with all the appurtenances thereunto belonging, including all heating, plumbing, hot water heaters, lighting fixtures, all carpets, rugs and linoleum now or hereafter permanently fastened to the floor, and all air conditioning equipment, mechanical dishwashers, disposal units, or other equipment, window shades, screens, awnings and storm windows, all of which are intended to be and are hereby declared to be a part of said real estate whether physically attached thereto or not, unto the said mortgagee, its successors and assigns, forever.

The mortgagors represent and covenant with the mortgagee that they are lawfully seized in fee simple of said premises; that they have good right and lawful authority to sell and convey the same; that they are free and clear from encumbrances and that they will warrant and defend the title to said premises against the claims of all persons

PROVIDED, always and these presents are upon express condition: That, Whereas the said mortgagors have this day executed and delivered to the said Association, one certain bond in the amount of the above consideration, which sum with interest as provided by said bond or any mutual modification or extension thereof, and all sums which said Association shall pay out of its own funds for taxes, insurance or repairs on the property described herein, or future cash advancements made by the mortgagee to the mortgagor, or his successor in title, for any purpose at any time before the release and cancellation of this mortgage (provided that the said advancement, together with the principal balance due at the time of the said advancement, shall not exceed the original amount of the mortgage and, provided further, that nothing herein contained shall be considered as limiting the amounts that shall be secured hereby when advanced to protect the security or in accordance with the covenants contained herein) shall constitute the debt owing to said Association, and by said bond said mortgagors promise to pay said debt and interest to the Association in monthly installments as provided in said bond of even date herewith. Unless modified or extended, the final payment is due months from date.

Mortgagors further agee to pay, before delinquency, the sums secured hereby, and all taxes and charges of every character assessed or now due, under the laws of Nebraska, upon said real estate and upon this mortgage or the bond or debt secured hereby; to keep the buildings upon said premises insured for fire and extended coverage in some company or companies acceptable to mortgagee, for an amount not less than the unpaid indebtedness of this loan, keep all improvements in good repair and condition, without waste during the life of this mortgage.

Should default be made in payment of the sum secured hereby, or any part thereof, and said default continue for two months, or should insurance not be promptly effected, or taxes or assessments not be paid before delinquency, or the fee title to said property sold or transferred, or in case of failure to duly observe and be governed by the provisions and conditions of the Articles of Incorporation, Constitution, By-Laws, rules and regulations of said Association, or the discovery by the Association, or its officers, that any of the statements contained in the application for the loan executed by mortgagors are false, then the whole of said indebtedness remaining unpaid, shall at the option of said Association, become due and payable without notice, time being the essence of this contract.

Should mortgagors fail to keep the buildings insured, as herein agreed, or fail to pay taxes before delinquency, mortgagee may effect said insurance, pay taxes and insurance premiums, and all such payments, with interest at nine per cent per annum, shall be a lien upon said premises and secured hereby

The makers of this mortgage hereby relinquish all homestead and marital rights of every kind in and to the said premises.

For the purpose of furnishing further security for the debt secured hereby, the mortgagors hereby assign, transfer and set over to the mortgagee, to be applied toward the payment of the bond and all other sums secured hereby, in case of a default in the performance of any of the terms and conditions of this mortgage or the said bond, all the rents, revenues and income to be derived from the mortgaged premises during such time as the mortgage indebtedness shall remain unpaid; and the mortgagee shall have power to appoint any agent, or agents, it may desire for the purpose of repairing said premises and of renting the same and collecting the rents, revenues and income, and it may pay out of said income all expenses of repairing said premises and necessary commissions, and expenses incurred in renting and managing the same, and of collecting rentals therefrom; the balance remaining if any, to be applied toward the discharge of said mortgage indebtedness. Mortgagee shall account for rents actually collected and not for the rental value of said premises

If the indebtedness secured hereby be guaranteed or insured under the Servicemen's Readjustment Act, as amended, such Act and Regulations issued thereunder and in effect on the date hereof shall govern the right, duties and liabilities of the parties hereto, and any provisions of this or other instruments executed in connection with said indebtedness which are inconsistent with said Act or Regulations are hereby amended to conform thereto

The terms used to designate any of the parties herein shall be deemed to include the heirs, representatives, successors and assigns of said parties, and the term "Mortgagor" shall also include any lawful owner, holder or pledgor of any indebtedness secured hereby.

Whenever the context hereof requires, reference herein made to the plural number shall be understood as including the singular, and likewise the singular shall be understood as denoting the plural.

The mortgagors consent that this mortgage may at the option of the said mortgagee be assigned to a corporation created by authority of the United States Government or as an instrumentality of the United States Government as provided by Section 8-323 of the Revised Statutes of Nebraska.

NOW, if the said mortgagors shall comply with all the terms and conditions of this mortgage, and the bond secured hereby then this obligation to be void. Otherwise to be and remain in full force and effect.

Dated

STATE OF NEBRASKA, } ss.
COUNTY OF }

On before me, the subscriber, a Notary Public duly commissioned and qualified for and residing in said County, personally appeared the above named

to me known to be the identical person described in and who executed the foregoing instrument as grantor , and severally acknowledged the said instrument to be voluntary act and deed.

IN WITNESS WHEREOF, I have hereunto set my hand and Notarial Seal at in said County the day and year last above written.

My commission expires NOTARY PUBLIC

Courtesy of The State Savings and Loan Association of Beatrice, Nebraska

FIG. 8–2. Illustration of real estate mortgage bond.

$_____ **REAL ESTATE MORTGAGE BOND** No._____

_____, Nebraska_____

Received, as a loan from THE STATE SAVINGS AND LOAN ASSOCIATION of Beatrice, Nebraska, (hereinafter referred to as the Association), the sum of

DOLLARS,

which sum, with interest, and all sums which said Association shall pay out of its own funds for taxes, insurance, or repairs on the property described in the mortgage securing the payment of this bond or future cash advancements made by the Association to the undersigned, or his successor in title to the said mortgaged property, for any purpose at any time before the release and cancellation of said mortgage (provided that the said advancement, together with the principal balance due at the time of the said advancement, shall not exceed the original amount of this note, and, provided further, that nothing herein contained shall be considered as limiting the amounts that shall be secured hereby when advanced to protect the security or in accordance with the covenants contained in the said mortgage) shall constitute the debt owing by us to said Association.

We promise to pay said indebtedness, with interest from date at the rate of per cent per annum, in monthly installments of

DOLLARS,

due and payable on the first day of each month beginning and continuing until said indebtedness and all future cash advancements are fully paid Past due interest shall draw interest at the same rate. Additional payments may be made on the principal at any time

In the event of any prepayment, this note shall not be treated as in default at any time so long as the unpaid balance of principal, additional advances under this note or the instrument securing the same, and interest (and in such case accruing interest from month to month shall be treated as unpaid principal) is less than the amount that said indebtedness would have been had the monthly payments been made as first specified above; provided that monthly payments shall be continued in the event of any credit of any proceeds of insurance or condemnation.

All payments upon the indebtedness represented by this bond shall be applied as follows: First, to the payment of interest; second, to the reduction of the remaining indebtedness.

For the purpose of providing a fund for payment of taxes, insurance premiums for insurance on the property securing this indebtedness, and other items that we direct you in writing to pay, we further agree and promise to pay to said Association, on the first day of each month, the sum of $ to be applied by said Association to the payment of said taxes, insurance premiums, and other items, and in consideration of the monthly reduction of the principal provided herein, and the application of said tax and insurance fund to the payment of taxes on said real estate, and insurance premiums, and other items that we direct shall be paid, we hereby relinquish and assign to said Association, all dividends which might otherwise accrue upon said tax and insurance fund, and upon the stock assigned by us as security for this loan. We agree that the said amount may be adjusted in an amount sufficient to pay said taxes and insurance

This bond is secured by a real estate mortgage of even date herewith, and by Certificate No for shares of Installment Stock in said Association, for which we hereby subscribe, which said stock is issued in connection with this loan and which stock by this instrument is assigned, transferred and set over to the said Association and is hereby pledged and lodged with the said Association as security for this loan, as provided by the Constitution and By-Laws of said Association.

If any payments herein agreed to be made by us remain due and unpaid, in whole or in part, for two months after the same become due, or if the undersigned or their successors or assigns fail to keep the buildings on said mortgaged property insured against fire and extended coverage, or fail to pay real estate taxes and assessments levied against said mortgaged property before same become delinquent, or sell or transfer the fee title to said mortgaged property, then in either of said events the whole of said indebtedness remaining unpaid, shall, at the option of the Association, become due and payable, without notice, and draw interest at nine per cent per annum.

Whenever the context hereof requires, reference herein made to the plural number shall be understood as including the singular, and likewise the singular shall be understood as denoting the plural

The undersigned, as members of the Association, hereby agree to abide by the Constitution and By-Laws of the Association and rules and regulations adopted by its Board of Directors, and I, , a married woman, do execute this note with reference to my individual estate, upon the faith and credit thereof, and with the intention to charge my separate property for its payment.

IN PRESENCE OF:

_____ _____

_____ _____

Courtesy of The State Savings and Loan Association of Beatrice, Nebraska

farm loans were looked upon with favor by life insurance companies. Only recently, however, these institutions have gone actively into the market for residential mortgages. Individuals seeking a loan from an insurance company may complete the transaction by dealing directly with a local branch office. Another method is to deal with a local real estate broker who acts as loan correspondent for one or more insurance companies.

Table 8–3

MORTGAGE ACTIVITY OF SAVINGS AND LOAN ASSOCIATIONS
(In Millions of Dollars)

Year	Loans Made			Loans Outstanding (End of Year)			
	Total	New Construction	Home Purchase	Total	FHA-Insured	VA-Guaranteed	Conventional
1941	1,379	437	581	4,578			..
1945	1,913	181	1,358	5,376			
1950	5,237	1,767	2,246	13,657	848	2,973	9,836
1951	5,250	1,657	2,357	15,564	866	3,133	11,565
1952	6,617	2,105	2,955	18,396	904	3,394	14,098
1953	7,767	2,475	3,488	21,962	1,048	3,979	16,935
1954	8,969	3,076	3,846	26,108	1,170	4,709	20,229
1955	11,432	4,041	5,241	31,408	1,404	5,883	24,121
1956	10,545	3,771	4,727	35,729	1,486	6,643	27,600
1957	10,402	3,562	4,708	40,007	1,643	7,011	31,353
1958	12,346	4,096	5,251	45,627	2,206	7,007	36,344

Source *Federal Reserve Bulletin*, February, 1960, p. 196.

Experience has shown that life insurance companies prefer mortgages of medium-term maturities, with loan ratios less than 70 per cent and with amortization clauses.

Commercial Banks. In the past, commercial banks have not been greatly interested in real estate loans and have placed only a relatively small percentage of their assets in mortgages. As their name implies, these financial institutions have attempted to secure their earning primarily from commercial loans and have left to others the major task of home financing.

Changes in banking laws now allow these institutions to make mortgage loans on a more liberal basis than ever before. National banks, for example, now may invest in twenty-year mortgages up to 66⅔ per cent of the value of the property involved, if the entire amount is to be amortized in the 20 years. They also may invest in ten-year mortgages up to 66⅔ per cent of the value of the property involved, if at least 40 per cent of the loan is to be paid off during the ten-year period. This 4 per cent per year amortization must take place before such a mortgage can be renewed on the reduced principal. These banks also can loan up to 50 per cent of the value, if the loan is not amortized and if it is to paid off at the end of 5 years.

Another factor accounting for the gradually increasing interest of commercial banks in the mortgage-loan picture has been the guarantee of loans by the Veterans Administration and the FHA insurance program. Commercial banks have made more generous use of both of these

safeguards than have some of their financial competitors. This changing development is clearly illustrated by the fact that in the post-World War II period the proportion of total real estate mortgage debt held by commercial banks rose to a point almost twice that reported in the middle 1930's.

In acquiring mortgages on real estate, commercial banks follow two main practices. Some of the banks maintain active and well-organized

Table 8–4

COMMERCIAL BANK HOLDINGS OF RESIDENTIAL MORTGAGE LOANS
(In Millions of Dollars)

End of Year	Total	FHA-Insured	VA-Guaranteed	Conventional
1941	3,292			
1945	3,395			
1950	10,431			
1951	11,270	3,421	2,921	4,929
1952	12,188	3,675	3,012	5,501
1953	12,925	3,912	3,061	5,951
1954	14,152	4,106	3,350	6,695
1955	15,888	4,560	3,711	7,617
1956	17,004	4,803	3,902	8,300
1957	17,147	4,823	3,589	8,735
1958	18,591	5,476	3,335	9,780
1959*	20,430	6,200	3,100	11,130

*Preliminary.

Source *Federal Reserve Bulletin*, February, 1960, p 195.

departments whose primary function is to compete actively for real estate loans. In areas lacking specialized real estate financial institutions, these banks become "the" source for residential and farm mortgage loans. The second technique of acquiring mortgages is simply to purchase them from mortgage bankers or dealers. A picture of commercial bank holdings of residential mortgage loans is given in Table 8–4, with a breakdown as to FHA-insured, VA-guaranteed, or conventional types.

Mutual Savings Banks. Mutual savings banks are found today in only 17 states, with the majority of them concentrated in New York, Massachusetts, and Connecticut. These banks receive their charters from the state governments, and the regulations governing their operations have a wide range of variations. In relation to their mortgage-lending programs, for example, the ratio of the maximum loan allowed to the value of the property varies from 50 to 80 per cent (except for FHA

and GI loans). The loans are amortized and mature on the average in about 10 to 20 years.

Mutual savings bank holdings of residential mortgage loans totaled more than $22 billion at the close of 1959. VA-guaranteed loans accounted for 38 per cent of these holdings; conventional loans for 34 per cent; and FHA-insured for the remaining 28 per cent. A breakdown of this information for selected years is shown in Table 8–5.

Table 8–5

MUTUAL SAVINGS BANK HOLDINGS OF RESIDENTIAL MORTGAGE LOANS
(In Millions of Dollars)

End of Year	Total	FHA-Insured	VA-Guaranteed	Conventional
1941	3,884	.		
1945	3,387		.	
1950	7,054	.		
1951	8,595	2,567	1,726	4,303
1952	9,883	3,168	2,237	4,477
1953	11,334	3,489	3,053	4,792
1954	13,211	3,800	4,262	5,149
1955	15,568	4,150	5,773	5,645
1956	17,703	4,409	7,139	6,155
1957	19,010	4,669	7,790	6,551
1958	20,935	5,501	8,361	7,073
1959*	22,457	6,335	8,635	7,487

* Preliminary.

Source *Federal Reserve Bulletin*, February, 1960, p. 195.

Mortgage Companies. Mortgage companies are often known as mortgage bankers or mortgage dealers. In the 1946 Constitution of the Mortgage Bankers Association of America, these companies were defined as "Any person, firm, or corporation . . . engaged in the business of lending money on the security of improved real estate in the United States, and who publicly offers such securities, or certificates, bonds or debentures based thereon, for sale as a dealer therein, or who is an investor in real estate securities, or is the recognized agent of an insurance company or other direct purchaser of first mortgage real estate securities for investment only."

These companies were severely hurt by the large decline in real-estate values during the Great Depression of the 1930's, and as a result today are not as important a source of home financing as they were during the 1920's. Nevertheless, it is important to understand their operations in order to have a complete picture of the various means by which residential property may be financed for the consumer.

Mortgage companies generally follow one of the two patterns in financing real estate loans. First, only after the company has obtained prior approval from the insurance company for which it is a loan correspondent, is the loan made in certain instances to the consumer. In this situation the mortgage company is actually acting as an agent for the insurance company. Second, the mortgage company may invest its own funds in the consumer's mortgage and then attempt to sell the mortgage to some investor who is interested in this type of outlet for its funds. These potential purchasers include insurance companies, commercial banks (particularly country banks), individual investors, and mutual savings banks. Savings and loan associations generally do not purchase mortgages in this manner but ordinarily originate their own.

Individual Investors. This source of funds constitutes a large but a declining segment of the potential money of home-mortgage loans. Unfortunately, there are no accurate data reflecting the proportion of mortgage lending provided by individual investors. However, experienced observers estimate that 15 to 20 per cent of the mortgage money originates from this source which is known to prefer short-term obligations and usually restricts its loans to less than two-thirds the value of the residential property.

Builders. This means of financing is primarily involved with second mortgages. Building contractors often are willing to accept second mortgages in part payment of the construction price of the home in those instances where the purchaser is unable to raise the total amount of down payment above the first mortgage money offered by one of the financial sources previously described.

Amortized versus Old-Type Straight Mortgage

Mention has been made previously of an amortized mortgage. While the use of this term is fairly well standardized in financial and credit circles, it is important that a clear distinction be drawn between this newer type of repayment plan and the older-type straight mortgage plan.

When a loan is made on the security of a mortgage, the lender of the funds makes a loan to the homeowner in return for a promissory note secured by the mortgage of the property. Formerly, most of the loans made for the acquisition of a home ran for a definite numbers of years, at the end of which period the entire principal amount borrowed became due and payable. These were known as "straight mortgages" because it was customary to pay only the interest periodically and to make little or no payment on the principal of the loan. Thus most borrowers

would meet the interest payments, forget or "try to forget" the principal until the note matured, and then try to renew the loan for another three- to five-year period.

In recent years, however, most of the loans granted by financial institutions have been of the amortized type. All the government mortgage-financing institutions, such as the FHA and the HOLC which were set up during the 1930's, insisted upon the amortized form of mortgage lending. This direct-reduction mortgage provides for a fixed monthly payment which not only covers interest and perhaps taxes and insurance

Table 8–6
AMORTIZATION SCHEDULE

Number of Years	Monthly payment to amortize $1,000 loan including interest at rate of: 4%	5%	6%
In 5 years	$18 42	$18 87	$19 34
In 6 years	15 65	16 10	16 58
In 7 years	13 67	14.13	14 61
In 8 years	12 19	12 66	13 15
In 9 years	11 04	11 52	12 01
In 10 years	10 12	10 61	11 11
In 15 years	7 40	7 91	8 44
In 20 years	6 06	6 60	7 17

but also provides for a payment toward reducing the principal of the mortgage debt. An amortization schedule is shown in Table 8–6.

Credit Investigation of Applicant for Loan

Recognizing the need for credit reports on prospective home buyers or builders, the Associated Credit Bureaus of America have devised forms designed to answer questions of financial institutions making GI and FHA loans. ABC of A Report No. 6, Credit Character—Loan Report (see Figure 8–3), is useful to expedite the handling of GI loans for processing through the Veterans Administration. ACB of A Reports No. 10 and No. 11 are designed to provide information for applicants for FHA loans. Report No. 10 is the FHA Modernization Report (see Figure 8–4) which is used on those applications which provide for modernization of existing homes, and Report No. 11 (see Figure 8–5) is used to make a credit report on an applicant for a loan to build a home.

Mention should be made, however, that in some areas more extensive use is made of the ACB of A Report No. 1, Standard Consumer Report (see Figure 8–6), than either of the three reports just men-

FIG. 8–3. Credit character—loan report.

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CHARACTER CREDIT LOAN REPORT
ACBofA No. 6
Compiled by member bureau

CONFIDENTIAL

1 REPORT ON: (Surname first) (Mr or Mrs) (Given Name) (Spouse's name)

2 RESIDENCE ADDRESS (Street Number) (City) (County) (State)

3 REPORT FOR: PURPOSE OF LOAN

PERSONAL (Family)	4	What is marital status?	4 Age____Single ☐ Now Married ☐ Widowed ☐ Divorced ☐
	5	Number and approximate ages of dependents?	5 Number_____ Approx Ages_____
	6	Do you learn of any serious domestic difficulties?	6 Yes ☐ No ☐
CONTACTS	7	Approx how many years has subject resided in this town?	7
	8	Time known (years) by you and each informant?	8 You_____ Informants_____
	9	How long since you or informants have seen or heard directly from subject?	9
STABILITY	10	Is subject's reputation as to character, habits, morals, honesty, fair dealing, and relations with neighbors good? If any feuds with neighbors, illegal activities, or other unfavorable information, explain below)	10 Yes ☐ No ☐
	11	Is reputation of his personal and business associates good?	11 Yes ☐ No ☐
	12	Does he live within income and keep his bills paid?	12. Yes ☐ No ☐
	13	Has he ever failed in business, been bankrupt, foreclosed, sued to collect a debt, or garnisheed?	13 Yes ☐ No ☐
	14	Are prospects for continued maintenance of his present income good?	14. Yes ☐ No ☐
	15	Is he making effort to improve present income? (Such as night, correspondence school, extra work, etc)	15 Yes ☐ No ☐ (If "No," give details below)

PRESENT EMPLOYMENT

16—A Name of present employer, or if operates own business name of such business_____ B Address_____

C Nature of business_____ D Position, trade, or job held_____

E Length of connection_____ F Work full time steadily?_____ (If not, approx number days a week)_____

G Name and title of superior, if possible_____

H Approximate monthly earned income $_____
Describe as follows Exact ☐, Estimated ☐ Wages or Salary ☐, Commission ☐

HEALTH	17	Does subject have health impairments? (Describe fully)	17
SUPPLEMENTAL INCOME	18	What is subject's approximate regular monthly income, if any, from other sources (such as rentals, investments, permanent disability insurance)?	18
	19	Approximate monthly income, if any, of spouse?	19

INVESTIGATOR AMPLIFY BELOW ANY UNFAVORABLE OR IRREGULAR ANSWERS TO QUESTIONS

REMARKS: 20—A State former and present business connections and prospects for permanent employment

B. Cover all property owned by subject or spouse, both real and personal Tell how local merchants and banks regard him as a credit risk Give sources of any supplemental income mentioned under questions 18 and 19

C. IF PURPOSE OF LOAN IS IN CONNECTION WITH OPERATING A BUSINESS, give all the information you know concerning the business, whether it is, or will be, operated by subject as a one-man concern partnership, or corporation If partnership or corporation give names of principal members of firm including subject, outlining briefly his and their business experience and their reputation in the community What is their credit standing and reputation for meeting obligations? Tell what you can regarding prospects for success of this business venture If business is already established, how long has it been in operation?

NOTE: If Amplified Report requested, see over and complete supplemental questions on pre-war employment.

Date Prepared by Name of member reporting bureau City State

The confidential information given in this report is in answer to a request for same This report is compiled simply as an aid in determining the propriety of extending credit, or the value or condition of an existing credit and is based upon information obtained from sources deemed reliable, the accuracy of which, however, is in no manner guaranteed The inquirer, in accepting this report, agrees to hold same in STRICT CONFIDENCE for his own exclusive use, never to be communicated, and to be personally responsible for any damage arising from a violation of any of the above provisions

Courtesy of the Associated Credit Bureaus of America, Inc.

FIG. 8–4. FHA modernization report.

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F.H.A. MODERNIZATION REPORT
ACBofA No. 10
compiled by member bureau

CONFIDENTIAL

1 REPORT ON: (Surname first) (Mr or Mrs.) (Given name) (Wife's name)

2 RESIDENCE ADDRESS: (Street Number) (City) (County) (State)

Amount applied for $ Payable $ per

Location of property to be improved

IDENTITY
3 Length of time applicant has been known in our files
4 Length of time applicant has resided at this address and in city
5 Former residence address and how long there?
6 Age (Verify if 21) Racial extraction
7 State if single, married, separated, widowed or divorced
8 Number and identity of dependents

HISTORY
9 Name and address of present employer or business
10 Nature of occupation or business and how long?
11 Name of previous employer, position and how long?
12 Prospects of permanent employment
13 Domestic troubles and financial or personal difficulties, if any

Character
14 How regarded as to character, habits, morals, etc
15 Has applicant reputation of living within income? Is he thrifty?

INCOME
16 Amount of salary or commission received annually
17 Details of estimated earnings of others in household
18 Income from other sources including rents and investments (annually)

Following Information Obtained From Mortgage Holder Principally And Pertains Only To Property To Be Improved

PROPERTY
19 In whose name is legal title to property to be improved?
20 Mortgage holder states present balance owing on mortgage is $
21 Give expiration date of mortgage and method of payment provided therein (whether monthly or annually)
22 Amount of payments—Principal $ Interest $ Due dates
23. Are payments of principal and interest up to date? If not, explain delinquency
24. Status of taxes—Amount $ State whether paid up to date or paid for what year

Credit Record
25 Bank experience
26 Reputation for paying bills (prompt, slow or unsatisfactory)
27 Value of account as a moral risk
28 Possibility of collection by legal methods, if neccessary

CREDIT RECORD:

Trade Line	How Long Selling	Date of Last Sale	Highest Credit	Terms of Sale	Amount Owing	Amount Past Due	Manner of Payment

Report for

Date Prepared by
Name of member reporting bureau City State

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(Printed in U.S.A.)

Tumble over if necessary

Courtesy of the Associated Credit Bureaus of America, In

FIG. 8–5. Factual data report.

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FACTUAL DATA REPORT
ACBofA No. 11
compiled by member bureau

CONFIDENTIAL

1. REPORT ON: (Surname first) (Mr or Mrs.) (Given name) (Spouse's Name) Case Number

2 RESIDENCE ADDRESS: Property Address

The following report is furnished in STRICT CONFIDENCE, for use under National Housing Act

IDENTITY	3. Is this person's name correct as given above? (If not, give correct name.)	
	4 About what is his age?	
	5 Is he married? (How many dependent on him)	Dependents
Social and Economic Characteristics	6. Is his general reputation as to character, habits, and morals good? (If not state nature of unfavorable reports.)	
	7 Is he regarded as steady and dependable?	
	8 Did you learn of any domestic difficulties?	
	9 What is class of business associates?	
	10. What is reputation of his social associates?	
	11. What ability has he shown in managing his affairs?	
	12 Does he have the reputation of living within his income?	
	13 What is his general attitude toward contractual obligations?	
	14 Has he ever failed, been bankrupt, foreclosed, sued or garnisheed? (If so, state which and explain under "Remarks")	
Employability and Banking Stability	15 What is the nature of his business and what position does he hold?	Position
	16. About how long has he been in present connection?	
	17. Does he work full time steadily? (If not, how many days per week does he work?	
	18 Has employment status changed in last two years?	
	19 Has his health interfered with his progress?	
Income and Obligations	20. What is his annual earned income from his employment or business? (State whether exact or estimate.)	Exact? $ Estimated. $
	21. About what income, if any, has he from other sources? (Investments, rentals, avocations, or contributions.)	
	22 About what would you estimate his net worth?	
	23. If married does his wife follow a gainful occupation?	
	24. What is the nature of her employment and what position does she hold?	
	25 About how long has she been in present connection?	
	26. What is his wife's independent annual income if any? Her independent net worth?	Worth: $

REMARKS 1. Amplify his business history.
2 Amplify fully all unusual and unfavorable information, such as bankruptcy, divorce, etc
3. If a woman, cover husband's or father's reputation, business history, worth and income.

Report for

Date Prepared by
Name of member reporting bureau City State

The confidential information given in this report is in answer to a request for same. This report is compiled simply as an aid in determining the propriety of extending credit, or the value or condition of an existing credit and is based upon information obtained from sources deemed reliable, the accuracy of which, however, is in no manner guaranteed. The inquirer, in accepting this report, agrees to hold same in STRICT CONFIDENCE for his own exclusive use, never to be communicated, and to be personally responsible for any damage arising from a violation of any of the above provisions. Printed in U.S.A.

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FIG. 8–6. Standard consumer report.

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CONFIDENTIAL

STANDARD CONSUMER REPORT
ACBofA No. 1
compiled by member bureau

1. REPORT ON: (Surname first) (Mr or Mrs.) (Given Name) (Spouse's Name)

2. RESIDENCE ADDRESS: (Street Number) (City) (County) (State)

IDENTITY	3 Number of years covered	A. In file	A.
		B In investigation	B
	4. A. Age (If near 21, confirm)		A.
	B Racial extraction (White, Black, Red, Yellow, Brown)		B
	5 A Marital status		A
	B Number of dependents?		B
HISTORY	6 A Name of employer		A.
	B Type of business		B
	7 A. How long so employed		A
	B Position held		B
	8 A Does applicant have record of steady employment?		A
	B Any recent employment change? (If yes, explain in remarks)		B
	9 Any suits, judgements or bankruptcies? (If yes, explain in remarks)		
Character	10. Is applicant well regarded as to character, habits and morals?		
	11 Is applicant favorably regarded by employer?		
	12 Any suspicion of illegal practice past or present?		
RESOURCES	13 A Estimate monthly income from present employment		A
	B Estimate other income such as rentals, investments, etc.		B
	C Estimate income of others in household		C
	14 Own home, rent or board?		

CREDIT RECORD (If feasible include whether subject has satisfactory bank checking account)

Trade Line	How Long Selling	Date of Last Sale	Highest Credit	Terms of Sale	Amount Owing	Amount Past Due	Manner of Payment

REMARKS A Give brief word picture of subject's history, explaining any unusual condition.
B Amplify any incomplete or adverse information in answers above. Use other side also for full details.
C. Include estimate of net worth if possible

Report for

Date Prepared by
Name of member reporting bureau City State

The confidential information given in this report is in answer to a request for same This report is compiled simply as an aid in determining the propriety of extending credit, or the value or condition of an existing credit and is based upon information obtained from sources deemed reliable, the accuracy of which, however, is in no manner guaranteed The inquirer, in accepting this report, agrees to hold same in STRICT CONFIDENCE for his own exclusive use, never to be communicated, and to be personally responsible for any damage arising from a violation of any of the above provisions

Courtesy of the Associated Credit Bureaus of America, Inc.

tioned. Financial institutions sometimes believe that the data contained in this basic report are adequate to answer any questions as to the applicant's credit.

REVIEW AND DISCUSSION QUESTIONS

1. Why might home mortgage loan credit be considered as a type of consumer credit? Why might it not be so considered?
2. Distinguish between a FHA-insured, a VA-guaranteed (GI), and a conventional type loan.
3. What are the sources available to the American family to finance the purchase of a home?
4. Check with a savings and loan association, a life insurance company, a commercial bank, a mutual savings bank (if there is one in your area), and a mortgage company as to their requirements for home financing.
5. Distinguish clearly between the amortized and the old-type straight mortgage.

PART III

ANALYSIS AND MANAGEMENT OF CONSUMER CREDIT

CHAPTER 9

Planning the Extent of the Credit Investigation

THIS PART OF the book—Chapters 9 through 13—deals with the central and one of the most important portions of credit work. The credit offered must be examined before acceptance and a decision made to accept it or reject it. Making these decisions is the single most important credit activity; all other activities of the credit department are contributory to this function. True, these activities support and implement the decision, but unless the decision to accept or reject credit is sound they cannot make the credit operation entirely successful. Thus, success of the credit operation rests squarely on the appraisal and acceptance of the credit offered; the activities of the credit department in administering its work and in collecting the accounts may make the operation more successful or less successful but they cannot by themselves substitute for or replace decisions.

In making credit decisions the credit executive must appraise or evaluate an individual's credit against the standards set by the general policy established. In order to appraise he must have information which is supplied by the credit investigation. The analysis of this information is measured against the standards of acceptability set by the credit policy. Analysis and decision are aided by proper operating procedures. These procedures should assure needed and accurate information made meaningful by proper analytical processes. After policy is established and standards set, the subsequent stages are gathering the information through investigation, evaluating and analyzing the information, reaching the decision to accept or reject, and carrying out the credit department operations to reach the ultimate goal—payment by the customer.

DETERMINATION OF POLICY

As pointed out previously, a well-managed organization operates on the basis of sound policies predetermined to guide the courses of action that will be followed. One such policy is the determination of whether or not to sell on credit.

Since a policy is usually defined as a line or course of action to be followed over a considerable period of time, it is imperative that clear thinking prevail and careful appraisal be made of the problems involved and desired results to be attained before a firm decides to follow a policy of accepting consumer credit.

Nor does the problem cease once the decision is made to sell on credit. The variety of credit plans now in effect in firms catering to the needs of the American consumer complicates the policy of simply saying, "We sell on credit." What type of credit plan or plans—such as open charge, revolving charge, or installment credit—to adopt immediately becomes a vital segment of policy determination. The preceding chapters have been designed to give a word picture of these various arrangements found in the consumer credit field today. Out of this assortment, the firm must select that one type or combination of types which best fits its business and which it believes will produce the results desired. And it has been pointed out that there are many factors—amount of capital available, desires of customers, competition, type of goods sold, size and location of community—involved in the firm's choice of which type or types of consumer credit plans to adopt. These factors vary widely, of course, and must be analyzed separately for each type of credit under consideration.

Credit Standards

Once the firm decides to sell on credit and the selection is made as to the types of credit plans to adopt, the determination must then be made of the standards of acceptability that the firm will follow and against which it will test specific credits.

One way of stating the standard of acceptability might be in terms of probability. A high standard might call for payment probability in 999 out of 1,000 cases. A lower standard might seek to select within a payment-probability range of 940 to 980 out of the 1,000 cases, and a quite loose standard might be content within the probability range of 900 out of the 1,000. The upper limit of the probability should be something less than 100 per cent. To adopt the 100 per cent level is the same as saying that there is no probability of nonpayment and is in

effect voiding the decision to engage in a credit operation. If selection is to be confined to only those accounts which will undoubtedly pay under all circumstances, very little extra business will result from the decision to offer the credit service. To put it another way, the soundly operating credit department should have some losses—if it does not, it is selecting its accounts so strictly that some profitable business is not being obtained.

The lower limit of a desirable standard is reached when the costs and losses associated with the extra business thereby gained are greater than the profit obtained from the additional business. A standard which seeks a probability goal somewhere between these upper and lower limits is a sound standard for most credit departments. Of course, no policy makers can deal with a concept such as standards with the exactness we have attempted to give the concept here. They can, at best, adopt policies that seek a high degree of certainty of payment or they can adopt policies that seek a somewhat lower degree of certainty of payment. From time to time the need for volume, general economic conditions, the nature of the clientele sought, the territorial conditions, or various other environmental situations may cause them to change previous standards.

Of course, credit standards are intimately related to other marketing policies. If selling desires and requirements call for solicitation of trade from preferred customers for a high quality product, the credit standards can be high indeed. Conversely when selling policies call for the seeking of patronage from a mass market and for an economy model of the product, somewhat lower credit standards may be indicated.

Terms of Sale. In selecting terms of sale for consumer credit, it is usual to associate stricter terms with lower credit standards. For example, when the credit standards permit acceptance of credit from customers falling in the lower payment-probability ranges the terms might be weekly, or payday terms, for open account sales. For installment sales of durable goods, the lower the credit standard the more necessary it is to obtain down payments which establish a feeling of ownership and monthly payments of an amount and frequency to increase steadily this equity. When nondurable goods are offered on an installment basis, the credit standard should be raised to correspond with the lack of support ordinarily afforded durable goods through repossession. Additionally when credits of lower standard are accepted, it is more important that the time and the amount of the payments be adjusted to the time income is received and the amounts of the income received. Unhap-

pily easier terms attract lower rated credit risks, and the task of rejecting those which are truly substandard becomes more difficult.

Comparison with Standard. Difficult as it may be to set exact standards and intangible as this concept may prove to be, it is necessary in the daily operations of the credit department to compare specific cases against the standards established and accept those which measure up and reject those which are regarded as substandard. The easy cases are those which are clearly acceptable and those which are definitely substandard. The effort of the credit department can then be concentrated on selecting the acceptable and unacceptable accounts from the minority which are not clearly acceptable. In fact, the reason for the existence of the credit department is to work on the cases within the area of difficult decision. The clearly good cases would not need a credit department—the clearly bad can be detected so easily no great skill is required. The talent must all be exercised upon the relatively small number which fall into the almost-good-enough class.

IMPLEMENTATION OF POLICY THROUGH CREDIT INVESTIGATION

The credit executive must appraise or evaluate the credit applicant against the standards set by the general policy established. In order to appraise intelligently, he must have information—information supplied through the credit investigation of the prospective buyer.

Purpose of the Credit Investigation

A credit investigation is undertaken to aid in making a sound credit decision; this purpose must be kept in mind constantly when a credit investigation is undertaken. It is not an activity to satisfy curiosity nor is it a research undertaking—it has a much more immediate and practical purpose, the guidance of a sound credit decision. The investigation does not seek information for the sake of information; it seeks information pertinent to the specific credit decision and sufficient to assure that the decision will fall within the probability range for payment set by the operating policies. The credit analyst must thus ask himself what he must know in order to make a proper credit decision. The information pertinent to that decision then becomes the guide to the type of information sought. The extent of the investigation should similarly be governed by the degree of certainty necessary for a proper decision.

At all times the credit executive also must weigh the value of additional information about a credit prospect against the cost of obtaining such information. He thus is faced on the one hand with needing suffi-

cient factual information from which he can make valid decisions and on the other hand with paying the cost of acquiring these facts. Truly the credit man must "walk a tightrope" in deciding when enough information is actually "enough" from the point of view of completeness, accuracy, and cost.

Facts or Opinions

It is important for the credit investigator to keep in mind the thought that references, informants, and credit reporting agencies do not create credit information. Credit information is created only by the subject of the credit inquiry, who constantly is creating information about himself through his conduct and activities. Such information becomes credit information when it can be used to predict future behavior of a credit applicant; it is important credit information when, if known, it would influence a credit decision.

Some information may be of that objective and verifiable type known as a fact; much is likely to be of that somewhat subjective type known as opinion. Opinions may rest on facts or prejudice or imagination; there is no way to tell. The opinion may be soundly based on objective facts and be the result of careful and logical analysis of the situation; it indeed may be as sound or sounder than the opinion the analyst would form after his own analysis, but it is still the opinion of someone else. Confidence may be placed on it only when the person expressing the opinion is known to the analyst and the basis of his opinion is known; in which case the analyst is in a position to draw his own conclusions.

It is our belief that the operating credit man who substitutes the opinions of others for his own judgment has thereby abrogated his position. He has permitted these outside persons whose opinions he accepts to become the credit men for the department and has himself become merely a credit clerk. Opinion should be allowed to enter in one respect only, that is when the opinion of others is itself treated as a fact and so used in the analysis. In effect this happens with that classification of information called reputation. Reputation is in large part the opinion of others and in fact does have some bearing on the credit analysis. For we must recognize that such opinions, whether soundly based or not, do affect the quality of the credit performance which may be expected and so have a place in the analysis. But in using them we should regard these opinions as simply a category of facts and in our analysis weigh them as we would any other factual category. When we do this, we use these facts in our analysis rather than substitute them for analysis.

When making a credit investigation the credit executive should do so in a manner designed to collect facts rather than opinions. The phrasing of questions should be such that informants are induced to reply factually rather than with loosely stated opinions or judgments. Specific questions should be selected which draw from each group of informants replies that supply those facts the informant may be expected to know. Asking informants questions about things they are not likely to know is an invitation to reply with opinion rather than fact and is also a temptation not to reply at all.

Prediction or History

The credit investigation brings together historical information which through analysis is used as a basis for a prediction of future behavior. The prediction desired is a prediction of credit behavior—that is, a prediction of the type and amount of credit obligations that can be expected to be paid and an estimate of the maximum amount of credit which should be accepted from the individual customer. Thus, historical information should be sought which has pertinence to this purpose. The credit analyst by implication necessarily subscribes to the belief that the past can be used to predict the future. The investigation becomes justifiable only because of adherence to this belief.

Not all history is appropriate to this purpose, however. As pointed out, the credit analyst is concerned with what may be called the credit history, or credit record. Put in another way he is interested in historical records which have a bearing on future credit behavior. He is interested in both the past and the present, but he may not be interested in the more remote past nor is he usually concerned with a complete historical review. His interest might be called current, and the things in which he is interested are definitely limited in scope to those items which can be analyzed in terms of prediction of current credit behavior.

What to Investigate

When the question of what to investigate is raised, it is easy to repeat the "four horsemen" of credit—character, capacity, capital, and conditions. These so-called four C's of credit have echoed down the ages and through the textbooks, articles, and speeches on credit with a remarkable persistency. However, present-day credit executives are becoming more and more skeptical as to the validity of these famous four C's of credit as "direct" guides to either the investigation process or the analytical work of the credit department. One reason is that these C's do not form a mutually exclusive classification scheme—it is not possible to separate

the facts which bear on character from those bearing on capacity, and those bearing on capacity from those bearing on capital. In fact then it is not possible to take the facts gathered during the course of an investigation and sort them into the categories suggested by the general terms of character, capacity, and capital. The same data have to appear several places and be used several times. Another reason is that seldom can these characteristics be best revealed by direct inquiry. If an informant is asked the question, "What is the subject's character?" he is at a loss as to how to respond; similarly with capacity or even with capital, although the latter is the most tangible and unified of the three.

But what is character? It may be defined as an intangible sum of personal attributes, and these attributes are revealed indirectly rather than directly. What we frequently accept as character is rather reputation, and reputation is really the opinion held by others about a person. Even reputation is a diverse thing reflecting the opinion of others about behavior in those situations where they have had an opportunity to observe. The elements entering into character may be personal, and thus be concerned with family situation, personal habits and attitudes as drinking, gambling, and so forth. They may include the virtues such as honesty and courage or the reverse. Character also may be inferred or revealed by business or professional conduct, such as payment of obligations, tendency to make unwarranted claims or to return goods without cause, attitude toward obligations, speculative tendencies, respect for the rights of others. Character being an inward thing, in effect an intangible personal quality, it can be correctly inferred only to the extent that it is revealed. In some respects a reputation for good character may be the result of never having been pressed by adversity.

General questions invite general answers. And one of the most general questions it is possible to phrase is, "What is his character?" Much better credit information will be obtained by seeking the answer to specific questions which, when properly interpreted, can be used to predict personal behavior. These questions may seek to develop facts about past behavior which have credit significance, facts about the current situation which have predictive value, and current information about the opinions of others (that is, a survey of the opinions of those in a position to form an opinion).

"How has he paid his bill with you?" is a better question than "What is his credit reputation?" and it becomes an even better question when the facts are sought even more specifically by asking the year the account was opened, the balance now owing, the highest recent credit, and whether payment is in 30, 60, 90 days, or longer. Attitude toward obli-

gations is better revealed by a question asking whether the person makes unjustified claims or acts in accordance with the contract than by general questions about attitude toward obligations. Family status is revealed in a more meaningful manner by specifics about marriage, number of children, place and length of residence, home ownership, major assets owned by the family, life insurance carried, major savings, and investments than by vague questions concerning personal and family status. Questions on church membership, membership in clubs, and other organizations are subject to more exact interpretation relative to reputation and associates than would be a question on reputation or associates.

It appears then that character is an inward thing which probably cannot be measured or appraised exactly by even those most intimately associated with an individual, certainly not by the measures available during a credit investigation. Nevertheless, the credit investigation can come closer to interpreting this quality correctly when it asks for specifics which can be ascertained and gives each of these specifics its proper weight in the analysis. Although they can be summarized under the heading of character, they are investigated by inquiries about specific and rather tangible elements. Evidence which is largely factual can be gathered about the specifics. Seeking evidence about the general obtains only opinions often vaguely stated and based on evidence which may be so unsound that were the evidence known the credit analyst himself might arrive at an opposite conclusion.

Another source of difficulty which arises upon investigating a rather vague characteristic such as character is the tendency of the informant to reply in terms of his own standards and the analyst to interpret in terms of his. And there is no way to know whether they are the same or different. One respondent may interpret good character as associated with church membership and reply in a somewhat derogatory tone when the subject is not an active church member. Another informant may be a foe of alcohol and honestly feel that even temperate social drinking is a mark of poor character. Certainly communication is neither complete nor exact when vague or general questions encourage answers which are value judgments resting on highly variable standards.

Likewise, capacity is a credit quality which rests on a widely diverse group of specific conditions. In a narrow sense it may mean simply the ability to pay a specific dollar obligation when it is due, but in a much wider sense it is a measure of the sources of the ability to pay. Such information bearing on an individual's credit capacity is often summarized under the headings of income and of employment. While capacity is es-

sentially a question of an individual's earning power, it must be recognized that income by itself should not be the sole determinant of an individual's ability to secure acceptance of his credit. It is generally understood that the average consumer makes his expenditures and meets his contractual payments out of current income rather than from accumulated savings. As a result, unless a fairly complete picture is available of previous commitments, the institution may find that it is dealing with an individual whose income is definitely earmarked for debts previously incurred—and this may be true regardless of the volume of income involved. Thus the relative adequacy of income should be tested by comparing it with the individual's current contractual obligations as well as with his present expenditure pattern. Certainly an individual whose monthly contractual payments exceeded his monthly income, as was discovered in one Midwest community, is a substandard risk to say the least, regardless of the volume of his earning power.

These comments are in no way designed to de-emphasize the fact that the most important evidence of capacity is income, but they are designed to emphasize the fact that credit analysts cannot neglect other evidence that may tend to give an entirely different slant to the value of the income figure other than the simple dollar amount.

In the field of consumer credit, it is generally agreed that the credit analyst gives more weight to those specific qualities that reveal the character and capacity of an individual than he does to those specific qualities reflecting the capital of the credit applicant. To the credit manager, capital means the financial strength of the risk that would be available in case of the inability (because of decreased capacity) or mere unwillingness (because of certain traits of character) of the individual to pay his obligations when due. Not only is the quantity of the capital important, but the credit manager also is interested in the nature of the assets in which the capital is invested and the proportion invested in each. While it is generally true that the average consumer has relatively little capital to be used as a "backstop," nevertheless information about the capital he does possess (such as home ownership, household furnishings and personal effects, bank accounts, stocks and bonds, real estate holdings, and so forth) may help add to the information already available to the credit manager and give him a better insight into the true character and capacity of the individual concerned.

Credit Qualities to Investigate

The preceding discussion has illustrated the basic issue raised earlier, that character and capacity and capital are not clearly defined classifica-

tions of elements of the credit investigation and that specific bits of information must be sought to have the raw material for proper analysis of each of these. Thus it seems desirable to list the personal credit qualities which appear to be the most essential to investigate. It is not claimed that the credit qualities listed here are all-inclusive of those which might be desirable to investigate. It is not even claimed that they are all of the most important credit qualities, but it is believed that these are the credit qualities which in the great majority of cases are most pertinent to the credit decision. If the investigation reveals information about these qualities, there should be sufficient information at hand to enable the analyst to reach a sound credit decision. And as will be seen later, a method of analysis of the individual's credit is suggested which rests on these very same credit qualities.

The order in which these qualities are listed is approximately in proportion to their importance, at least their importance in the usual case. Obviously, in certain cases some information will be more important than in others. One should never forget that credit judgments are individual judgments; each credit case is unique. Although the credit analyst works toward averages and trusts to averages to test his work, there is no such thing as an average credit prospect. Each credit prospect —the subject of each investigation—is an individual.[1] The weight given to various credit qualities must necessarily conform to the circumstances of the individual case. So the importance of certain qualities rise and fall in the particular case. The need for and importance of these credit qualities also vary with the circumstances surrounding the credit offered by the consumer—whether it is to initiate the establishment of credit for the first time with a retail or service concern or whether it is to secure added credit on an already existent account.

Income. Since most consumer debts are to be paid from income, investigation of the income of an individual is essential. The amount of it should be ascertained, its regularity of receipt established, and the probability of its continuance estimated. Since income must be evaluated relative to the demands placed upon it, information should be sought about the demands upon the income brought about by family needs and existing obligations. This seems to be a formidable body of information about the income quality. Actually the discussion has illustrated the nature of the information and the analysis which will be made of it. In the

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[1] It should be recognized, however, that in most large stores there is a need to process a tremendous volume of credit requests. In such situations, there is often an attempt at least to categorize credit applicants, however individualistic they may be, simply to handle the tremendous volume of credit transactions.

course of the investigation, the specific facts sought should be simply the amount and source of the income.

Employment. Employment is probably the principal source of income, so it should be investigated along with income. Information about employment should seek as a minimum the name of the employer, the the type of business, and the position occupied by the subject of inquiry. Additionally an effort should be sought to determine how long he has been employed by his current employer. When employment has been for a comparatively short period of time, less than five years being considered short, it may be advisable to investigate previous employment and to continue the investigation of previous employment, until the record has been established for at least a five-year period. In the case of credit prospects who are self-employed, the investigation should be especially extensive since the employment information also must necessarily be the source of information relative to income.

Payment Record. Many creditors regard the payment record as the most important factor revealed by the investigation. It not only shows the manner of payment, and thus is important as a predictor of behavior, but it shows the past payment habits as well. Often creditors feel that the best basis of a forecast of credit experience is the past payment record. While there is no question that such information is important, it should be recognized that in certain instances payment record may not have the prime importance sometimes attributed to it. In connection with the information sought relative to payment record, the investigation should seek facts as to the type or types of account involved, the amount currently owed, the amount past due, the highest recent credit, and the manner of payment. Manner of payment should be stated specifically—pays 30 to 60 days, pays 90 days, and so forth.[2] The adjectives "prompt," "good," "slow" can have a variety of meanings; 60 to 90 days may be considered prompt by one firm, slow by another, depending of course on the type of account involved.

The date of the experience also should be established. This is especially important when information is sought about an individual with a varied record which contains some derogatory data. It is important to known whether the profit and loss charge off, or the collection through judgment, or the paid only after call by collector, or the repossession is

[2] The section on *Payment Record* indicates that the manner of payment should be stated specifically by the reporting store or service concern. It should be recognized, however, in some companies this may not be possible at the present time, in view of the mechanization of the accounting processes. Many companies which used to provide information for interchange with other companies or for the various credit reporting agencies have found that it is just too expensive to develop this specific information.

years in the past or the most recent experience. Certainly a very different conclusion may be drawn from a bad record of years ago and a good current record than from the opposite sequence. All too frequently a payment record continues to record old unsatisfactory experience long after the current experience has reversed the former manner of payment.

Residence. Check of residence through the investigation is first of all a routine verification of identity. In addition the information about residence should show the length of time at that location and if less than five years in duration should reveal the previous residence. These facts can be used as the basis for more intensive investigation in the locality should such be necessary. They also may reveal certain information about the other credit qualities of the credit applicant himself. In addition, the investigation of residence should determine the status of the credit applicant as owner or tenant of the property. If ownership is involved, the investigation should be extended to reveal the amount of the mortgage, if any, and the payment thereon. The amount of the rent and manner of payment should be determined, if the property in question is being rented.

Marital Status. The marital status of the individual is a significant quality in most consumer credit transactions, and as a result it should be included as a fact sought through the investigation. In most cases the information is simply married or single. In some cases information may be sought as to whether the person is a widow, widower, or divorcee, as this status often affects the income and obligations against that income as well as the person's attitude toward credit obligations. In certain investigations not only is the marital status significant, but the happiness or unhappiness associated with this status is important to consider. Many difficulties with consumer collections stem from family difficulties, and the investigation may need to be extended to include information relative to the stability of the family situation. A creditor involved in a family which is on the verge of breaking up is almost certain to have collection difficulties. To the extent that such a situation appears imminent, it permits future difficulties to be forecast and perhaps avoided.

Age. With the youthful the investigation should establish that legal capacity to contract is present. With most investigations age is not an important credit quality. However, with the extremes of youth or agedness it can be of crucial importance, and in these instances this quality becomes the proper subject for intensive investigation. For example, some lenders make it a point not to lend to individuals under 25 years of age nor to individuals over 65 (with certain exceptions in both cases).

On the other hand, some retail firms have promoted credit to teenagers, as long as parents or some adult guarantees payment.

References and Reputation. The investigation also may seek to develop information about the reputation of the credit applicant and to secure information adequate for evaluating the credit data reported by references. In effect references and reputation plus payment record are an investigation of character. As previously pointed out, when discussing character, in most instances the credit analyst does not actually appraise the character, which is a complex medley of personal traits and qualities. What he does appraise is the reflection of character as revealed by reputation and references. Thus the importance of these qualities is such that information is needed to make a credit appraisal of them. So the investigation may be extended to develop such information.

Reserve Assets. In only a few instances are reserve assets to be relied upon for payment of a consumer credit obligation. In most cases they are additional surety which both debtor and creditor hope there will not be a need to use. In some cases, especially with aged customers who are living upon a pension or income from investments, the investigation of reserve assets may be essential in order to establish capacity to handle the credit obligation. A word of caution is necessary, however, when considering property ownership to avoid attributing a positive effect to something which when carefully analyzed should be given negative weight. Often the ownership of a home may be accompanied by such heavy payments on the mortgage that instead of being an addition to reserve assets it is an earmarking of current income to such an extent as to preclude the assumption of any additional commitments. Such a situation should be revealed in sufficient detail to assure that the proper inference is drawn from it relative to the credit decision.

Equity in Purchase. An additional credit quality, equity in the purchase, is of major concern especially under the installment method of consumer purchasing. Strictly speaking this is not an attribute of the individual himself, but it is an attribute of the market value of the property. The presence of this market value, as it is available to the creditor through the terms of the lien contract, may raise an otherwise unacceptable credit well above the level of acceptability. When the equity is large and is maintained by the amount and frequency of payment, the major question may not be, "Will he pay?" but instead, "Can the property always be found and retaken?" To the extent that the equity is smaller and is not maintained by the amount and frequency of payments, the personal credit qualities should be analyzed more carefully and should be corre-

spondingly stronger to attain equal safety. In addition the proportion of the initial equity may reflect the attitude of the buyer toward the obligation. When the initial equity or ownership is large through a significant down payment, it will appear that the buyer fully intends to complete the contract as agreed and by inference is indicative of character. Conversely, when the initial equity is small, it may reflect an attitude of possession through rental rather than a sense of ownership and by inference a potential adverse indication of character.

Collateral. While this element of capital in the form of collateral usually is lacking in most retail and service credit transactions, it does often appear in those instances in which cash loans are made to the consumer. Thus collateral in the form of some tangible asset owned by the individual and offered as additional security to the loaning institution is another credit quality to take into consideration. It is thus another factor to consider when an over-all appraisal is made of the individual who is offering the collateral as a way of making himself less of a credit risk.

Influence of Economic Conditions

While it is generally agreed today that a fairly reliable picture can be obtained about an individual's character, capacity, and capital through a series of specific questions, the credit analyst must always be faced with the problem of interpreting this information in terms of the economic environment or conditions in which both his business concern and the credit applicant exist.

This economic environment is not secured by a series of general or specific questions but rather it must be part of the general knowledge and makeup of the credit analyst himself. Some of this knowledge is secured by keeping abreast of what is happening in the line of business and the community of which the credit manager is a part. Are there strikes in effect in certain industrial plants, or are such labor curtailments imminent? Is the weather too dry or too wet and is the farmer going to be hurt as a consequence? Are some businesses expanding rapidly in the area and thus furnishing new openings to new residents of the community? In other words, he must know "how's business?" in his own line, other lines, his own town, and surrounding towns. Of course, he will know that some activities are expanding and some contracting—some people are benefiting and some are getting hurt.

Perhaps a knowledge of this short-run economic climate is easier to acquire than the ability to predict the long-run economic picture. The background, experience, and training of the credit man will be vital

factors in how he looks at the future. His political beliefs, his international views, his own financial position, and his own experiences in attaining his present position will of course color his views as to the future.

Consistent with his short-run and long-run views of economic conditions, the credit man then must interpret the information that he has obtained about the credit applicant and make the decision to accept or to reject the credit.

Investigation and Verification

The investigation is a way to develop information not at hand. It is also a method to verify the information supplied. Most credit investigations are initiated because credit has been offered by an individual and the individual has supplied some credit information about himself. Good credit management should conclude that if any investigation is deemed necessary it should have as a portion of its task verifying some of the information supplied by the applicant. Thus the credit executive may find it desirable to confirm some of the most vital and important facts that the credit applicant has supplied by seeking information concerning them from several separate and independent sources. To some degree, the extent of this verification may depend upon the judgment of the credit executive as to the over-all quality of the credit applicant as well as upon the manner in which the information supplied coincides with that already known or easily secured.

How Much to Investigate

It has been emphasized that a credit investigation is undertaken to aid in making a sound credit decision. Now the problem must be faced as to just how much investigation is needed to make this sound credit decision, because every bit of information secured through investigation costs money. And it has been pointed out earlier that the credit executive always "walks a tightrope" in deciding when enough information is actually "enough" from the point of view of completeness, accuracy, and cost.

Recognition should be given to the fact that it is possible to overinvestigate as well as to underinvestigate. Errors of judgment can arise from not having sufficient information. Inadequate information means that some pertinent fact was not known which if known would have caused a different decision. Thus the decision is different than it would have been had the investigation revealed all pertinent information. Even more probable as a cause of error is not giving sufficient weight or the correct interpretation to certain information. The investigation in such

cases was adequate, pertinent information was at hand, but the analyst either did not give sufficient weight to certain information or even worse interpreted the information incorrectly.

Very extensive investigation costs money and takes time; meanwhile a decision is delayed with consequent loss of customer good will and friction with the sales department. Also the accumulation of additional bits of information is costly, whether the information is purchased from sellers of credit information or developed by direct inquiry. Unless the information is used and useful, it is not worth what it costs in either time or money. When the extensive information develops a mass of factual data, the very mass of the evidence may actually interfere with the analysis and decision. The sheer extent of the evidence may result in its not being correctly weighed or interpreted. The more pertinent evidence may be buried under the mass of nonpertinent detail.

The time when acceptance of credit is requested is the proper time to seek information from the applicant and to decide upon the extent of the investigation. Should the information supplied by the applicant be unusually complete and the case appear on first analysis to be very sound, the investigation may be quite limited, perhaps to payment experience only or to payment experience and verification of employment and residence. Should the information obtained from the applicant be limited as it sometimes is with retail charge accounts, the investigation should be much more extensive if information sufficient for analysis is to be obtained. Of course, it is quite possible for an account to be accepted without investigation, or perhaps it would be more accurate to say without verification of the information supplied by the applicant. Clearly also when such is done the credit policy is either to accept credit only from the very highest-grade applicants or to have sufficient profit margin to accept high losses because of the lack of screening. Most credit policies seek neither extreme but attempt to select those applicants where the probability of payment is sufficiently good enough to meet the standards and to reject those applicants where the probability of nonpayment is sufficient to make the gain on such business undesirable.

It should be made clear that in some cases the "no-investigation" policy may be advisable. In fact, money often is wasted when investigation is undertaken to verify the obvious. It is far better to save investigation budgets for extensive use with those cases where there is a probability of trouble than to disperse it over those cases in which there is practically no chance of finding cause for rejection.

It is not possible, nor if possible would it be desirable, to gather all possible evidence before reaching a credit decision. The amount nec-

essary is just that needed to reach a decision. Whenever sufficient is on hand to reach a decision, that is enough. It is here that the judgment and experience of the credit executive appears, as it is he who must decide what is sufficient for a proper credit decision.

Where to Investigate

What then should the investigation do? It should seek specific information from those sources which possess the information desired or which can get the information desired—most accurately, completely, speedily, and at minimum cost. It also should be stressed that since information is the raw material of credit decisions, the credit man must keep before himself constantly the thought that he must *give* as well as *get* credit information. The best basis for a full flow of clear credit information is an exchange of information.

The sources available to the credit man to secure accurate, complete, speedy, and reasonable information are the basis of the next three chapters. In these we will look at the information supplied by the credit applicant himself, data from direct investigation, facts from in-file ledgers, and information from local retail credit bureaus, the Retail Credit Company of Atlanta, banks, Hooper-Holmes Bureau, Inc., Dun & Bradstreet, Inc., specialized credit bureaus, and other miscellaneous sources.

REVIEW AND DISCUSSION QUESTIONS

1. Why is it necessary to plan the extent of the credit investigation?
2. Define the term "policy." Why is it necessary that an organization operate on the basis of sound policies in order to be well-managed?
3. What factors influence a firm's choice of the type or types of credit plans to introduce into its activities?
4. What is meant by a credit standard?
5. Explain the connection between the terms of sale used in a retail establishment with the credit standards it follows.
6. What is the purpose of the credit investigation?
7. Explain the differences between facts and opinions. Why should a credit executive be careful to discriminate between the two?
8. What is meant by the statement, "The operating credit man who substitutes the opinions of others for his own judgment has thereby abrogated his position"?
9. What are the "four horsemen" of credit? Why are they not emphasized in this book as much as they are in other credit texts?
10. What credit qualities should a credit executive normally evaluate in his credit determination? Why these qualities?

11. Check with three retail firms in your city as to the importance they place on each of the credit qualities suggested.
12. What is meant by "equity in purchase"? Is this quality important in all credit transactions? Why or why not?
13. Why are economic conditions an important factor in a credit executive's determination of credit risk?
14. Why is the question "How much to investigate?" difficult to answer?
15. What are the possible sources from which a credit executive may secure credit information on which to base a decision?

CHAPTER 10

Basis of the Credit Decision— Internal Company Data and Direct Investigation

THIS IS THE first of three chapters dealing with the basic information that is usually available to the credit man and upon which he is able to base his decision to accept or reject the credit offered by the consumer.

Perhaps the greatest emphasis in most of the literature on this subject has been upon the so-called "purchased" information from such organizations as the local credit bureaus, specialized credit reporting agencies, the Retail Credit Company of Atlanta, and other similar credit-reporting sources. But it is necessary, before considering these sources, to recognize that much of the credit information is obtained internally within the company itself and externally through direct interchange of information with other retail, service, and financial concerns that likewise are interested in securing accurate and up-to-date credit data.

This information obtained internally may be for the initial acceptance of credit from a consumer. Undoubtedly, here the credit application and credit interview will come into importance. The extent to which this information is verified or expanded through additional investigation depends upon the judgment of the credit analyst. This information obtained internally also may be used in the determination of whether to accept requests for an increased amount of credit on an already established account. Here the information supplied from the in-file ledgers will come into play, as the credit analyst thus will have readily available one type of evidence, the internal records of his own company as to how the applicant has paid his bills in the past.

INFORMATION SUPPLIED BY APPLICANTS

Most investigations of consumer credit applicants start with information supplied by the prospect. It is generally agreed that such information should be regarded as a part of the credit investigation. The information thus supplied by the prospect is treated as statements of fact which have not been verified. Certain facts may be accepted as fact without verification; other facts may be verified through further investigation. The first credit determination is to decide whether any facts shall be verified. If it is decided to verify certain facts, a second and third determination become necessary. The second credit determination is which facts shall be verified through investigation; the third is what sources shall be used to verify the facts requiring investigation. It is, of course, obvious that if the first determination is negative the second and third are never made.

The Credit Application

Most credit departments consider some formality desirable before opening a credit account. This formality usually is carried to the point of becoming an application for credit which is signed by the applicant. The extent of the information sought varies considerably depending upon the policies of the firm, the type of account requested, and the customs of the trade and region (see Figures 10–1 and 10–2).

The Case for a Formal Application. Those who argue for a rather formal application procedure advance a number of reasons for their view. Completeness of information can best be obtained by requesting the applicant to fill out a comprehensive application. Certain facts are likely to be known only to the applicant himself and unless asked for at the time the account is opened such facts may not be developed through the investigation; in fact they may not even be sought. It is more economical to obtain such "leads" from the applicant and then simply verify them through further investigation if verification is considered desirable.

Psychological attitudes toward the seriousness of credit obligations are improved when the application is rather formal and complete. When the opening of the account seems a rather minor or routine procedure, the applicant may not be properly impressed with the value of credit service nor with the necessity of conforming carefully to the terms established. At the time an account is opened, there exists the unusual opportunity to educate the customer in proper credit behavior. First we are likely to esteem more highly those things which are difficult to

FIG. 10–1. Formal application used by a bank.

THE FOLLOWING CONFIDENTIAL INFORMATION IS FURNISHED FOR THE PURPOSE OF ASCERTAINING MY ELIGIBILITY FOR A $ LOAN.

NAME: LAST FIRST MIDDLE WIFE'S NAME MI

ADDRESS HOW LONG PHONE

M R O MTG PURPOSE

CO-MAKER

ADDRESS

PHONE

LIMIT AMOUNT OF RENT OR MORTGAGE PMTS

AGE C SECURITY NO OF DEPEND

CHECKING OR SAVINGS A/C

H E.

WKS. SALARY HOW LONG

SHE SALARY HOW LONG

OTHER INCOME

FORMER WORK

FORMER ADDRESS

JUDGMENTS BANKRUPT

DATE OF LOAN

NUMBER

PMTS DUE

1ST PMT. DUE

PMTS.

x

x

RATE

CASH ADV

INS

SUB-TOTAL C A

NON-FILING INS

TITLE

TOTAL C A

INTEREST

FACE OF NOTE

C C NO

HEALTH AND ACCI INS OFFERED

FINANCIAL STATEMENT

CASH		ACCTS PAY	
R E		R E MTGE.	
FURN		NOTES & C/M	
CAR			
OTHER		OTHER	
		TOTAL LIABILITIES	
		NET WORTH	
TOTAL ASSETS		TOTAL	

I agree to notify the bank of any material change in this statement. I authorize you to obtain such information as you may require concerning the statements made in this application and agree that the application shall remain your property whether or not the loan is granted.

I certify that there is no suit or judgment pending against me, that I have never taken bankruptcy, that the foregoing statements are true in every respect to the best of my knowledge and belief, and are made for the purpose of obtaining credit and under the penalties of perjury in accordance with the Statutes of Nebraska. This debt is made for community purposes.

(WITNESS) (SIGNATURE)

(ADDRESS) (SIGNATURE)

get. If we are impressed with the fact that not everyone can receive credit service, we are more likely to regard the account as a privilege and not as a right and to cherish it accordingly. Second, the best time to establish sound habits or behavior patterns is when the first of a series of transactions is initiated. The payment of accounts in accordance with terms is a habit which should be established early. By making the opening of the

account a rather formal process the first step toward the establishment of good credit habits is taken. Third, the customer is more likely to respect the credit department which operates in a careful and businesslike manner. A casual attitude toward the opening of a credit account is likely to impress the customer as being typical of all operations of the business. It is obvious that to attain the psychological attitude toward credit that has just been described it will be necessary to combine a personal interview

FIG. 10–2. Informal application used by a department store.

Date							
Phone							
Occupation							
Bank							
Reference							
							Limit
Relative							
Address		P	G	A	L	S	R

between the credit prospect and the credit manager with the completion of the credit application blank.

The Case for an Informal Application. As to be expected, there are those firms which strongly believe that informality in credit investigation is the more desirable arrangement. They point out that credit is a sales promotional tool just as much as advertising. Advertising is easily viewed and read by store customers, thus credit should be made easily obtainable. A brief application form for credit is made accessible to the credit prospect at various convenient points throughout the store. The prospect simply fills out the short form, mails it to the credit department, and in the majority of such instances never comes into direct contact with any representative of the credit department. In most of the credit accounts established by this technique, the personal interview is not combined with the use of the credit application.

The reasoning often advanced by stores using such a plan or one similar is that the vast majority of people pay their accounts as they are ex-

pected to do. Thus why bother to spend money interviewing such people? But to these stores it appears better to conserve these funds to secure proper payment from those people who do not live up to the provisions of the credit arrangement. Of course, such a plan presupposes that the credit department will know exactly when and how to go after reluctant payers and that these collection efforts (which cost money) will be successful in securing payment of the indebtedness.

What Information Should Be Requested? Since there is a considerable range of information which might be requested on an application form, it seems best to illustrate the extent of the information to be sought through a discussion of the minimum and the maximum. The bare minimum might be generalized as simply identifying information —merely the name and address of the credit prospect. Since most retail accounts are opened by women, it is necessary in the case of married women for the credit department to get the husband's name. For the sake of accuracy of posting to the account it is desirable to secure the complete given name and at least the middle initial. A retail store handling thousands of accounts often finds itself in a confused situation in this respect; it is quite possible to have a number of Carl Johnsons, or Edward Smiths, and even a considerable number of Mary A. Smiths. A minimum addition to the identifying information is to request the place of employment and the occupation, as well as the length of time the credit applicant has been a resident at the given address or employed by the present employer. Intelligent seeking of credit information will then prompt the question of previous address or previous employment when the current residence or current employment is less than, say, one year. A rule-of-thumb standard often used in retail credit departments is that residence and employment should be known for five previous years. Such information enables the investigation to develop facts or verify information over a sufficient period of time to satisfy doubts as to current behavior. Investigation at earlier places of residence or employment may then be undertaken whenever there is reason to question the consistency of credit behavior. With the widespread movement of population, such caution seems indicated.

For persons desiring to open revolving credit accounts and installment accounts, some retail establishments have prepared application forms that are more detailed in the type of data sought than the applications used for opening the regular 30-day charge accounts. The reasons given for this distinction include reference to the fact that the amounts charged under revolving credit and installment are usually larger in dollar amounts and longer in payment duration than those charged

under open account arrangements. Some stores, however, currently are using the same type of application form regardless of the type of retail account that the customer is seeking.

Maximum credit from the application blank is commonly sought by sales finance companies and cash lenders. Credit institutions of this type may need the additional information because they are entering into credit transactions which are larger in amount and longer in duration than those generally contemplated when a retail charge account is first opened. These financial institutions may simply be taking advantage of the fact that custom in their line has made it possible to obtain more information without customer resistance. Whether opportunistic or simply representative of more careful credit operation, it does remain a fact that more information is commonly sought by the credit analysts in these institutions.

Such additional information is likely to extend to questions which seek information as to income received and assets owned. They are likely to ask for statements as to real estate owned, bank deposits and other savings, and insurance carried. They are also likely to seek information as to past credit dealings by asking for other installment contracts currently open and recently paid and other cash loans currently open and recently paid. They usually ask for a list of references, best asked by the heading, "firms with which you have had recent credit transactions," and also for a list of personal references. A statement as to the name of the customer's bank and the type of account carried also is a natural addition to the list of references.

Some questions may be asked which are precautions against the time when tracing a "skip" becomes necessary. A "skip" may be defined as a debtor who deliberately disappears and leaves no forwarding address. When a lien has been retained on property purchased on an installment contract or used as collateral for a loan, both the debtor and the property may be sought. In fact when the property under lien is an automobile, it may itself be the means of facilitating the disappearance. Since such a disappearance is deliberate, tracing the debtor becomes somewhat of a detective act. Certain classes of information supplied when the account is opened can be the leads needed to initiate the search. Such questions as "Name of nearest relative with whom you are not now residing," are used for this purpose.

Signature and Contract. It is regarded as good credit practice to have the applicant sign the application. In the case of retail open accounts, the signature may be a part of the authorization and release procedure. In any event the signature is an important part of the credit

process when the application is designed to impress the applicant with the value of an account, with the careful businesslike operation involved, and with the importance of the step just taken. Some credit departments add words above the signature which make the application a rather formal written contract. This clause may be an affidavit that the information is given for the purpose of obtaining credit and that the facts are complete and correct. The clause may also recite the credit terms and be drawn as a contract between creditor and debtor. In the case of installment or loan contracts the application may be made a part of the contract by its position and wording. Although it is doubtful that these procedures enhance the legal position, they certainly add to the impressiveness of the occasion. When such words are included as a portion of the application form and are solemnly referred to by the credit interviewer, there is less chance that the applicant will regard the opening of a credit account as a rather casual operation. In fact, some promotional-minded credit executives avoid such a process because they fear it will be regarded by the applicant as too formidable a procedure.

The Credit Interview

Obviously the nature of the credit interview should be consistent with the character of the application and the philosophy of the credit department relative to the information to be sought through the application. Opinions differ markedly as to the procedures which are best for conducting the credit interview, especially as to the procedure for completing the application; others prefer to develop the answers to questions through the interview and to record the information on the application form themselves. It would seem, however, that the ability of the credit personnel available for interviewing and the physical facilities available are more important in properly deciding these questions than any principles relative to which procedure is preferable.

In favor of having the applicant fill out the form may be cited the points that less skilled credit personnel are necessary and that more customers can be accommodated in the same space. In favor of having the credit interviewer complete the form may be cited the points that a skillful interviewer can secure much more information than can the blank spaces on a form and that the interview can be made a lesson in the rights and wrongs of credit behavior. However, these points are not so rigidly or exclusively associated with one procedure or the other as to preclude their accomplishment with either of the procedures suggested.

What appears more important is to develop the right attitude toward the credit interview and to accomplish the objectives sought rather

than to prescribe a single procedure for completion of the application. The credit interview should be a part of the credit department promotion, in other words promotion of credit sales. It should be regarded as an opportunity for converting a credit prospect into a credit customer. Accordingly the attitude should not be that of an inquisition—rather it should be a business procedure for establishing that the credit offered is equivalent to the goods or services sought. The attitude should not be one of conferring a favor nor should it be extremely inquisitive. The interview should proceed with the quiet confidence that the prospect has a value to offer which is fully equivalent to the values for which it is to be exchanged. Since the assumption that the vast majority of the credit prospects are honest is reasonably valid, the great majority should not be made to feel uncomfortable by efforts to identify and screen out the very small minority who are not well intentioned.

The credit quarters should be appropriate to the reception of customers. Too often the credit department is located in an area that is difficult for customers to find, is poorly lighted and inadequately furnished. Such conditions are not conducive to proper customer reception, nor for that matter, to good work by credit personnel. Since credit interviews are likely to be considered by customers as private affairs, arrangements for privacy should be provided.

Credit interviewers should be polite; this is saying no more, however, than might be said of any store employee. In addition they should be trained to be tactful and encouraged to be helpful. For many customers the credit interview is somewhat unusual and often results in something of an emotional strain. The interviewer should be able to put them at ease. Tact and good training in credit fundamentals will result in obtaining a maximum of usable information. The credit interviewer who knows what the information will be used for and how it will be used can be more successful in conducting the interview and in removing the customer's doubts, which can be anticipated. When a line of inquiry seems to produce conflicting or inconsistent information, additional nonroutine questions can be asked and much future investigative time will be saved.

Even when the procedure calls for the credit interviewer to fill in the application, it is well to provide space on the form for the recording of more information than the minimum asked for and for the interviewer to record this additional information *after* the customer has left. When the customer fills in the application, it is well for the interviewer to look over the form and to provide supplemental information which will as-

sure completion of blanks not filled in or which probes more deeply into questionable areas.

Analysis of the Application

It has been suggested that the credit application be considered as a source of credit information which has not been verified. So considered, the analysis then should be directed toward the need for verification and the means of verification to be used. Certain information can be verified by confirmation. For example, the address can be confirmed by checking with a telephone directory or a city directory. In some cases the directory also will confirm the occupation of the husband. Date of publication also will give some indication of length of residence. The residence address can give the credit analyst who knows his community some additional information. Certain neighborhoods are known to be upper-, middle-, or lower-income areas. Some addresses can be warning signals indicative of the need for very careful investigation, perhaps because such areas are known to have a heavy concentration of residents of poor morals. On the other hand, other neighborhoods which are known to be beyond the apparent resources and income of the applicant may indicate that he is attempting to live beyond his means. Such inferences will direct the extent of the investigation and the degree of its penetration.

Brevity of residence or brevity of employment may indicate the need for more extensive investigation. Knowledge of the employment policies of certain employers in the community can even help direct the extent of the investigation. Certain employers may have a policy of very careful screening of employees, and employment with such a firm may in itself permit an inference of credit reliability.

Sometimes an occupation itself may indicate more complete investigation. Occupations which are seasonal in character, which have considerable fluctuations in the level of income, or which have a high turnover of personnel obviously call for more complete investigation than more stable occupations. An interesting, yet rather controversial, bit of retail credit research takes the form of studying occupations and arriving at credit standings related thereto. There have been few attempts to gain such objective credit ratings. This may be attributed to the fact that there is more of a lay interest in this type of study, since people in the field feel that occupation alone does not provide a rational basis for the evaluation of a credit risk.

The study of occupational credit standings dates from 1931 when Professor P. D. Converse, a pioneer in the field of marketing, first made

such an analysis. In 1941 he repeated the survey, increasing the size of the sample and the number of occupations studied.[1] Because of widespread interest in Professor Converse's 1941 study and requests for a similar analysis since World War II, a repeat of the earlier studies was undertaken in 1951 by Professor R. S. Hancock. The list of occupations to be rated was drawn from the *Dictionary of Occupational Titles,* prepared by the United States Department of Labor. This was done to utilize standard titles of the more common occupations. Forty-two occupations were selected in 1951 to be surveyed, representing professional, managerial, clerical and sales, service, agricultural, skilled, semiskilled, and unskilled groups. The occupations were rated by local credit bureau managers and by retail store credit managers. Although the 1951 study used somewhat different occupational titles than did the 1941 study, the relative standings exhibit little distortion. This is shown in Table 10–1.

There are certain characteristics which seem to prevail among the higher-rated occupations, which consist largely of professional, clerical, and highly skilled manual workers. Stability of income and better utilization of income are characteristics which are generally apparent among these occupations. These are important factors in the business of accepting credit at the retail level. Although there are exceptions among all occupations, the sense of responsibility which an occupational group may have will substantially affect their paying habits. This fact may be attributed to the kind and amount of education or training which is necessary to perform these better-rated jobs. Some of the training may be of an informal nature and gained over years of experience; on the other hand, many of the better-rated occupations represent several years of formal education and personal discipline. Although this may or may not be true of office workers, retail sales people, public officials, and others, it should be noted that many of them hold responsible and better-paying positions.

Several of the occupational groups with low ratings are made up of transient workers. Such workers have always been regarded as doubtful credit risks because they have little sense of credit responsibility. This is true of those thousands of workers who frequently move from one town to another, such as men in the building trades, unskilled factory workers, section hands, common laborers, and farm laborers. Until recently, it

[1] P. D. Converse, "The Occupational Credit Pattern," *Opinion and Comment,* August 12, 1941, pp. 1–9. The 1941 study was made by the Associated Credit Bureaus of America, the Credit Management Division of the National Retail Dry Goods Association, and the Bureau of Business Research (now the Bureau of Economic and Business Research), College of Commerce, University of Illinois.

Table 10–1

RELATIVE STANDINGS OF VARIOUS OCCUPATIONS, 1951 COMPARED WITH 1941

Occupation	*1951*	*1941*
Business executives	1	1
Accountants and auditors	2	
Retail managers (independent)	3	7
Chain store managers	4	3
Physicians, surgeons, and dentists	5	12 & 14
Engineers (chemical, civil, etc)	6	9
General farmers (owners)	7	10
Army and navy officers	8	2
Office workers (clerks and stenographers)	9	5
College professors and instructors	10	
Railroad clerks	11	
Skilled factory workers	12	4
Post office employees	13	15
Railroad workers (trainmen)	14	6
Hotel and restaurant managers	15	
Other school teachers	16	11
Clergymen	17	18
Nurses	18	16
Public officials (federal, state, and local)	19	
Retail sales people	20	13
Printers	21	
Lawyers and judges	22	21
Traveling salesmen	23	17
Plumbers	24	24
Policemen and firemen	25	20
Carpenters	26	25
Guards and watchmen	27	
General farmers (tenants)	28	28
Truck and bus drivers	29	
Soldiers and sailors (enlisted men)	30	35
Unskilled factory workers	31	26
Janitors	32	27
Section hands	33	22
Plasterers	34	34
Barbers	35	33
Coal miners	36	31
Common laborers	37	29
Bartenders	38	36
Musicians	39	39
Domestic servants	40	30
Painters	41	37
Farm laborers	42	38

Source *Current Economic Comment*, August, 1952, p 32

was a relatively simple matter for a worker to "skip" his debts and assume another name on arrival in a new community. The network of credit bureaus throughout the nation, strong union affiliations, social security registration, and income tax laws have significantly hampered this practice.

Stability of income is a more tangible characteristic of the better-rated occupations. Inasmuch as the stability of income is as important as the amount of income in credit risk appraisal, it plays an important role in credit study. Credit selling is most effective when directed toward those individuals who have the financial ability to respond successfully to the series of demands of an installment contract or the recurring amounts due on open account purchases. Selling techniques thus are perhaps best when designed to attract the largest number of people with a reasonably regular income to move the product from the retailers' shelves. The merchant who appeals to the few family units in the highest income bracket has no particular credit problem and is not affected; and conversely, the lowest income brackets which tend to utilize all of their income for the necessities of life constitute almost no market for the credit seller. Consequently, those occupational groups which have a high degree of regularity of income would seem to make up the largest and most satisfactory group of credit purchasers in the long run.

Not all credit men are in agreement as to the significance of occupation to credit risk appraisal. This is the basis for some controversy as to the value of occupational credit pattern studies. It should be emphasized, of course, that occupation alone is not a rational basis on which to offer or withhold retail credit. What is important is the fact that there appear to be certain outstanding characteristics of the people who are in particular types of employment. It has been illustrated that regularity of income and better utilization of income may play a significant role in determining the reliability of an occupational group. It is, therefore, felt that occupation should not in itself be the deciding factor in the offering or withholding of credit—but that it should be an important factor.

Indicating the Investigation to Make. The decision of whether to make a further credit investigation and if so, the extent of the investigation should be a product of the analysis of the application, in the case of an initial request for credit. Of course, a distinction must be made as to whether the decision involves an initial application for credit or the request of an established credit customer for a larger amount of credit than is currently allowed. It has been pointed out previously that the application and interview are the primary sources for determining further action with the initial credit applicants. On the other hand, payment record data from in-file information will play a dominant role in deciding whether to expand the credit base currently being accepted from an individual customer.

What to investigate and what sources of credit information to use

should be carefully considered by the credit analyst. Selection must be made between the various sources and each must be selected on the basis of the type of information desired, the speed and accuracy and completeness of response, and the relative cost of obtaining the information.

INFORMATION SUPPLIED BY DIRECT INQUIRY

Direct inquiry is one of the common methods of obtaining information to verify facts presented on the application or during the interview of an applicant for an initial credit transaction. Likewise, it is commonly used to obtain additional facts needed in the process of deciding whether to accept the credit of an initial applicant or to enlarge the amount of credit being accepted from an established customer. For this reason, this section is devoted to a discussion of obtaining credit information by direct inquiry from sources other than the applicant himself. A careful distinction is made between obtaining credit information directly from the sources having such facts and between buying somewhat similar credit data in the form of prepared reports from credit reporting bureaus and agencies. The latter organizations are discussed in detail in Chapters 11 and 12.

Whereas investigation may be by direct inquiry or by purchase of reports from professional sources of credit information, it should be noted that the term "free" should not be used to distinguish between purchased and direct. Neither is free. Purchased data are obtained upon the payment of a stated fee; direct, through the incurring of costs to obtain it. Actually the purchase fee in some instances may be less than the cost of obtaining the information through direct inquiry. On the side of direct inquiry may be the saving of time, the ability to direct the questions specifically, the chance to develop additional information as needed, the ability to confine the response to only that information thought pertinent in the current case. It may, for instance, be decided on the basis of preliminary analysis of the application that only employment and its duration need be verified. A telephone call or a letter to the employment office of the employer may suffice to verify the stated facts as to the employment and the length of time so employed and the case is closed in a matter of minutes. Should inquiry along these lines not confirm the information supplied by the application or raise some additional questions not anticipated at first, the investigation can be extended along the new lines indicated.

On the negative side of direct inquiry is the problem of duplication and the lack of completeness and uniformity of information at hand

about all accounts. When information is possessed by a number of persons, a middleman usually is the most efficient way to secure complete exchange of such information. For each creditor to know the experience of say, six other creditors, each must send out six inquiries and each must reply to six inquiries. If each submits his information to a central clearing agency the complete information can be in the possession of each creditor by each making only one inquiry and each submitting only one reply; a total of only seven inquiries and seven replies. (See Figure 10–3 for an

FIG. 10–3. The economy of centralized clearance.

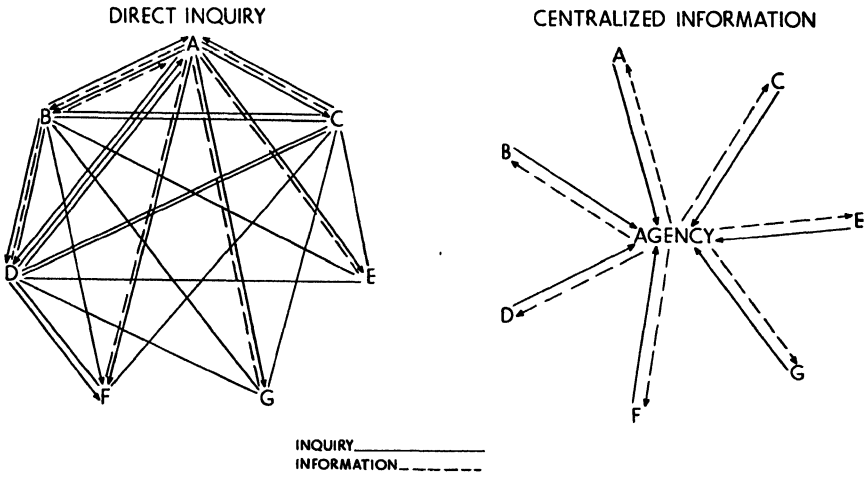


illustration of economy of centralized clearance.) The economy of such a system of clearance makes the direct exchange of ledger facts a relatively inefficient and costly means of investigation. Despite this, direct inquiry is a source of credit information currently being used and thus should be discussed.

Inquiry by Mail

Direct inquiry by mail may be directed to the employer, firms that have had credit dealings with the applicant, the applicant's bank, attorneys who might have had contact with the applicant, and other references. In each case the reference letter should be carefully framed to solicit information which the informant may be expected to have, which is pertinent to the credit decision, and which the informant may be expected to reveal. The questions should be phrased as specifically as possible and the form designed in such a manner that it is easy for the respondent to reply. In all cases an offer to reciprocate should be made,

and a self-addressed, stamped envelope supplied for reply. While communication by letter is the more common practice, some firms do use double-return postcards with the name of the applicant shown on the reply card in code to avoid possible legal complications. It is usual to indicate that the information is desired because of a request for credit, and in some cases the nature of the transaction is indicated. Since such information should be and usually is on a "give-and-get basis," some firms submit their own experience when asking for the experience of others. It also is usual to state, at least when such is a fact, that the inquiry is directed to a person whose name was supplied as a reference.

As previously mentioned, questions should be phrased in a manner which permits specific and unequivocal answers. So far as possible the questions should invite, in fact require, factual response rather than opinion or judgment. The questions should not indicate or invite bias in either inquiry or reply. The whole tone should be tactful and considerate of the respondent.

Appropriate questions to be directed to the employer are suggested by the following:

Employed since? _____ or How long employed? _____
Position? _____ or Occupation? _____
Salary? $_____ monthly, or $_____ weekly, or $_____ per day.
or
Earnings?

And if a former employer it is appropriate to ask:

Employed? From _____ to _____
Position? _____ or Occupation? _____
Reason for separation? _____

Appropriate questions to trade creditors are suggested by the following:

Type of account? _____
When account was opened? _____
Present balance? $_____
Highest recent credit? $_____
Payment experience: Pays when due _____
Within 30 days _____
In 30 to 60 days _____
In 60 to 90 days _____
Other _____
(If experience has been unsatisfactory please state the nature of the difficulty, the manner of collection, and if there was a charge to profit and loss _____ Date? _____

Appropriate questions to banks are suggested by the following:

Is he a depositor? Yes? __ No? __ Checking? __ Savings? __
Approximate amount of the usual balance? _____ figure
Have you had lending experience with him? Yes __ No __
Was the lending experience satisfactory? Yes __ No __
Would you recommend? _____

This last question, which violates the precept not to ask for opinion, is suggested because of the desire to conform to bankers' prejudices. Some bankers will not answer specific questions as to the amount of the balance, or even as to the lending experience but will recommend. A question which permits the banker to say whether he would or would not recommend the depositor thus may obtain an answer from a respondent who would not otherwise reply.

Appropriate questions to references who have not had business dealings are suggested by the following:

Is applicant personally known to you? ____ How long? _____
Do you regard him as responsible? _____
Is he of good reputation? _____

When the applicant is of such youth that legal incapacity to contract may be suspected, such references may be asked about his age:

How old is he? ____ What is the date of birth? _____

Developing Additional Informants

It should not be thought that the informants previously listed are the only ones from whom credit information should be sought. Ingenuity should be exercised in order to tap informational sources not supplied by the prospect. It is obvious that when a person is asked for references he will carefully select from the potential list those more likely to give favorable replies; a man must be poor indeed if he cannot select a biased list of references. Although this inherent bias exists, specific questions will develop usable information even from biased sources since few reputable businessmen will actually falsify credit information. They are more likely to bias their reply by just not mentioning the unfavorable points or by being vague, even overly generous in response to requests for opinion or judgment. Also it is sometimes surprising to the credit analyst, and would be even more surprising to the prospect, how frank some supposedly biased references are in their response.

Despite these mitigating factors the predictable bias should impel the skillful investigator to develop evidence from informants not supplied by the prospect. An added reason for developing such additional

sources often is supplied because of the failure to secure a complete list of reference names during the interview or when taking the application. Ingenuity and knowledge of the market often will enable the investigator to add sources. For example, utilities are usually not listed as references, but they do have experience records. A similar situation exists with the local dairies. Public record information also can be used to supplement that supplied. Ownership of property can be checked against tax records. The presence of liens can be determined by examination of the public records. The police records may in some cases be revealing. While it is not suggested that every case be made the subject of such a costly and time-consuming investigation, it should be recognized that when circumstances warrant it, the investigation can be extended in unusual directions.

Inquiry by Telephone

Direct inquiry by telephone may be directed to the same informants to whom a mail inquiry may be sent. The same or similar questions may be asked. When a telephone inquiry is made the employee conducting it should have a form upon which the replies can be recorded, and this form should be similar to that used in letter-mail inquiries. Standard questions will attain uniformity of response, but trained telephone investigators should be sufficiently skilled to ask further probing questions as indicated by the nature of the replies.

Telephone inquiry has an advantage over mail; replies are received immediately. The cost per completed inquiry may compare very favorably with a mail inquiry. There is a disadvantage to the respondent because the reply to a telephone inquiry may be more disruptive of normal work procedures and more time consuming than the preparation of a reply to an inquiry letter.

Inquiry by Outside Representative

Some firms, particularly cash lenders and sales finance companies, use their own employees as credit investigators. The employee, or outside representative, may be assigned the dual task of outside or personal collector as well as that of credit investigator. He usually will be supplied with the names of employer, landlord, and business references and is expected to call upon these persons and ask questions very similar to those asked in a mail investigation. Here too, there is an advantage in using standardized questions and a standard form upon which to record replies.

The outside representive should be aggressive in developing addi-

tional informants and in extending the depth of the inquiry. Obviously the mail investigation cannot readily be extended on a discretionary basis, but a good outside representative should analyze the information supplied as it accumulates. He thus should extend his inquiries to the point where in his judgment sufficient information is at hand to reach a sound decision to accept or to reject. He may develop through discrete inquiries information which no other means of direct investigation can match. He can make inquiries of neighbors and local tradesmen; even the postman or policeman can sometimes supply very pertinent credit information which could only be obtained by careful personal inquiry.

Some cash loan companies, lending on the collateral of household effects, believe that the inferences drawn from personal examination of the home develops useful credit information. Such information as the type and quality of the furnishings, the quality of the housekeeping, the pride or lack of pride in the home can be useful as indicative of the credit quality of the applicant. Also during the interview the rent or other receipts can be inspected for evidence of payment habits and the insurance carried can be determined.

Although direct inquiry through outside representatives is costly, it can be used advantageously by firms specializing in certain types of credit where the volume of investigative work is sufficiently large to give a reasonable per unit cost.

Inquiry through Credit Group Meetings

Although the technique of group meetings is more common in commercial credit transactions, in some communities it is a convenient method for creditors selling consumer goods to exchange ledger facts and other valuable information. While it is true that such meetings often are held under the auspices of the local retail credit bureau, it still seems correct to classify the action as resulting from direct inquiry.

The purpose of such group meetings, which often are held in conjunction with a social luncheon or dinner, is to provide a quick and easy means of exchanging information about initial applicants for credit, slow-pay customers, and other accounts that are exhibiting an unusual behavior. Usually each participating store is limited in the number of names that it can bring up in the discussion. Thus the credit executive is forced to be careful in selecting those customers about whom he believes there exists an important need for an exchange of credit information.

Direct Inquiry—Summary

Direct inquiry has its advantages and its disadvantages. Cost is one of the chief disadvantages and this may be sufficient to preclude its use

by firms which do not specialize in credit work. These comments are in no way designed to discourage direct inquiry. In many instances the direct contact between creditors is extremely valuable and should be encouraged. It is believed, however, that the apparent economy of direct inquiry may be misleading. After all, the true cost is the cost per completed return. Even mail investigation, which appears to be low cost, can have many hidden costs. The cost per outgoing letter should include the costs of having processed letters prepared, the costs of addressing and filling-in, and the costs of the outgoing and return postage. All of the costs of the nonreturns must be added to the cost of the completed usable returns in order to get an average cost per return. Also, one of the large hidden costs of direct inquiry is the high cost of replying to others. If such a system is to work, those sending out inquiries must be prepared to respond and reply to inquiries directed to them. The more the system is used, the larger the number of replies which they must themselves make.

Such a system may lead to a very unequally divided burden upon the larger creditors in a community. Not only do more customers have accounts with the major stores in a market, but they are much more likely to offer the names of such stores as references. Thus investigators are much more likely to direct inquiries to such leading stores. One of the prices of leadership may be the obligation to respond to more than a proportionate share of investigation letters.

Because of the burden of such inquiries, some retailers have attempted to have the credit investigation centered in professional hands and to clear all local inquiries through a merchant-sponsored local credit bureau.

INFORMATION SUPPLIED FROM IN-FILE LEDGER FACTS

It must be recognized that in-file ledger facts are one of the most important sources of information available to the retail credit analyst who is asked to decide whether to accept or reject a larger amount of credit from an already established credit customer. In these cases the applicant for a larger credit basis already has been placed on the books as a credit customer through analysis of the application and the interview, through verification of the facts thus obtained, and through investigation to secure any additional facts believed needed at the time of the initial request.

From the in-file records, the credit analyst has at his ready disposal the experience of the concern with the customer. He knows the customer's payment habits, the complaints registered, the collection efforts, if any,

needed to keep the customer in line with the established terms. Thus he is in a position to use these data in deciding to accept or reject the request for more credit. In many cases such information is sufficient to enable a decision to be made; in other instances it is necessary for the credit executive to seek more information, which can be called "purchased information," from the professional sources established to supply the additional facts needed before a decision can be reached. Such professional sources are the basis of the next two chapters, Chapters 11 and 12.

REVIEW AND DISCUSSION QUESTIONS

1. Differentiate between the case for the formal application and the case for the informal application.
2. What are the advantages of the formal application? The disadvantages?
3. What are the advantages of the informal application? The disadvantages?
4. Check the leading retail stores in your town to determine the type of credit application that is in use in these firms.
5. Why is it considered good credit practice to have the applicant sign the credit application?
6. Explain how a credit interview should be conducted.
7. What is the purpose of having the interviewer record additional information *after* the customer has left?
8. How do you account for the changing status of the various occupations (see Table 10–1) from 1941 to 1951?
9. What is meant by the direct inquiry method of obtaining credit information?
10. By what means may the direct inquiry method be accomplished? What are the advantages of each? The disadvantages?
11. Distinguish between "purchased" information and "free" information.
12. Check with the leading retailers in your city to discover whether they make use of the direct inquiry method.
13. When is it desirable to use information supplied from in-file ledger facts?
14. Distinguish between internal company data and direct investigation.
15. Attend a luncheon of retail credit executives in which an interchange of credit information on certain slow-pay customers takes place.

CHAPTER 11

Basis of the Credit Decision (cont.) —Local Credit Bureaus

THERE ARE many sources from which information relevant to the credit position of individuals may be purchased; each has its special merits and each has some disadvantages. For certain types of information one source may be preferable to others. In some localities one source may be particularly strong. Because of special conditions, however, this same source may not hold a preferred position in another locality. Thus, the variation from locality to locality in the quality of the credit reports supplied points up the inadvisability of making dogmatic statements about the superiority of any one reporting organization. Each credit manager should be free to select the source which, all things considered, is best in his own area and which best supplies information of the type he needs.

It will be recalled that the direct method of investigation, as described in the preceding chapter, is "free" only in the sense that a fee is not paid to an outside organization; it is not free in the sense of being costless. Such a technique may in fact be more costly than the fee service and the product supplied may be inferior. Since the product of the credit investigation is information upon which a sound credit decision can be based, the quality of the information should be a prime consideration. The work of the credit investigation has become specialized, and as with any other specialized job, it is usually better entrusted to specialists in that work. In addition the special agencies avoid unnecessary duplication of effort. Credit information in the files of specialized credit reporting agencies may be used more than once; in fact, multiple use of the same information is the principle upon which this type of organization is founded. The credit information gathered by direct methods is

available only to the firm which has currently made an investigation. Obviously for this same information to be available to others interested in the subject, the entire investigation must be repeated with a greater strain on the contributors because of the duplication of their contribution of credit information.

There are two basic types of purchased informational credit-reporting services when the area over which they operate is used as the basis of classification:

1. Those which serve primarily a local area. Typical of the credit organizations falling into this category are the local retail credit bureaus, both the mutually owned and the privately owned. These organizations are set up with a primary objective of serving retail merchants, service concerns, professional men, banks and loan companies, and all other types of businesses concerned with the credit of consumers in a localized area. These local credit bureaus are established to provide the latest information in credit reporting and obtain their source data in most instances by centralizing credit information from the ledgers of the principal and most representative credit granters of a local community and by examining the facts contained in public records. They also have a secondary objective in that their membership in the Associated Credit Bureaus of America (ACB of A) extends their services outside their own communities. Thus the credit record of an individual who moves from one area of the country to another is made available to credit businesses in the new community through interbureau reporting arrangements. An examination of the activities of these organizations operating on a local level is the principal subject matter of this chapter.

2. Those which operate primarily on a national basis. Typical of the credit organizations falling into this category are the Retail Credit Company of Atlanta, Georgia, and the Hooper-Holmes Bureau, Inc. These organizations maintain, in addition to their home offices, an extensive branch-office system over the entire country. Also they utilize part-time investigators or correspondents in the smaller towns and villages which are not of sufficient size to justify full-time employees. These credit reporting organizations use as their principal method of operation a detailed investigation by their staff of field men who gather information in order to supply a specific request for a report. They are in the specialized business of gathering credit information in response to a request from their subscribers or clients. They do not draw from a pool of information contributed by the same people drawing from the pool as in the case of the local retail credit bureau but instead develop the information by inquiry or investigation. They too charge fees on the basis of

their service agreement or contract and serve those firms that elect to purchase their services. They are in fact specialized independent credit reporting agencies. The activities of these firms make up the principal subject matter of Chapter 12.

HISTORY AND ORGANIZATION OF RETAIL CREDIT BUREAUS

The local retail credit bureau is generally recognized today as one of the most important sources of consumer credit information. In fact, in thousands of communities it is "the" most important source for the exchange of ledger information among concerns dealing with consumer credit.

Beginning and Development of Local Retail Credit Bureaus

The local retail credit bureau is primarily a development of the twentieth century. Although the first so-called credit bureau through which creditors exchanged information concerning their common customers was organized as early as 1860 in Brooklyn, the growth and development of such organizations was slow prior to World War I. In the years prior to the First World War, only a very small segment of the total retail business was conducted on a credit basis and that which was so conducted involved only persons well known to the seller. Movement of people was limited because of the lack of rapid transportation and communication facilities.

Many of the old-time credit exchanges operated on the basis of "black" lists which worked negatively by warning members against known poor credits. In effect the listing of such risks closed the barn door after someone's horse had been stolen.

From this humble beginning, the local credit bureaus have grown to the position of importance that they now occupy. The local retail credit bureaus have become the principal clearinghouses for information furnished by their subscribers and members and other outside sources and are one of the best examples of close co-operation among business firms serving the American public.

Origin and Growth of the Associated Credit Bureaus of America

The organized exchange of consumer credit information between local areas appears to have started about the turn of the century. In fact, it was in 1906 that William H. Burr, owner of a "credit company" in Rochester, New York, asked the managers of several other consumer

credit reporting agencies to meet with him to discuss the possibility of forming a national association of credit bureaus. Prior to that time there was no roster of credit bureaus, no system for interchanging reports between bureaus, no standardization of forms. This 1906 meeting resulted in the formation of the first national organization of credit bureaus and was called the National Association of Retail Credit Agencies (now known as the Associated Credit Bureaus of America). The need for a closer co-operation between credit bureaus and credit granters soon became evident, and in 1912 the Retail Credit Men's National Association (now known as the National Retail Credit Association) was formed as a trade association of retail credit managers. This latter association and its activities are discussed in detail in Chapter 14.

From this 1906 beginning, when six small credit reporting agencies incorporated and agreed to co-operate in the exchange of credit information, the ACB of A has grown rapidly until today it is one of the foremost trade associations in the credit reporting industry, offering its members such widespread benefits as interbureau reporting rosters, prepaid interbureau coupons, standardized Factbilt reporting forms, trade publications, national advertising, educational services, credit bureau research, special information reporting service, and annual meetings and conventions. It also serves its members through the affiliation of collection service offices which can be called upon for personal collection effort to collect unpaid consumer accounts. Likewise this Collection Service Division may help in locating any "skip" debtor of a local credit granter. Another affiliated organization is the Credit Bureau Reports, Inc. which was established in 1932 to provide a centralized reporting and collection service to national concerns which use the facilities of many local credit bureaus. In addition, the ACB of A has become an international trade association and counts among its members many of the retail credit bureaus located outside the continental limits of the United States.

Organization and Ownership of Local Retail Credit Bureaus

The majority of the local retail credit bureaus are merchant owned; thus they may be considered mutual or co-operative associations. In most cases the ownership by the merchants, which means retail and service firms doing a consumer credit business, is effected through a local credit association. The association elects a board of directors who in turn employ the bureau manager to operate the bureau. General policies of operation are set by the board of directors. A substantial number of the local bureaus are privately owned. Such bureaus usually are owned by an individual, frequently the same person who originally organized the

credit reporting service in the community. As with any private business these bureaus may be bought and sold, and of course they are operated for a profit. Some bureaus are incorporated and there is at least one instance where a number of them are owned by the same organization and operated as a chain operation. Some bureaus are owned and operated by local Chambers of Commerce which run the bureaus as a department of the Chamber. In effect such bureaus are merchant owned but the membership of the Chamber of Commerce is, of course, wider and not so specifically interested in consumer credit.

Regardless of the ownership, the operation of bureaus is much the same. In fact subscribers are not likely to be conscious of ownership. Most of the local bureaus charge fees for their services based on the use made of the services, and the level of fees charged appears to bear no relationship to the type of ownership. All rely upon co-operation of creditors to contribute credit information to the general pool and to draw credit information from the pool. Whether users of the service are members or customers, they are expected to contribute information if they are to get credit information—thus the bureaus rest firmly on the principle of "give and get."

Bureaus are located in practically every city of over 10,000 population in the United States, and many of the smaller cities which do not themselves have a bureau are covered by the nearby bureau in the larger city. In effect the bureau service covers every person in the United States and reaches into every city, village, and crossroads. Thus both urban and rural territory are covered. By territorial assignment made by the Associated Credit Bureaus of America, every portion of the United States has been assigned to a bureau and that bureau is responsible for supplying credit information on persons residing within the territory assigned it. The bureaus thus constitute a well-organized network of credit reporting facilities capable of reporting on anyone anywhere in the United States.

Confidential Nature of Credit Bureau Work

Since the local retail bureau usually has more information about the persons and firms of a community than any other one organization, it is imperative that the credit bureau maintain this trust and keep clear control of the facts it has learned through its interchange of information and investigations.

To accomplish this, all records of the credit bureau must be kept strictly confidential, and no sources of the compiled information should be revealed at any time, unless allowed by bureau rule or by special permission of members and other informants. This confidential informa-

tion is to be furnished only in authorized reports, oral and written, and then only in accordance with the strict rules laid down by the individual bureau and by the Associated Credit Bureaus of America. Thus the credit bureau has to make a careful and constant check on the identity of the persons and firms receiving its reports. While firms that are not members of the bureau usually may purchase reports, such firms must be identified properly and have agreed, in writing, to use the furnished information *only* for the purpose of making credit decisions. Such an action prevents this confidential information from falling into the hands of "nosey" individuals who are seeking information about their friends and neighbors, from being received by firms desiring such data on a nonpay basis, and from involving the credit bureau in costly lawsuits because of the release of data to unauthorized recipients.

Such careful safeguarding of the information entrusted to the credit bureau has resulted in a closer co-operation among retail stores, service concerns, banks, and employers in the interchange of credit information through a third party—the credit bureau—than ever was dreamed possible by the founders of the plan. They know that the information they give will be handled confidentially and that they in turn will benefit from the combined data reflecting the experiences of others with the customer desiring to use his credit.

Principal Sources of Their Credit Information

Since the primary activity of a local retail credit bureau is to furnish reports—both written and oral—on consumers desiring to buy goods and services on credit, it seems best to explore the principal sources that generally are used to supply the data found in the assortment of reports commonly in use today. The most commonly used of the written reports is the Standard Consumer Factbilt Report (ACB of A No. 1 compiled by a member bureau).[1] To complete such a report data are required to cover the following points:

1. Identity—name, address, age, marital status, name of spouse, number of dependents.
2. History—name and address of present employer plus some information on previous employment.
3. Character—habits, morals, how regarded by employer, record of illegal activities of any kind.
4. Resources—income from employment, other income, property owned.
5. Credit record—summary of ledger records from firms with whom the subject has had credit dealings.

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[1] A copy of ACB of A Report No. 1 appears as Figure 8–6 in Chapter 8, page 179.

From this list of desired facts, it is easy to see that the credit data must be gathered from a large number of persons and firms located in one or more communities and willing to co-operate in the interchange of information on the subject. Thus it is desirable that the local retail credit bureau arrange to secure the necessary information from the following sources of credit information: ledgers of credit granters, employment records, public records, directories, newspapers, landlords, collection services, the post office, other ACB of A credit bureaus, field investigators, and correspondents. Because of the importance of these sources, it is desirable that each of them be examined separately and in some detail.

Ledgers of Credit Granters

The ledger experiences of credit granters of all types furnish the credit bureau with its basic master file information. This information shows, in outline form, the exact manner in which an individual meets his credit obligations. Since most of the goods and services available may be bought on credit terms, the ledger experiences of a wide variety of firms are available to the credit bureau. Sources of ledger information include all types of merchants, banks, loan companies, insurance firms, physicians, dentists, hospitals, public utilities, real estate rental agencies, etc.[2]

Employment Records

One of the most important facts needed by the credit granter, when considering an application, is a verification of the subject's employment. By establishing a proper relationship with employers, the credit bureau is able to secure information regarding the exact type of work done by the applicant, the amount of wages paid, the length of time employed, a description of the employees' character, habits and even economic and domestic circumstances. Similar information is available from former employers together with the reason why the subject left the firm or was discharged. Trade associations are helpful in supplying information on individuals in business for themselves.[3]

Public Records

It is vitally important that the master file contain essential facts copied from public records. These include property ownership transactions, mortgages, lawsuits and judgments, petitions in bankruptcy, marriages, births, divorces, deaths, arrests, indictments and convictions.[4]

Directories

Directories are available for several classifications of activity. City and county directories, showing names and addresses of residents in the community,

[2] *Credit Reporting Fundamentals* (St. Louis, Mo.: ACB of A, Credit Bureau Div., 1951), Section III, p. 1.

[3] *Ibid.*, Section III, pp. 1–2.

[4] *Ibid.*, Section III, p. 2.

are usually published by commercial printers. Special lists are available from city and county governments, such as lists of qualified voters, etc. In addition to the alphabetical telephone directory, telephone companies in many communities also publish special directories, indexed by street addresses, which are available on a monthly rental basis. Various types of "who's who" directories are published, including those for regions of the country as well as various professions and groups of executives. Under this classification there are available the published lists of members of labor unions, trade associations and civic and fraternal groups.[5]

Newspapers

The newspapers published in a community contain numerous articles reporting favorable, unusual and derogatory facts about individuals. In certain instances, trade publications, real estate and other specialized newspapers contain much desirable antecedent information.[6]

Landlords

Landlords are usually able to furnish a variety of information about their tenants, including their manner of paying the rent, personal habits, morals, number of dependents, as well as a verification of the address and length of time the tenant has lived there—a fact considered by many credit granters of great importance in determining the stability of an applicant.[7]

Collection Services

Through cooperation with collection service offices in the community, an arrangement can be made to secure prompt reports on all new accounts turned over by credit granters for collection. When a credit bureau maintains its own collection department, the posting in the master file of accounts turned over for collection should be automatic.[8]

The Post Office

A list of rural routes, showing the districts through which they pass, is published by the Post Office Department. Frequently, the address given is a route and box number from which it is possible (with the help of someone familiar with the area) to locate the nearest rural retail business in order to obtain information.[9]

Other ACB of A Credit Bureaus

The credit bureaus affiliated with Associated Credit Bureaus of America are best able to furnish credit information on their former residents because of information in their own master files and a knowledge of the local sources of information.[10]

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[5] *Ibid.*, Section III, p. 2.

[6] *Ibid.*, Section III, p. 2.

[7] *Ibid.*, Section III, p. 2.

[8] *Ibid.*, Section III, p. 2.

[9] *Ibid.*, Section III, p. 2.

[10] *Ibid.*, Section III, p. 2.

As our population has become increasingly mobile, there are many instances of purchases outside the home trading area. Also there are increasing numbers of families moving from one city to another. Both circumstances usually occasion an interbureau inquiry. Through the facilities of the bureau system the record of an individual in other markets can be made available to subscribers. The ACB of A has designed and operates a system of prepaid inquiry tickets (see Figure 11–1) which the inquiring bureau can use to draw a report from the files of the bureau which has the subject's prior record. Such a system permits an inquiring bureau to make payment in advance for reports without the bother of bookkeeping or billing and also does away with the need for the bureau to write many checks for small amounts.

The prepaid inquiry ticket system also has been attractive as a means for selling bureau reports to national subscribers or other sellers whose credit business spans a larger territory than the trading area of any one bureau. Such accounts found membership in all the bureaus necessary to cover their operations burdensome, and the number of inquiries, invoices, and checks which these subscribers would need to issue was so bothersome that they were not attracted to use the services of the bureaus. Still the bureaus had a national pool of credit information which it seemed desirable to tap. The use of interbureau inquiry tickets makes it possible for membership in the home bureau to open the tap to the extensive credit information held by all bureaus belonging to the system. In order to facilitate this and to guarantee complete coverage of the country it was, however, necessary to assign territory to the bureaus so that there was universal coverage. This has been done, and progress has been made in selling this service. One difficulty, however, has been to persuade the bureaus that foreign reports are as important as local reports. Some bureau managers have been more inclined to give local customers preferred service since they were more easily recognized as their employers. Another difficulty has been to educate the bureaus to give a uniform high quality report regardless of recipient. A great help in this matter has been the standardization of reports by the ACB of A under the name of "Factbilt Reports."

Field Investigators

Since all of the sources of credit information cannot be reached by telephone, field investigators provide a highly efficient means of obtaining certain facts from neighborhood contacts. The location of persons who have moved without a forwarding address often can be accomplished by a skilled field investigator after other methods have failed. The field investigator is also of value in obtaining information from individuals or firms who are not members of the

FIG. 11–1. Copy of prepaid inquiry ticket of ACB of A.

ASSOCIATED CREDIT BUREAUS OF AMERICA INC. — Official "T" Ticket

NOTICE Please carefully follow all rules that apply to Credit Reporting Division Members' use of "T" Coupons. Rules require the use of ACBofA forms for inter-bureau reporting. Refer to the rules brochure, "Factbilt Reports Anywhere Through Inter-Bureau Service," for specific forms to be used.

Date 10/19/5 — *Factbilt* REPORTS — Nº 196520

Type of service desired Standard Consumer

1. FULL NAME DOE (Last) John (First) James (Middle) Age 46 Spouse Mary L
2. Present Residence 162 Pine Street Utopia, Missouri
3. Former Residence Fairville, New York
4. Present Employer Commercial Radio Company
5. Employer's Address 512 Main Street Utopia, Missouri
6. Position - Department General Sales Manager
7. Former Employer and Fairville Furniture Company
8. Business Address 1000 Madison Street, Fairville, New York
9. References - Remarks Gudinoff Grocery
   May-Bee Department Store

Our member is interested in subject's resources

Credit Bureau of Lincoln
Box 28
Lincoln 1, Nebraska

Please return top of Inquiry Ticket

NOT NEGOTIABLE

ASSOCIATED CREDIT BUREAUS OF AMERICA INC. ST. LOUIS 19, MO.

Standard Inter-Bureau "T" Coupon Nº 196520

The Treasurer of the ACBofA, upon presentation of this coupon, will pay to the CREDIT REPORTING DIVISION member whose name appears below the sum of

SEVENTY-FIVE CENTS

This coupon shall be VOID if not presented to Associated Credit Bureaus of America for payment before January 1, 1963

Associated Credit Bureaus of America, Inc.

John A. Lafferty
Exec. Vice-Pres

Credit Bureau of Utopia
107 River Street
Utopia, Missouri

The Treasurer may, without prior notice, apply this coupon in payment of past due accounts with ACBofA.

2 4 4

2 4 4

Courtesy of the Associated Credit Bureaus of America, Inc., St. Louis, Miss

bureau and with whom it is necessary to conduct a personal interview in order to obtain the cooperation necessary to secure satisfactory information.[11]

Although the basic service of a retail credit bureau is the exchange of ledger experience, it must be recognized that not all significant credit data will be represented by such material. The bureaus do not, and should not, limit their data collection to merchant sources. As was mentioned previously, the employer may be called on to confirm employment, occupation, and position and perhaps to supply income information; the landlord to confirm rental payments; and the bank or building and loan to confirm property ownership and encumbrance. Nonmember and nonmerchant creditors, such as loan companies or finance companies, may be asked for their experience with the subject involved and his current position of indebtedness. In certain cases, especially when the subject is a newcomer to the community or the head of a new household, no real information can be obtained through telephone or mail inquiry to the conventional sources. For such cases most bureaus have an outside representative who can develop the case by personal calls. He may even interview the subject or members of the subject's family in order to ferret out additional sources of information. He may interview neighbors for the same purpose and thus may develop some information about the living habits and associates of the subject. He may call on the employer to get information not readily put in writing or said over the telephone. While personal investigation is not a part of the standard service offered by bureaus, it is a valuable complement to the standard service.

Correspondents

More than 50,000 towns and villages, throughout the United States and Canada, contain individuals who are qualified to obtain and report credit information on residents living in rural areas. As the name implies, the bulk of a correspondent's reporting is done by mail. However, when speed is necessary the bureau is often able to contact its correspondents by telephone, both for requesting reports and for receiving them. Because the credit reporting activity of a correspondent in a small community is not a full-time job, arrangements usually are made with justices of the peace, postmasters, insurance agents, real estate agents, attorneys, county recorders and general stores.[12]

Need for Facts—Not Opinions—from These Sources. In using these sources of credit information, it is imperative that the credit bureau distinguish carefully between actual facts and simply statements of opinion. This is one of the basic problems of the credit bureau and

[11] *Ibid.*, Section III, pp. 2–3.

[12] *Ibid.*, Section III, p. 3.

must be carefully watched in order that the bureau reports may be considered reliable by all users. Thus, it becomes the responsibility of the recipient of the report to use the facts contained in the report to form his own opinion—not that of the bureau—as to the credit applicant, and thus the recipient is better prepared to make the "right" decision as to the acceptance or rejection of the credit.

As these sources supply the information needed to complete the reports, the credit bureau must analyze and censor the data, in order to observe any shortcomings or omissions and if possible to develop any needed additional information. Such a review also will enable the bureau to determine whether there may be any legal liability involved as to either the content or the form of any derogatory information that has been furnished by these sources.

Scope of Bureau Operation

The primary purpose of the local retail credit bureaus is to supply information. The ways in which this information is distributed to business concerns will be explained in the following sections which discuss the reporting and other services rendered to subscribers of the bureaus.

Preparation and Maintenance of Master Card File. It has been said that the heart of the credit bureau records is the master file. This file thus becomes close to being the "who's who" for consumer credit in a community and its surrounding trading area. Since the principal task of a local credit bureau is to secure and maintain all available information about consumers, the master file is *the* source of credit information from which data can be obtained quickly and easily and in turn transmitted to inquiring firms. In most bureaus the so-called "master card" may be either a thin, durable cardboard (4 by 6 or 5 by 8 inches in size) or a heavy paper envelope, or a combination of the two. Illustrations of these are shown in Figures 11–2 and 11–3.

Thus, the basic stock in trade of a local bureau is its in-file information, most of which is obtained through ledger clearance among the bureau members. Firms having experience with the subject of an inquiry are asked to supply the bureau with current information covering their recent experience with that subject. New members, upon signing a contract with a bureau, agree to furnish a list of their current customers and supplemental information as to their present and former residences, occupations, business addresses, references, dates accounts were opened, high credit extended, and other pertinent remarks. Data on all new or reopened accounts also are submitted according to the terms of the contract.

At a minimum the card shows the length of time member firms have had dealings with the subject firm, the high credit, the amount owing, and the payment experience. If all works as it should, the basic card accumulates automatically and reflects the credit experience of all member firms interested in that person. Practice varies as to how old information must be before it is regarded as obsolete, but most bureaus will institute

FIG. 11–2. Master card, ACB of A Form R2 (4 x 6 inches).

Form No. R2

NAME _____ M_____ S_____ W_____

Wife or Husband's Name _____

Rooms_____ Rents_____ Landlord_____

Addresses

Former _____

Now _____

Occupation

File No._____

Claim No _____

Phone _____

Dependents_____

Age_____

Income

Cross Reference _____

Date Inquiry	Firm	Date Cleared	Open Installment	Date Opened	NC Contract	Owes	Past Due	Rate	Special Information

(Front)

PROPERTY AND OTHER ASSETS				INCUMBRANCES AND ADVERSE RECORDS					
Date	Form	Description	Amount	Date	Form	Description	Amount	Due	Disposition

CLAIMS FOR COLLECTION

Client							
Amount							
Progress							

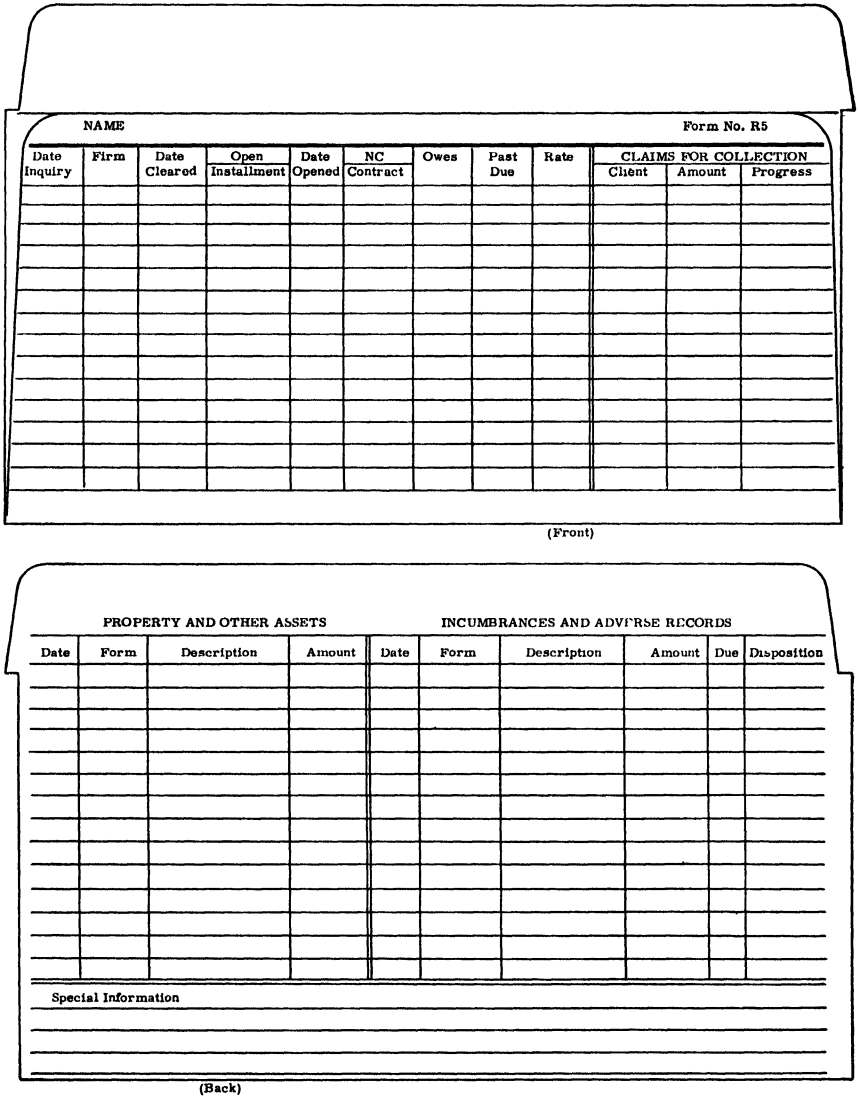
(Back)

Courtesy of the Associated Credit Bureaus of America, Inc , St Louis, Missouri

a new clearance when the date of the last clearance is more than 90 days prior. When a new clearance is instituted, all members listed as interested are contacted and their recent experience is added to the record. Experience of nonmember references is added when available. The experience of members or nonmembers may be sought either by telephone or through written report.

In addition to ledger experience the basic master card usually con-

FIG. 11–3. Master envelope, ACB of A Form R5 (4 x 6 inches).



NAME

Form No. R5

Date Inquiry	Firm	Date Cleared	Open Installment	Date Opened	NC Contract	Owes	Past Due	Rate	CLAIMS FOR COLLECTION Client	Amount	Progress

(Front)

PROPERTY AND OTHER ASSETS

INCUMBRANCES AND ADVERSE RECORDS

Date	Form	Description	Amount	Date	Form	Description	Amount	Due	Disposition

Special Information

(Back)

Courtesy of the Associated Credit Bureaus of America, Inc., St Louis, Missouri

tains additional basic credit information, such as the address and previous residence addresses, name of wife, occupation, employment, previous employment, and income. Property ownership and public record information may be added. Many bureaus supplement the basic credit information with clippings covering such items as mortgages filed or released, property transfers, births, deaths, suits and judgments, and similar matters. When clippings are added, they may cover matters of direct or indirect credit interest, such as police record, divorce proceedings, engagement announcements, social activities, and business news.

Variety and Transmission of Reports. While previous mention has been made of the importance of the Standard Consumer Factbilt Report, it must be recognized that by no means is this the only important report rendered by the local bureau. It is only one of a wide assortment.

A large segment of the activity of a bureau is its oral reporting, in which member firms call directly by telephone to the bureau for an oral report, identify themselves by some predetermined plan, and obtain such information as is available in the master card file about the subject desiring credit acceptance.[13] In case the information in file is out of date, a clearance must be made before the oral report can be given. The oral report usually is the least in cost, sometimes costing as little as 60 cents per inquiry, and is furnished quickly and with little effort on the part of the bureau.

In the written report category, credit bureaus furnish a wide variety of special-purpose reports. These, along with the Standard Consumer Report may be furnished to subscribers by mail, teletype, telautograph, or messenger.

Certain groups of creditors desire these special reports which are either more detailed or less detailed than the standard credit report and which may cover certain aspects of the credit situation more adequately than a standard report. This demand has led bureaus to develop a number of special reports of various types, the most important of which are listed below:

Trade Clearance (ACB of A No. 3)—particularly useful to the credit applicant because it provides up-to-the-minute information about the pay habits of the applicant.

Previous Residence Report (ACB of A No. 5)—used to compile information on an individual who has moved from the community.

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[13] It is worthy of note that in view of the cost of reports a number of lending agencies now have arrangements to call the local credit bureau and for a very small fee to ask merely whether there is any negative information in file about the particular customer in question. They receive a "yes" or "no" answer. If the answer is "yes," then they draw a credit report for which they pay, of course, the usual fee.

Credit Character—Loan Report (Veteran) (ACB of A No. 6)—useful to expedite the handling of GI loans for processing through the U.S. Veterans' Administration

Petroleum Credit Report (ACB of A No. 8)—used to compile oil company reports.

Business Credit Report (ACB of A No. 9)—used to cover small and medium-sized businesses on which credit bureau users desire credit information.

F.H.A. Modernization Report (ACB of A No. 10)—used on those applications which provide for modernization of existing homes.

F.H.A. Factual Data Report (ACB of A No. 11)—used to make a credit report on an applicant for a loan to build a home.

Rental-Tenant Credit Report (ACB of A No. 12)—prepared primarily to serve real estate management firms and private individuals who rent residential and small business property.

Collection Aid Report (ACB of A No. 14)—used as an aid to decide upon the type of collection effort needed for a delinquent account.

Personnel-Employment Credit-Character Report (ACB of A No. 16)—used to cover important antecedent questions about an individual.

Property Ownership Report (ACB of A No. 18)—used for a detail check of public records of reputed real estate property ownership.

Public Record Search (ACB of A No. 19)—used when a report is needed on the ownership of personal property as well as real estate property.

Farmer-Rancher Credit Report (ACB of A No. 20)—used to answer questions regarding farmer or rancher credit applicants.

Auto Purchase Credit Report (ACB of A No. 22)—used to answer questions that a firm may have on an individual desiring a loan to buy or refinance an automobile.

Auto Insurance Report (ACB of A No. 23)—used to help determine the risk of granting insurance to the owner of an automobile.

Professional Services Report (ACB of A No. 26)—designed for physicians, dentists, lawyers and other professional people whose charges for their services may amount to a substantial amount.

Professional men, such as doctors, dentists, and lawyers, often feel that the complete ledger clearance report overwhelms them with facts which are not especially useful to them because of the different character of their relations with clients or patients. In addition they do not have organized credit departments and do not believe that they are doing a standard credit business. Still they desire to have some protection against abuse of credit relations. Their true preference would be for an advisory service—a service which in effect makes some outside agency their credit (and collection) department. In some communities this desire has been met by the organization of a special medical or professional credit bureau, in others by the setting up of a special department in the bureau, and in still others by the development of a summary or opinion type of credit report.

The loan companies, especially the cash lenders, often want complete information about the contractual obligations of their customers and applicants. To satisfy this desire the bureaus may develop a report which undertakes to exhaust the sources of such information. The loan companies also may work with a special department of the bureau which attempts to make a ledger clearance of all lenders whenever an inquiry is made on a name.

Another special need is represented by the real estate lenders that desire information about other indebtedness, mortgages, and similar public record information. This desire can be met by a property record search or public record search.

Various other trade groups often have special requirements, such as oil companies, insurance companies, and federal agencies. To some extent the bureaus have attempted to meet these demands by developing special written report forms which have appropriate blanks for the insertion of the special type of information such groups desire. Obviously before such special information can be inserted, it must be discovered by the investigation. Thus, the blanks on the form in effect direct the investigation into the desired channels.

Supplementary Credit Bureau Services. Services of the credit bureau thus far discussed have been individual; that is, they have been custom tailored for the inquiring customer. The bureaus also provide certain services which are not individually tailored in response to an order. The same information is made available to all subscribers to that particular service, and the subscriber selects from the mass of information the portion significant to him.

Rating Book. The issuance of rating books in the form of black lists was one of the earliest of bureau services. This has been replaced by the service of providing factual information to be analyzed and interpreted by the subscriber. The written or telephone report is the more complete way of distributing relatively complete factual information. In some markets and among some subscribers, however, there remains a desire for a service which provides a listing of individuals and a summary of their credit standing or credit rating. This desire is met by some bureaus by the issuance of rating books. Such books may either give a rating which summarizes the past credit experience, or they may publish the credit experience in greatly summarized form. Present information indicates that they are now published by a minority of the bureaus.

Daily Reporter. Most bureaus now publish a daily reporter through which they make available to subscribers all public record information. This daily report covers such items as: mortgages recorded or released,

transfers of property, judgments, suits filed, bankruptcies, marriage licenses, births, deaths, building permits; in short, all those things which become a matter of public record. Some interpret public record information broadly and include police blotter information and similar items. Information of this type is picked up daily, often by a special reporter who visits the public offices, organized under the various headings, and distributed to subscribers on mimeographed sheets. Subscribers can check the listings against their own list of accounts and add the information to their credit files or take such action as the information indicates is appropriate. Another use of this information is made by the bureau which adds the items to its regular credit files at the same time that it is selling such facts in the form of a daily reporter for a subscription fee.

New Account Solicitation Service. A somewhat similar service is provided by those bureaus which distribute lists of moves into, out of, and about town (see Figure 11–4). Such lists enable subscribers to keep their addresses of customers and of mailing lists current. Moves into town may be used for account solicitation, out of town for collection attention, and within and about town for keeping addresses current. Such information may be acquired by the bureau from several sources—moving and storage companies, public utilities, and police records. However acquired, it is organized in the form of lists, duplicated, and distributed in some cases as a free service.

Watch and Warning Service. Most bureaus have a special service in the form of flash or warning bulletins. Such bulletins are a means of putting members on notice of the operations of bad check artists, credit frauds of one sort or another, and other warnings about things which are important to credit departments.

Regular Bulletins. The regular bureau bulletins are both a service to members and a part of the educational program of bureaus. They also may be regarded as house organs, customer relations, advertising, or public relations publications. It appears that such bulletins should be considered as a part of the services of a bureau to its members. Through these bulletins, members and their employees are informed of developments in credit work which are in the interest of good credit operations.

Collection Service. Most bureaus, either through a collection department or the organization of an affiliate, offer collection service to their members. A variety of collection services ranging from the supplying of a series of collection letters to the services of professional collectors is provided. Some bureaus also aid in collections through pooling accounts which are refinanced by the bureau. Since collections are covered in detail in a later chapter, it is merely mentioned here as one of the services available.

FIG. 11–4. Daily moving record.

DAILY MOVING RECORD

Compiled and Published by The Credit Bureau of Lincoln Nebraska, Inc.

Credit Reports · Collections

Publishers of the BLUE BOOK

Our Seventy-First Year — October 27, 1959

126 NORTH 16TH STREET — **Lincoln 1, Nebraska** — TELEPHONE 2-8891

INCOMING

Burnside, Orvin C	StPaul, Minn	To- 3329 Starr
Conaway, Wayne A	Ravenna, Nebr	4840 South
Kaster, Wilbert	Salina, Kansas	1643 O #12
Keeler, Marvin D	Kansas City, Mo	7210 Kearney
Pittman, Denton	Colorado Springs, Colo	400 S 24
Sweeney, Earl W	Grand Island, Nebr	5432 Benton

OUTGOING

Batey, William A	4303 South	To- 3252 Farnum #703, Omaha, Nebr
Bonnett, Freddie C	2700 N 27	152 Burning Springs Rd, Belle, Va
Coffey, John F	609 S 37	4653 Farnham, Omaha, Nebr
Crokus, Ethel Mrs	1127 D	Superior, Nebraska
Glass, Margaret R	2010 K	Millard, Nebraska
Hemstrom, Morris	3801 Dudley	University of Idaho, Moscow, Idaho
Long, John R	6245 Balwin	1813 Kearney, Casper, Wyoming
Nielson, Joyce Elaine	633 S 17 #B-5	Aurora, Nebraska
Redford, Marion L	7212 Havelock	Pleasant Dale, Nebraska
Schroder, Myron P	2442 S 14	Palmyra, Nebraska

CHANGES

Anderson, Frank M	3420 Mohawk	To- 3433 Mohawk
Anderson, James D	2121 West O	1826 N 24
Asch, Norla J Mrs	4718 Calvert	4650 Calvert #2
Bonebright, Ronald L	4502 Sherman	3645 A
Bryant, Jerry J	600 N 19	2239 T #A
Carlson, Roy A	1045 N 66	1560 E Manor Drive
Christiansen, Dan P	1415 N 43	7240 York Lane
Dais, Helen	301 S 18 #2	301 S 18 #8
Downs, Joseph M	3409 Orchard	4717 Baldwin #403
Fagerstrom, John A	3329 Starr	7321 York Lane
Gerard, Clarence J	2830 S 48	4344 S 54
Greenwald, Robert L	805 G	101-B Huskerville
Guajardo, John	1743 Que	1531 Whittier
Hornady, Margaret	345 N 12 #15	228 N 12 #408
Hornung, Edward	1900 N	720 S 16 #302
Jelley, James D	2925 S 26	1925 S 25
Jinright, Frank L	1849 Garfield	2410 T #1
Krull, Donald E	5636 Judson	1347 D
McMullen Ray O	1135 S 31	1127 S 31
Morgan, Jerry D	1832 L	2943 S 9

(Over)

Courtesy of The Credit Bureau of Lincoln Nebraska, Inc

Educational Activities. The local bureaus and their national organization have been very active in credit education. The national organization holds an annual meeting and sponsors regional and state meetings. Such meetings are properly considered educational in their purpose, although the fellowship and inspiration generated are considered by-products. The national organization also sponsors institutes or

short courses for credit bureau managers, such institutes usually being held in co-operation with a college or university. Currently such institutes are operating at the University of Illinois, the University of Kansas, the University of North Carolina, the University of Texas, and Yale University. The national organization also has published numerous books, periodicals, and bulletins especially directed toward the exchange of information and "know how."

The various local bureaus engage in similar activities but on a local level. They too have meetings of the credit department personnel and of owners of the businesses for the discussion of credit matters. In some cases they have organized short courses on credits and collections. Their bulletins and newsletters contain a great deal of educational material. They work to improve the knowledge of credit principles and the proper application of credit procedures both with their own employees and with the employees of retail credit departments.

As with any educational program the progress is occasionally discouraging, but continuous effort applied to it does yield significant results in time. Certainly much of the credit for the improvement in consumer credit operations and understanding is properly attributable to the work of the local bureaus. Consumers too are exposed to these educational activities directed toward a better understanding of what constitutes wise or unwise use of consumer credit. They are a potent voice for the avoidance of credit abuses.

Cost of Credit Bureau Services

Whether operated as a mutual merchant-owned service or as a private business, bureaus must charge for their services in order to continue to provide them. There are three basic ways of charging for the reporting services:

1. A flat charge for membership, this charge to provide all reports requested. The rate charged members generally varies with their business classification, and perhaps size, and is a rough estimate of the extent of use anticipated. It has the merit of assuring income adequate to meet the expenses providing enough members can be secured. It has the disadvantage of not being proportional to use. As a practical matter it is likely to result in disproportionate charges to a few strong supporters of the bureau and inadequate charges to the numerous smaller members.

2. A charge which is metered on the basis of use. Under this method each report is priced and members are charged on a per report basis. Thus the cost of credit information varies exactly with the extent of its use and the type used. This has the advantage of being strictly equitable,

at least equitable on the basis of the extent of use. It has the disadvantage of making budgeting less certain and of not encouraging use by smaller members that are less conscious of the need for credit facts.

3. A combination of the membership charge with the metered charge. Under this method members are charged a monthly membership fee which entitles them to a specified number of reports. Each report above this number is charged on a unit basis. This method has the advantage of giving some certainty of monthly minimum income and of being reasonably equitable. It also is likely to encourage use up to the minimum, thus enabling all members to get better acquainted with the value of credit facts.

Charges for the special-purpose services usually are established on a subscription basis, thus the rating books are on a subscription basis and the daily reporter on a subscription basis. Flash and regular bulletins usually are free services. Collection services usually are charged on the basis of a percentage of amounts collected.

Evaluation of the Local Retail Credit Bureaus

As has probably been evident from the preceding discussion, it is believed that the local credit bureaus are a valuable contributor to the work of consumer credit. Their method of exchanging credit information through a pool is sound in principle. The method is one which leads to more complete information exchanged economically. The facilities provided by the bureaus are adequate for the task of gathering and exchanging credit information and are properly applied to this task. Without them retail credit would be exchanged without the benefit of sufficient facts to verify quality or the necessary facts would be gathered more slowly and at greater cost. It is justifiable then to say that the method used is sound and to date superior to alternatives which have been discovered.

However, some bureaus fail to some degree in the execution of their tasks. Some of these failings are properly attributable to the lack of complete co-operation from their members. The pool of information can be full only when the members contribute fully; the information in the pool can be fresh only when the members supply current information immediately and when all firms accepting credit in a community are members. To the extent that membership is far from universal and co-operation and participation by members far from ideal, the work of the bureaus suffers. In many markets the bureaus are much poorer than they might be, or indeed than they should be, because they have insufficient members and the members do not properly support their efforts.

Some failings of the bureaus are properly attributable to the failings of the bureau personnel. Not all bureau managers are efficient and are content to be no better than their members demand that they be. In some communities the members do not know what a good report is and continue to accept from their bureaus inferior reports—reports which are incomplete, information which is not verified, and opinions rather than facts. Such failings become especially troublesome when the bureaus attempt to sell their services on a national basis. Delay in reporting also is often troublesome, especially delay in handling interbureau reports.

Some weaknesses of the bureau work may be properly attributable to the effort of retail credit managers to buy reports too cheaply. There is a reluctance to pay enough for credit reports to obtain quality reports. The effort to tailor reports to low costs often leads to poor reports. While economy in operation must be sought, it may be unwise economy to save a few cents on a credit report which is to be the basis for dealings running into the hundreds of dollars.

In summary, it is believed that the local retail credit bureaus are doing a good job—not the best job which might be done but a good job and one which is being constantly improved.

REVIEW AND DISCUSSION QUESTIONS

1. Distinguish between the two basic types of purchased informational credit reporting services (when area is the basis of classification).
2. What is meant by a mutually owned credit bureau? By a privately owned bureau?
3. Explain what is meant by a "black" list?
4. Trace the beginning and development of the local retail credit bureau.
5. Trace the beginning and growth of the Associated Credit Bureaus of America.
6. What is the principle of "give and get" in credit bureau operation?
7. Why must credit bureau work be highly confidential?
8. What procedures are followed to make credit bureau information highly confidential.
9. What are the principal sources of credit bureau information? Discuss each source briefly.
10. What are the data reported on ACB of A Report No. 1?
11. How has the prepaid inquiry ticket helped the operations of the local credit bureau?
12. Explain the statement, "The heart of the credit bureau records is the master file."

13. What does the master card generally show?
14. What methods may be used to furnish subscribers the reports prepared by the credit bureau?
15. Review the list of reports available from a local credit bureau.
16. What supplementary services do some credit bureaus furnish? Describe each service you have listed.
17. What methods of charging for their services do credit bureaus use?
18. What are the advantages and disadvantages of each method of charging?
19. What is your opinion of the value of the local credit bureau serving your area?
20. Tour your local credit bureau.

CHAPTER 12

Basis of the Credit Decision (cont.) —Other Sources

NOW THAT WE have examined the sources of consumer credit information which are characterized as *local* in scope, it is appropriate to turn to those sources which are national in their operations. In contrast with local credit bureaus which supply valuable credit information to users operating in local markets, the national agencies fulfill the needs of users selling in the national markets. The dominant companies which concentrate in the field of reporting upon individuals are the Retail Credit Company, its subsidiaries, and the Hooper-Holmes Bureau, Inc. The wholly owned subsidiary firms of Retail Credit Company are Retailers Commercial Agency, Credit Bureau, Inc., and the Credit Bureau of Montreal, Canada.

RETAIL CREDIT COMPANY

The Retail Credit Company of Atlanta, Georgia, has been selected as representative of the national firms which work on the plan of investigation by a staff of field men and which gather information to supply a specific request for a report. Although there may be differences in the operating procedures of the various companies which work on this basis, it is believed that Retail Credit Company is quite representative and that a description of its manner of operation and services will permit an understanding of reporting agencies of this type. The Retail Credit Company operates nationally and although it does not dominate the field of consumer credit reporting to the same extent that Dun & Bradstreet

does commercial credit reporting, it is correctly characterized as the Dun & Bradstreet of the national consumer credit reporting business.

History and Organization

The Retail Credit Company was started by Mr. Cator Woolford in 1899. His original purpose was to report on the credit of consumers to the retail merchants of Atlanta, Georgia. Developing some reputation for the quality of the information which he was able to supply, the founder soon found himself making reports to insurance companies interested in this sort of information for the purpose of underwriting. Under the impetus of this demand the operation was extended to Dallas, Texas, in 1902 and subsequently to other points, and the methods have been modified until the present techniques were developed as the basic pattern of operation. Although credit reporting was never abandoned and the name of the company has continued to emphasize credit reporting, the business of reporting to insurance companies for underwriting purposes quickly became more important than credit reporting. However, in 1935 the credit reporting side of the business was again emphasized by the organization of Retailers Commercial Agency, a wholly owned subsidiary, which was organized to specialize in credit reporting in major markets throughout the nation.[1] Further expansion of the credit reporting phase of the company came about with the acquisition of the Credit Bureau of Montreal, Canada, a few years ago.

The principle guiding the operation of Retail Credit Company differs from that of agencies where credit information is exchanged among members. Retail Credit Company gathers credit information through personal investigations made by field reporters ("inspectors," to use their term), rather than through the exchange of credit experience among members. When a subscriber requests a report on an individual or firm, the request is transmitted to the office which covers the territory in which the subject resides. Through this office the assignment is given to a field investigator who develops the desired information and writes the type of report designated by the subscriber.

The Retail Credit Company is well organized throughout North America and has branch offices in Canada, Cuba, Hawaii, Mexico, and

[1] Another wholly owned subsidiary, The Credit Bureaus, Inc., owns and operates local credit bureaus in many smaller cities, chiefly in the southeast. Since the bureaus owned by this corporation are operated in a very similar manner to the bureaus previously described and apparently are not integrated with the operations of Retailers Commercial Agency or Retail Credit Company, their ownership is simply an interesting aspect of company growth rather than a special type of credit reporting service.

Puerto Rico. In 1959, the company had approximately 7,500 full-time salaried employees, of whom about 5,200 were investigators. Full-time inspectors are located in 249 branch offices and in more than 1,000 additional cities. Practically all cities of 25,000 or more population and many smaller places are covered by full-time inspectors. Salaried reporters complete the major proportion of the reports rendered by the company. There are, in addition, more than 25,000 part-time reporters, or correspondents. The much more numerous correspondents give coverage in the smaller towns and villages. Correspondents may be bank personnel, local merchants, insurance agents, real estate brokers, retired citizens, or similar persons. Usually they know their community intimately and have access to excellent sources of information. In the early history of the company, considerable reliance was placed on such persons for the development of reports. The later history of the company has seen a shift toward larger proportions of reports being developed by salaried personnel who work at credit reporting on a full-time basis. For a map showing coverage of the Retail Credit Company's field organization, see Figure 12–1 (pp. 248–49).

Users of Retail Credit Company Services

Although Retail Credit Company does not publish information as to its volume of business, it was estimated in 1952 that the company completed more than twelve million reports yearly.[2] Volume of reports is substantially greater today inasmuch as the activities in which this company has a primary interest have greatly expanded. The services are used by subscribers of many types: insurance companies writing life, accident and health, automobile, fire, and casualty policies; financing and lending organizations engaged in installment financing, small cash lending, and real estate loans; manufacturers who sell on credit themselves or who desire reports to aid in the selection of dealers; merchants, especially those who sell over large territories or on a mail-order basis; oil companies; public utilities; federal agencies; publishers; service organizations; and others. A marketing research service is also available. This service is presently being used for research by magazine publishers, radio broadcasters, advertising agencies, and manufacturers for new or improved products.

Methods of Investigation

Many subscribers use reports for other than credit purposes, but the nature of the information is similar if not identical with the information

[2] John Garth, "12 Million Reports A Year," *American Business*, April, 1952, p. 8.

pertinent to a credit decision. Although the principal interest here is credit information, a rather complete description of the methods, whether for credit or noncredit in use, is necessary to understand the credit aspects of the service. Retailers Commercial Agency was organized to specialize in credit reporting services and operates in major metropolitan markets. Retailers and other users sign service contracts for credit reports, and if the Retailers Commercial Agency has no service in the area then the facilities of Retail Credit Company operate to gather the information and complete the credit report. Conversely, if the Retailers Commercial Agency is active in a market, its function is the supplying of credit reports. Thus, facilities of the Retail Credit Company and its subsidiaries are completely pooled, with the functions of reporting prescribed according to the organization in any particular market. For example, a major market may have a Retail Credit Company office to supply noncredit reports and a Retailers Commercial Agency office to perform the task of credit reporting.

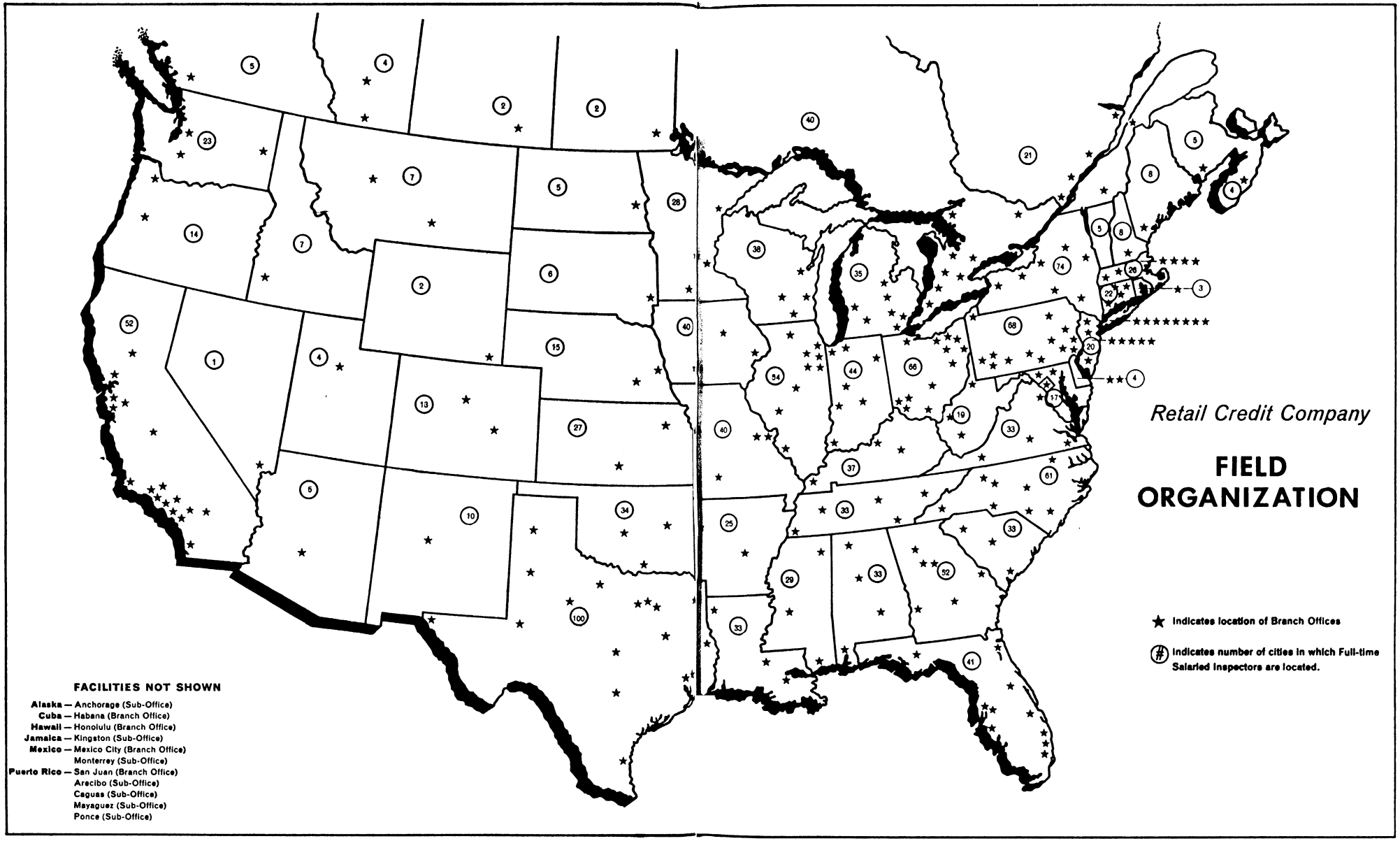
Credit and noncredit reports are supplied only to subscribers of the service. When a subscriber enters into a service contract, he is given a subscription code number, a pad of order blanks to be used in requesting reports, and various directories giving him the information as to offices covering the territories from which he may desire reports. Subscribers order reports by filling out an inquiry form. These forms cover the necessary identification of the person on which a report is desired, and the type of report requested. The inquiry form is then sent either to the branch office handling the subscriber's account, or directly to the office in the territory in which the subject of the investigation resides. By mailing direct to the office serving the territory, mail time is saved and by reporting directly to their customer, mail time on rendering completed reports is also reduced. Inquiry forms are finally routed to the Home Office in Atlanta, Georgia, from which the subscriber is billed for all reports supplied, thus avoiding duplication of billing and auditing.

The information for credit and noncredit reports is gathered in essentially the same way. The investigators gather their information by means of personal interview with business associates, friends, neighbors, tradesmen, former employers, and others. Retail Credit Company sets forth the following four steps to be followed by their investigators:[3]

Planning: Determination and location of best logical informants through reference of name of subject to city and telephone directories and other listings

[3] *Retail Credit Company—Description—Principles—Practices* (Atlanta, Georgia: Retail Credit Company, n.d.).

FIG. 12–1.



Courtesy of the Retail Credit Company

that indicate present and former connections. This step includes discussion of inspector's plan with his supervisor who may add suggestions based on a review of any file.

Investigation: Inspectors interview these logical informants. They introduce themselves as representatives of Retail Credit Company and do not give the name of company requesting the report. They engage in conversational interviews, leading these over the ground to be covered, briefly, courteously and in a businesslike manner. Unfavorable information is confirmed through two or more sources or through records and is supported by dates and circumstances as far as possible. Inspectors collectively make 60,000 to 70,000 interviews daily.

Discussion—with supervisor after investigation—to check accuracy and adequacy of information obtained. At this time any file is turned to the inspector to use as supplementary or confirmatory information.

Writing: Inspectors write their own reports in order to record their findings as directly as possible. They follow two basic principles:

1. Present facts only;
2. Avoid opinion or any coloring of information due to inspector's prejudice or tolerance.

In addition to the personal interview, reports may be verified or supplemented with information on file. It is estimated that company files have information on more than 33 million persons. Reports which are entirely favorable are held in file for 13 months; reports containing derogatory information are filed for five years; and any report which is extremely derogatory is held in file indefinitely. Current reports are checked against previous reports made within these time intervals so as to reveal inconsistencies and the relative improvement or deterioration of the subject's record, or to provide a basis for reinvestigation. In all cases the subscriber is assured that the report rendered has been currently checked by a field investigation.

Credit Reporting Services

Regular reports and special service reports are the two kinds of services available. Regular reports are somewhat standardized in that they cover specific facts commonly sought by the users of the service. Special service reports are made when a large amount of information is needed on an individual, and a minimum of one-fourth the lifetime of the subject is investigated. Regular reports are by far the most frequently requested by subscribers. Facts on these reports are to a great extent supplied by answers to specific questions or the filling in of blanks which deal with specific types of information. Some reports have space for narrative reporting. Character credit reports on individuals serve as an appropriate example of a regular report. This report on an individual covers employment, income, resources, personal living habits, associates, antecedent history, marital status, and payment record. The character credit report on farmers develops additional facts pertinent to the appraisal of a farmer's credit such as acreage cultivated, type of crops, equipment, livestock, and local conditions affecting farming. Although Retail Credit Company does not specialize in reports on business firms, such reports are made when requested and develop in addition to the information on the principal individuals, information concerning the business such as length of time in business, methods of operation, net

worth, and general reputation. For some purposes such as the issuance of a gasoline credit card, reports may be condensed; for other purposes, they may be extended.

Retail Credit Company has developed a variety of reports designed to yield the special information needed for subscriber's particular purposes. In credit reporting this has led to variation of reports to cover installment purchases, real estate transactions, and gasoline credit cards. There has also been some special variation to appraise the quality of dealers and agents. In many respects the reports on smaller businesses reflect a desirable blend of personal information about the individuals operating the business and the business itself.

Through this diversity there runs a constant centralizing thread. This is the emphasis on character credit reports and the development of information through interviews with informants who know the subject personally. Thus with all the diversity of special reporting forms, there is certain basic credit information which remains almost a constant. This information may be seen under the various headings of the standard character credit report: identity, employment, finances, and character.

Figure 12–2 shows the character credit report (individual); Figure 12–3, the auto purchase report; and Figure 12–4, the petroleum credit report (individual).

Special Credit Services

In addition to specialized types of credit reports, Retail Credit Company offers some specialized credit services. For example, a sales finance company can have the collateral securing its loans to dealers on floor-plan financing checked by a representative of the credit company. This enables the finance company to assure itself the collateral is intact and in good condition without the time or expense involved in having an employee physically inspect the collateral. Similarly a mortgage lender can have reports made showing completion of a construction job upon which they have agreed to lend money. They can also purchase a record search report to determine properties returned for taxes or ownership of a specified parcel of real estate. A creditor can also have a special report made on a delinquent purchaser. This will emphasize property ownership and other assets held, the knowledge of which will aid in the decision to collect through legal processes. Special reports are also made which are designed to aid in locating missing debtors or "skips."

Another special report is the *personnel selection report* which emphasizes the type of information especially desired by personnel depart-

FIG. 12–2. Character credit report (individual).

RETAIL CREDIT COMPANY
CHARACTER CREDIT REPORT
(INDIVIDUAL)

CONFIDENTIAL

Acct. No. | File No.

_____ OFFICE

Date

NAME (& Spouse)

Address

Emp-Occ.

Bus Add.

REPORT FROM _____ (If not city in heading)

_____ (State whether former addr., etc.)

Transaction:
Amount $
Mo. Notes $

			1. You?	Informants?
IDENTITY:	1	Time known (years) by you and each informant?		
	2.	Are name and address correct as given above?	2.	
	3	About what is age? (If around 21 verify if possible)	3.	
	4.	Is applicant married, single, divorced or widowed? No. dependents?	4.	No. dependents
	5	What is racial descent?	5.	
EMPLOYMENT:	6	Name of employer? (Give name of firm.)	6.	
	7	What is nature of business? (State the kind of trade or industry.)	7.	
	8	Position held—how long? (If less than 1 year, explain.)	8.	How long?
	9	Work full time steadily? (If not, how many days per week?)	9.	
	10	Are prospects for continued permanent employment good?	10.	
FINANCES:	11	What would you estimate NET WORTH?	11. $	
	12	Of what does worth consist principally? (Real estate, cash, stocks, bonds, etc.)	12.	
	13	Does applicant own home, rent or board?	13.	
	14	What is ANNUAL EARNED INCOME from work or business?	14. $_____	Exact ☐ Estimated ☐
	15	ADDED ANNUAL income from investments, rentals, pensions, disability, etc.?	15. $	Source:
	16	If spouse employed, give name of employer.	16.	
	17	Position held—approximate ANNUAL INCOME.	17.	Income $_____
	18	Approximate number of years employed.	18	
CHARACTER:	19.	Is reputation as to honesty and fair dealing good?	19.	
	20	Do you learn of any illegal activities, or domestic troubles? (If so, explain.)	20.	
	21	Any illness (physical or mental) affecting ability to pay? (If so, explain)	21	
CREDIT RECORD:	22	Do you learn of any failures, bankruptcies, mortgage foreclosures, suits, judgments or garnishments against him? (If so, state which. Give details.)	22.	
	23	Do you recommend doing business with applicant on a credit basis?	23.	

24. CREDIT RECORD Set out CREDIT RECORD in tabular form below.

25. BUSINESS-FINANCES Comment on present and past business connections, irregular employment or lack of stability, ability to manage finances.

26. PROPERTY: Show all property owned (both real estate and personal) and estimate value.

Kind of Business	*How Long Selling*	*Date Last Sale*	*Highest Credit*	*Terms of Sale*	*Amount Owing*	*Amount Past Due*	*Paying record on: Specify 30, 60, 90 days, etc. (Is this in accordance with terms?) If Contract Acct., so state.*

RETAIL CREDIT COMPANY

Signature of person making report _____

Form 63-LB—4-46 Printed in U. S. A.

CHARACTER CREDIT REPORT—INDIVIDUAL

Courtesy of Retail Credit Company

FIG. 12–3. Auto purchase report.

RETAIL CREDIT COMPANY
AUTO PURCHASE REPORT

Acct. No _____

Founded 1899

CAUTION TO INSPECTOR: *In making this investigation, do not under any circumstances contact the interested auto dealer.*

_____ OFFICE

Make and Model of Car or Truck.

Terms of Sale

File No _____ CONFIDENTIAL

			You?	Informants?
IDENTITY:	1.	Time known (years) by you and each informant?	1	
	2.	Are name and addresses correct as given above?	2.	
PERSONAL:	3	About what is his age? (If around 21, verify if possible.)	3.	
	4.	Is he married?	4.	
	5	How many are dependent on him, including wife?	5.	
	6.	What is his racial descent—Greek, Hebrew, Anglo-Saxon, Negro, Italian, etc.?	6.	
	7	Does he own his home? (If not, state whether he rents or boards.)	7.	
PRESENT EMPLOYER:	8.	By whom is he employed?	8.	
	9	What is nature of business?	9.	
	10	What position does he hold?	10.	
	11	How long has he been in present connection?	11.	
INCOME:	12.	What is his gross ANNUAL income from all sources? (If a farmer, total figure should include gross cash income from sale of crops, live stock, poultry, dairy products, crop control, bonus, odd jobs, etc.)	12. $	
CONFIRMATION OF PURCHASE:	13	Has he recently purchased a car or truck?	13.	
	14	If so, what make is it?	14.	
CREDIT RECORD:	15	Check how he pays his bills	15	Prompt ☐ Satisfactory ☐ Slow ☐ Unsatis. ☐
	16	Is his reputation as to honesty and fair dealing good?	16.	
	17	Has he had an auto or other goods repossessed in the past?	17	
CONFISCATION HAZARD:	18	Any business connection, past or present, with illegal or non-tax-paid liquor? (If so, has he been arrested for violating liquor laws?)	18.	
DRIVING REPUTATION:	19	Is he a capable and considerate driver?	19.	
	20	Who else drives his car?	20.	
	21	Are these other drivers capable and considerate?	21.	
	22	Does he or any other driver of car drink to boisterousness or intoxication?	22	
LOSSES:	23.	Do you learn that he or other drivers have had any accidents?	23	
	24.	Has he had any total or partial loss of an auto by fire or theft?	24	
	25	Do you recommend him for purchase of auto on installment plan?	25	

Form 65—11-41 printed in U.S.A.

Inspector: Amplify below unfavorable or irregular answers to any questions above.

REMARKS: (Please write a separate paragraph on each)

26 BUSINESS HISTORY—CREDIT RECORD Tell of his former business connections and occupations Does he change positions frequently? Is outlook for steady employment good? Tell how local merchants and banks regard him as a credit risk.

27 IF REPORT COVERS A FARMER, is he considered a successful farmer, does he own his farm, how many acres, what are main crops or sources of income and are prospects good for current year?

28. IF REPORT COVERS A WOMAN, give name and occupation of husband (if married) or father, his net worth and annual income.

RETAIL CREDIT COMPANY

Signature of person making report _____

AUTO PURCHASE REPORT

Courtesy of Retail Credit Company

FIG. 12–4. Petroleum credit report (individual).

RETAIL CREDIT COMPANY
RETAILERS COMMERCIAL AGENCY, Inc.

CONFIDENTIAL

PETROLEUM CREDIT REPORT (Individual)

File No

Acct No _____ Report made by RCCo ☐ Retailers ☐ _____ OFFICE

REPORT FROM _____ _____
(If not city in heading) *(State whether former addr., etc.)*

			1. You?	Informants?
IDENTITY.	1	Time known (years) by you and each informant?		
	2	Are name and address correct as given above?	2.	
	3	About what is age? (If around 21 verify if possible)	3.	
	4	Is applicant married, single, divorced or widowed? No dependents?	4	No dependents
	5	What is racial descent?	5	
EMPLOYMENT:	6	Name of employer? (Give name of firm)	6	
	7	What is nature of business? (State the kind of trade or industry)	7	
	8	Position held—how long? (If less than 6 months, explain.)	8.	How long?
	9	Work full time steadily? (If not, how many days per week?)	9	
	10	Are prospects for continued permanent employment good?	10	
FINANCES:	11	About what would you estimate his net worth?	11	
	12	Does he own or is he buying his home?	12.	
	13	About what is his annual income from all sources?	13	
	14	If spouse employed, give name of employer	14.	
	15	Position held—approximate ANNUAL INCOME.	15	Income $_____
	16	Approximate number of years employed	16	
	17	Does he have the reputation of paying his bills?	17	

REMARKS: (a) Cover credit record by giving narrative statement as to kind of business extending credit, how long selling, highest credit extended, amount now owing, whether past due and paying record

(b) Amplify any answers to the above questions if needed, and comment on any unfavorable circumstances that would affect desirability for credit (such as financial difficulties, irregular employment, lack of stability, etc). Otherwise, no comment necessary.

Signature of person making report _____

Form 816—9-37 Printed in U. S. A. PETROLEUM CREDIT REPORT (INDIVIDUAL)

Courtesy of Retail Credit Company

ments. These are expanded investigations showing a complete record of employment, previous employment, education, health habits, and personal traits. Such reports usually provide a record over a period of at least five years instead of the one-year minimum, more common in other types of reports.

Foreign service reports for Canada and Central America are also available through Retail Credit Company's foreign service department.

Disappearance Broadcasts

The disappearance broadcast is another example of a special service which was recently added. The basis of this service is the extensive files in the various branch offices. By subscribing to this service at a cost of $10 to $12 per name, a concern can have the name of a "skip" broadcast to all branch offices. At each of these offices a special notice is placed in these files at the proper alphabetical spot. If and when the person sought appears in any of these files, notice is immediately given the client. Special delinquent purchaser reports may then be requested, and the creditor can determine what action to take to effect collection from his missing debtor.

Cost of Services

The most common basis of charge used by Retail Credit Company is on a price per report, the rate varying with the type of report and with the reporting point but generally ranging from $2 to $5 per report, with the higher rates applying in metropolitan areas and in more extensive reports. Certain types of service, such as property checks, car checks, and other unstandardized reports or services, carry special rates or may be priced on an hourly rate basis of $4 to $5 or more depending on the city in which the investigation is to be made. The disappearance broadcasts as previously mentioned carry rates of from $10 to $12 per name. For special speed all wire service is available at a slightly additional charge plus the cost of the telephone and telegraph expense incurred. Service is rendered on an open account basis when annual usage will be $200 or more; when annual usage is less than $200, a service charge of $25 is required in advance.

Evaluation of Service

Retail Credit Company and Retailers Commercial Agency, and other subsidiaries, supply a valuable addition to the credit informational facilities available to creditors. Their reports are standardized, thus regardless of point of origin the quality of the report and the type of informa-

tion supplied will conform to the standards set by company policies. Supervision is close, and even when reports are submitted directly to the client there is a copy filed at the branch office. This copy is reviewed for quality and criticized when not up to standard. Similarly at the home office, reports are audited from time to time for quality, and offices criticized or commended on the basis of this review. The form of the report and the operating standards are such that the substitution of opinion for fact is discouraged, and the reporter is not supposed to give his personal judgment except in the portion of the report clearly so labeled. The agency attempts to be only a reporter of the record, not the maker of the record—they do not make the record nor do they evaluate it—they simply gather the information which their clients may analyze and evaluate.

Costs are standardized. The subscriber knows exactly what each type of report from each point will cost. Because of centralized billing, a single account is rendered regardless of the origin of the reports. This feature is especially appealing to firms doing a national or extensive regional credit business.

That the operation is efficient seems amply demonstrated by the remarkable growth of the company. In a half century it has developed from a purely local business into a national, even an international business. It has enjoyed a constant growth which during recent years has accelerated. The cost of the reports has been held down despite constantly rising expenses, especially wage rates. Considering the amount of information supplied, the cost per report is remarkably low. This in fact may be a disadvantage because the effort to hold down costs leads to pressure on inspectors to handle a large daily quota of reports with consequent deterioration of quality or the use of short cuts to report making. Perhaps creditors who insist on low report charges are to be blamed for these pressures which result in poorer quality reports.

Although Retail Credit Company was attracted, or diverted, from credit reporting into insurance reporting, the company now seems to be once again putting more emphasis on credit reporting with consequent improvement of its credit reporting. For any credit department which does more than a strictly local business, it would seem that this is a credit service designed to be of value and assistance.

SPECIALIZED CREDIT BUREAUS AND OTHER SOURCES

In addition to the retail credit bureaus and the several national credit reporting companies, there is a number of specialized credit reporting

agencies throughout the country. Some of these serve particular professional groups, while others are organized to do a highly specialized type of reporting. The medical and dental profession has available to it the Medical Credit Bureau. This organization is believed to be nationwide and has a collection service as well as a credit-reporting service. Much educational effort has been expended in orientating medical doctors and dentists in the matter of credits and collections. These professions have had a history of poor financial management, but the educational programs of the American Medical Association, American Dental Association, and credit groups have done much to overcome past business practices. In some cities the Medical Credit Bureau is a division or closely associated with the local credit bureau. In other cities separate bureaus are in operation for the exclusive use of these professions. The services and reports to the medical and dental users do not differ fundamentally in character from the types of services rendered businesses. It is thought, however, that this development has had a substantial effect on these professions adopting more uniform credit and collection procedures.

Small loan companies and a few other financial institutions have established what are generally known as "lenders" exchanges. These exchanges operate in some metropolitan markets for the express purpose of servicing particular types of lending and financing institutions. It is their function to keep master records of all loans or contracts financed by their members. The records are maintained so that a rapid check can be made on the loans outstanding against a prospective loan customer for which an inquiry is initiated. Telephone inquiries are made by subscribers and immediate reports received. This service supplies the subscriber with a listing of outstanding loans against a potential debtor and the identity of the lenders. Directing an inquiry to the lenders having had or currently having experience with the subject quickly ascertains their payment record experiences with the debtor. The subscribers or members of the exchange are obligated to disclose their loan activity by individual name, hence a complete record of the subject's similar dealings is available. Exchanges as described here more frequently service the small-loan industry of a particular metropolitan area. In some cities, banks and sales finance companies also make use of similar facilities.

The network of credit investigating facilities in the United States conforms to the needs of practically all types of creditors. So complete and highly developed is this phase of credit granting that as a practical matter any credit grantor has credit information sources which are easily and rapidly available to him. In those instances where the more stand-

some unique requirements, there are other sources of information available to him. Lawyers, bank personnel, and others with intimate knowledge of a community may be valuable sources of credit information. On occasion Dun & Bradstreet services might be used as a source of consumer credit information. Even though Dun & Bradstreet does not purport to gather consumer credit information, its ratings apply to individuals as well as businesses in some instances. Individual proprietorships and partnerships are frequently of such a nature that the credit reputation of the business and the individual is one and the same. Banks, as well-known subscribers to this service, may find the services a reliable source of consumer credit information when the business and individual reputation are known to be so regarded.

Intelligent selection of a reliable source of consumer credit information contributes to risk minimization. Risk minimization must be gained at relatively low cost. The vast majority of services today is standardized to meet the information needs of creditors. Standardization which has made possible low-cost credit reporting may reveal more information than is sometimes needed, and on occasion less information than is desired. However, the economical and factual reporting as developed by various information sources has become an indispensable tool to a rational and sound credit decision.

REVIEW AND DISCUSSION QUESTIONS

1. Distinguish between those credit reporting agencies that are local in nature and those that are national in nature.
2. Trace the history, organization, and development of the Retail Credit Company.
3. How does the principle guiding the operations of the Retail Credit Company vary from that of agencies in which credit information is exchanged among members?
4. How has the credit reporting side of the Retail Credit Company business been emphasized in the past 25 years?
5. Who uses the services of the Retail Credit Company?
6. What methods of investigation does the Retail Credit Company employ?
7. What are the four basic steps followed by the Retail Credit Company investigators? Describe each step in detail.
8. Describe the credit reporting services of the Retail Credit Company. The special credit services.
9. Compare the costs of the Retail Credit Company services with those charged by the local retail credit bureau serving your area. How do you account for the differences?
10. Describe some of the other types of specialized credit bureaus.

CHAPTER 13

Final Analysis, Decision, and Setting of Credit Lines

DECISIONS MUST be made in all credit work. Credit is offered by customers for goods and services, and credit managers must decide rapidly whether to accept or refuse the credit transaction. Judgment should be based on the information that is readily and economically available and most pertinent to the problem and on an analysis that is sufficiently penetrating to make the available data yield the greatest help possible in arriving at a correct and right decision. Generally the information at hand, or readily available without excessive cost or undue delay, is incomplete. Thus the facts that are obtained through the credit investigation must be used to the utmost in order to offset this common deficiency.

Good judgment is one of the most difficult skills to develop and one of the skills most necessary to the credit manager. Because it is so difficult to develop good credit judgment, too many credit managers have emphasized unduly the negative aspects of credit decisions. Errors of judgment as revealed by bad debt losses are quite evident, but errors of judgment resulting in lost sales are well hidden. Thus the easy route is to err through excessive refusals of doubtful credit transactions. Sales lost because of refusals to sell accounts which would have paid and which would in turn have contributed to profits are difficult to total.

Errors of judgment may arise from insufficient information, misleading or false information, or improper interpretation of the data on hand. The investigation should be adequate to supply sufficient information on which to base a decision and should at a minimum reveal false information as well as give a basis for properly interpreting data which otherwise

would be misleading. Unfortunately the pressures of time and of costs and the desire for sales often cause inadequate investigations and faulty decisions. Faulty investigations tend to increase collection costs and bad debt losses, whereas excessive investigations tend to increase investigation costs and to lose time as well as to produce customer irritation. The credit manager thus continually attempts to walk the narrow path, or tightrope, between both extremes, hoping to compensate for the lack of data by more careful analysis and relying perhaps too heavily on the belief that most people are honest in order to protect himself from excessive losses.

As previously pointed out, the credit investigation brings together the raw materials which are processed through the credit analysis in order to get the final product, *the credit decision.* It is this end product which is the objective of all the efforts directed toward gathering information and of all the skill exercised in the analysis of the information.

DECISIONS—THE ESSENCE OF CREDIT WORK

In the operation of a credit department many things are done—applications are taken, investigations are instituted, credit files are opened, accounts are controlled, credit records are maintained, customers are billed, collections are pressed, and adjustments are made. However, the really critical portion of the work is arriving at credit decisions. When credit decisions are formed on the basis of accurate information, properly evaluated, and carefully analyzed they will reflect sound and rational judgments. They may not always be free from error—no prediction of the future can be 100 per cent correct—but they will be right in a sufficient proportion of the cases to conform to the credit policies previously established.

Analysis and decision are necessary in every consumer credit transaction, and each transaction is an individual transaction. In all instances credit is offered by the customer in payment for goods or services; the credit department must decide whether to accept or refuse this amount of credit from this particular individual. At the time of acceptance it is expected that this amount will be paid by this individual at some predetermined future date. When a predictable loss account is accepted, it should be called by its proper name, charity not credit.[1] Of course some

[1] Failure to recognize the distinction between charity and credit causes many doctors to complain of large bad-debt losses. The doctor often feels that he cannot refuse to give a patient the benefit of his skill even though there is no prospect of payment. If such contributions were correctly labeled as charity rather than entered on the books as credit, he would not confuse his charity cases with bad-debt losses.

of the accounts which appear safe when they are opened or when additional charges are added to them will eventually fail to pay. Such defaults in payment are inevitable when a forecast of the future is made, especially when it is made on the basis of incomplete information. It should be remembered that the information at hand is always somewhat incomplete, since time and costs do not permit complete information for the usual case. Also the information may not be completely accurate. In the face of sometimes inaccurate and always incomplete information, greater analytical skill must be employed to balance these defects of the information. In any event it must be remembered that the goal must not, indeed it cannot, be perfection in the sense of no losses. It must rather be losses within the limits set by the credit policy. To this end the evaluation and analysis can contribute to sounder credit decisions.

EVALUATING AND ANALYZING CREDIT INFORMATION

As mentioned previously, credit information is necessarily somewhat incomplete. It is needlessly costly and time consuming to try to make it complete. In addition not all information will be verified; some of the information must be accepted as the basis for decision without verification; and some will be verified only by reasonable inference. Despite these limitations, it is believed that the first step of the analysis should be to evaluate the credit information at hand. This step of evaluation should be based on a complete review of the credit file and an examination of all information therein. During this examination the two questions, "How complete is the information?" and, "Is the information verified?" should always be in the forefront of the analyst's thinking. The source of the information will lend greater or lesser credibility to certain statements. Other statements may be considered reliable because they are consistent with other facts. By way of illustration, the salary or income claimed by a credit applicant has not been verified through his employer or other sources; we only have the statement on the application. However, we know it is in line with the community level for similar occupations or it is consistent with the amounts paid by that employer. The length of employment has not been verified either, but it coincides with information at hand relative to the period of residence in the community and the stated age of the applicant. Or as an example of negative evaluation, there is one very favorable reference letter in the file; however, the writer is not personally known to us and from the appearance of the letter it is from an individual, a personal friend of the applicant. Conversely the information from known informants may be

considered more reliable than that from those unknown, or information from a professional credit reporting source may be evaluated higher than information from personal sources.

It is not suggested that evaluation of credit information be made a separate part of the credit analysis. It is suggested, however, that prior to analysis the entire file be reviewed for credibility and completeness. If sufficient information is not at hand, the investigation should be extended. Under these conditions the specific character of information still needed is known, and the additional investigation can be pointed toward obtaining the exact data desired. When the information is not regarded as reliable or believable, the points in doubt can be cleared up by directing the additional investigation specifically toward these issues. In addition to this review prior to the analysis, the evaluation should be continued during the course of the analysis. As each element of the credit case is examined the judgment of its quality should be mentally tested against the evaluation of the information as to completeness and credibility. Thus when the final credit decision is reached, its reliability or unreliability can be based on the completeness and credibility of the source information.

CREDIT IS RELATIVE

It has been pointed out in previous chapters that the particular credit must be measured against the standards of certainty of payment and found acceptable or unacceptable on the basis of the standards established by the credit policies of the firm. In effect the determination must be whether or not the particular case falls within the limits established by these credit policies. Obviously judgment is necessarily relative, not an absolute certainty—it is relatively good or relatively poor against a somewhat intangible standard. Judgment is necessarily subject to error and information is necessarily somewhat incomplete; accordingly the decision can at best be only a close approximation of reality.

An aid to careful interpretation is to separate the total quality of the credit into the specifics or elements of the credit. The quality of the whole is in effect the net summation of the quality of a number of credit elements or pieces. When each factor of the credit is considered separately, the judgment about each can be arrived at somewhat independently without the reflection or halo effect which certain elements are likely to cast over the whole. When a credit decision is made on an overall basis—the credit is acceptable, or the credit is not acceptable—one or two very favorable elements are likely to exercise an undue influence on

the judgment. The decision-making process is better when each pertinent element is considered separately and given its proper appraisal. This tends to avoid overlooking items which are pertinent, or giving relatively unimportant items excessive weight, and it gives more assurance that all available evidence is brought to bear upon the problem in a properly weighted fashion. Unless the available evidence is carefully analyzed, the decision is liable to be faulty.

GRADING AS AN ANALYTICAL DEVICE

Two major points have been emphasized thus far: (1) credit quality is a relative evaluation, not an absolute measurement; and (2) measurement of a number of specific factors is likely to be more accurate than a single over-all judgment. In the decision-making process these two generalizations may be attained through the device of grading the credit. Grading the credit is simply the examination of evidence and the recording of the quality judgment drawn from specific evidence bearing on specific factors in an orderly manner. It is the assignment of a quality grade (such as A, B, or C) to each pertinent element of the credit appraisal and finally assigning a summary grade which reflects the combined judgment of the whole credit.

Separate grading of all factors pertinent to the decision permits these specific factors to be appraised independently on the basis of evidence relevant to each. By assigning a quality grade the relative evaluation is recorded for that factor. Skilled and experienced credit personnel do this automatically, perhaps unconsciously. A formal grading device and system assures that the less experienced person will do what the more experienced credit analyst does informally. By working through a rather formal method of grading, the beginner is assured of sound analytical practices and begins to employ good habits or analysis. Thus the product, the credit decision, will be improved and will become more standardized.

By making the grading process formal and systematic the beginner is assured that all elements pertinent to a decision have been considered; that all available evidence has been used in reaching a decision. He also can have before him the extent to which the information has been verified, and if he is unable to reach a decision because of insufficient verification or inadequate information he can proceed to verify more evidence or to gather additional information. In other words, the process of grading also can indicate the extent of the investigation needed and point to the sort of investigation that will be most rewarding in the specific case.

ELEMENTS TO BE GRADED

Certain classifications of evidence are almost standard subjects for analysis in any consumer credit appraisal. Certainly evidence relative to income, employment, and payment habits would be accepted as essential in any analysis. Some additional qualities such as residence, marital status, age, reserve assets, references, and reputation may be more debat-

FIG. 13–1. Open account grading form.

Credit Qualities	Grade			Verified
	Good A	Fair B	Poor C	
Income				
Employment				
Residence				
Marital status				
Age				
References				
Reserve assets				
Payment record				
Reputation				
Summary—over-all appraisal				
Decision Limit Special Conditions·	Accept_____ Refuse_____ $_____			

able. Obviously no one list of qualities will be accepted by all credit analysts, nor will any one list best meet the needs of all credit situations. For example, analysis of an installment purchase becomes more meaningful when equity in the purchase is added. When the dealer has some contingent responsibility, as is often the case when such paper is discounted with a sales finance company, the dealer's credit standing attains added importance. Similarly when analyzing a cash loan the grade assigned to collateral usually has considerable meaning and the purpose of the loan may be a classification of evidence worthy of having a grade assigned to it.

The grading forms which follow (see Figure 13–1) illustrate classi-

fications of information which are important to a credit decision and include those qualities which are sufficient to assure a complete appraisal of the credit applicant. For practical reasons it is suggested that the credit qualities to be graded should be limited in number—too long a list makes the operation unduly time consuming and also causes difficulty in

FIG. 13–1—*Continued.* Cash loan grading form.

Credit Qualities	Grade			Verified
	Good A	Fair B	Poor C	
Income				
Employment				
Residence				
Marital status				
Age				
References				
Reserve assets				
Payment record				
Reputation				
Collateral				
Purpose of loan				
Summary—over-all appraisal				
Decision	Accept_____		Refuse_____	

appraising the evidence sharply. Too brief a list of qualities may not bring all the evidence into sharp focus, since it causes judgments to be formed on the basis of an unrepresentative list of qualities. The items suggested are intermediate between an extended list and an abbreviated list and are about the number which experience indicates to be practical in an operating sense.

Illustration of Grading Income

It also must be noted that the evidence obtained during the course of the investigation does not fall into neat and mutually exclusive classifications consistent with the qualities which it may have been decided to

grade. The same items of evidence, or the same factual information, may be used in determining the grade on several qualities. This situation will be apparent as illustrated in the grading of income in the following example.

Let us start with these limited facts. The subject is named John Doe,

FIG. 13–1—*Continued.* Sales finance credit grading form.

Credit Qualities	Appraisal before Investigation			Verified or Developed by Investigation*		
	Grade			Grade		
	Good A	Fair B	Poor C	Good A	Fair B	Poor C
Income						
Employment						
Residence						
Marital status						
Age						
References						
Reserve assets						
Payment record						
Reputation						
Equity in purchase						
Dealer credit standing						
Summary—over-all appraisal						
Decision	Buy_____ Reject_____			Buy_____ Reject_____		

* This particular form is designed for use in those cases in which the repurchase agreement is in effect.

Note The forms illustrated and much of the discussion which follows on the subsequent pages are based on material appearing in H W Huegy and R S Hancock, *Credit Problems* (Champaign, Ill : Stipes Publishing Co., 1956).

and he receives an income of $100 a week. With these limited facts it is difficult to grade the income for nothing is known of the certainty of its continuance nor of the demands upon it. It cannot be said whether it is adequate without knowing: adequate for what? or whether it is certain without knowing: relative to what? If we add the information through a telephone call to the employer that he is employed as a cutter

in a local shoe factory, has been so employed for seven years, and is 31 years old, a judgment can be formed that the income is likely to continue based on his age and length of employment. Of course, the judgment becomes better if through knowledge of local conditions something is known of the shoe business and the market position of the local shoe factory. Knowledge is further improved when something is known of the employment policies of the local company. These comments illustrate the value to the credit analyst of general knowledge of local and national business conditions.

With the facts now before us we might be warranted in assigning a grade of A on the income quality of the credit although we still would not be able to grade exactly on the issue of relative adequacy of the income. The information about income also is verified and may be so noted on the grading form. Other facts may help us to grade by forming a judgment as to adequacy. Suppose we add the information that he is married, has one child, and has lived in the community for 15 years. On the basis of the information before us, we now might be willing to assign a grade of A to income and to consider the grade verified. Income of $100 a week, which on the basis of 7 years employment with the same company in a skilled occupation is reasonably certain to continue, should be adequate to the needs of a married couple with one child.

To illustrate the sort of information which might cause a change to a lower grade, some facts might be added which makes the income appear somewhat inadequate. Illustrative of this situation would be the existence of other obligations. Let us assume that the credit bureau reports the John Doe's have purchased their home and have contracted to make payments on this purchase of $85 a month; they also are buying a Pontiac automobile purchased 15 months ago upon which they have contracted to make 18 payments of $90 a month; a department store reports a balance of $127 with payments slow; a clothing store balance of $57, payments 60 days slow; and a men's store reports no balance now, were slow. This family may have assumed commitments which are excessive relative to the income.[2] Because the income may not be adequate relative to the obligations, a grade of B may be assigned to the income in the light of these new facts.

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[2] Undoubtedly, this statement will be challenged by some readers. One commercial bank lender has pointed out that by his rule of thumb of salary alone this customer would be worthy of credit in the amount of $500 above and beyond the commitments for house and automobile. He also pointed out that although the slow pay might in some instances cause the bank to say "no," or in other instances to consolidate the debt or to reduce the amount which might be granted, the bank might be willing to lend as much as $300 for reasonable purposes.

A grade of C would be warranted if the information indicated the continuance of the income to be doubtful; for example, knowledge that the shoe factory was about to shut down for 60 days because of a lack of orders. Or a grade of C might be correct if the occupation was less regular than is the case with a skilled worker in a shoe factory; for example, if John Doe were a construction worker in the common-labor classification.

PROCEDURE IN USING GRADING FORMS

When using the grading forms previously illustrated, or similar forms, the credit analyst records his appraisal of each credit quality in the appropriate column. These columns may be considered adjectively; good, fair, or poor. Or they may be given letter grades; A, B, or C. Only a threefold division is suggested since finer gradations may confuse the process more than they would contribute to the end result. The description of the general grading standards suggested is as follows:

A, or good, should be assigned to those credit qualities which indicate that the credit will be redeemed with no more than normal difficulty or effort.

B, or fair, should be assigned to those credit qualities which indicate that the credit will be redeemed but only after abnormal difficulties or delays and in response to active collection effort.

C, or poor, should be assigned to those credit qualities which indicate that the credit will not be redeemed.

Although as illustrated earlier the same information may be used in grading several specific credit qualities, the analyst should attempt to keep the qualities separate in his mind as he works. Thus although existing obligations and manner of payment may be used to qualify the income as adequate for the obligations and family responsibility, he should use these only as they apply to income when that quality is considered. When he considers them under the payment record quality, he should eliminate the income factor from consideration and grade separately on payment record. Only by so doing can the individual qualities be given their proper importance in developing a properly weighted summary judgment.

The summary grade or over-all appraisal should not be an average of all the grades nor should it be an addition of the respective individual grades. There is considerable temptation to give each a numerical value and to weight them so the total would be 100 were they all A, with a passing grade of say 70 required for acceptability. Such a system could be

devised and it would have an appearance of scientific evaluation. Unhappily such appearance would be misleading. What grading should accomplish is a prediction of credit experience. This prediction, or forecast, should reflect the best possible over-all judgment considering all the evidence at hand. Earlier grading was recommended as a device which would assure that all pertinent factors were considered and would avoid being unduly influenced by a single especially favorably or especially unfavorable piece of evidence. Now caution is suggested against not being influenced by a single unfavorable, or favorable, credit quality. In the final prediction a single highly unfavorable quality (for example, inadequate or uncertain income; a very adverse payment record; or a reputation for very poor morals) might very properly dictate the grade. Any one of the above might well justify a grade of C even though all other elements of the credit appraisal were favorable. After all the end result is a credit decision which, after considering all the evidence and properly analyzing it, forecasts the credit experience that it is reasonable to predict. Although the forecast cannot be 100 per cent correct, the orderly and systematic making of it should improve the accuracy of decision making.

The summary grades may be defined as follows:

A, or good, predicts excellent to satisfactory experience. Clearly the credit is acceptable.

B, or fair, predicts possible unsatisfactory experience but not so clearly predictable to warrant rejection. Although credit losses and excessive costs will arise from the handling of such accounts, it is not possible to label the one being graded as a certain loss. Thus it is profitable to handle this group, but cautiously. The maximum investigation and the most penetrating analysis should be lavished on such credits in order to screen out and reject those which should be more correctly labeled C.

C, or poor, predicts unsatisfactory experience with sufficient certainty that it will apply to warrant rejection. In other words, rejection does not deprive the creditor of a potential profit nor prevent a worthy customer from having his credit accepted. Instead it saves the creditor from a predictable loss and it prevents a debtor from adding to his unredeemable obligations.

A CREDIT DECISION IS THE PRODUCT

Properly used grading of credits should be an aid to judgment, not a substitution for it. The grading of credits makes certain that the analysis is orderly and systematic and that all significant elements are considered. The fact that grading is used as an aid to judgment also assures

that the investigation is more careful and that the information necessary to the case is sought and in large part is verified.

Grading is not itself the product sought; it is but a means to the end.[3] The end product remains *the credit decision.* A credit decision can be reached without grading the credit, in fact in most instances it is so reached. However, at least for the beginner it is believed that the decisions will be better when grading is used as an aid.

USE OF THE CREDIT GRADE IN OPERATIONS

When credit grades are used, their usefulness may be extended beyond the aid they supply to the making of credit decisions.

The summary grade is a prediction of future experience. This prediction may be used to determine the type of collection effort and the time when it is to be applied. Clearly when a credit which was graded C is up for collection, the gentler collection reminders should be abandoned quickly and more severe collection devices applied. Routine and reminder type of collections are not appropriate and early personal handling is indicated. Even the cases graded B will be pushed to a decision more rapidly than would be the case with those initially graded A. Thus the grading guides the intensity of collection effort and will assist in obtaining satisfactory results from lower quality credits.

The quality of business also can be analyzed by means of the credit grades assigned. Comparison of new accounts currently opened can be compared with accounts opened during past periods and a larger or smaller proportion of B and C credits can be taken as an indication that better or poor quality credits are being put on the books. Or when the business comes from different areas in a city the quality generated by various areas can be compared on the basis of the proportion of A, B, and C quality accounts. Various means of promoting credit sales can be compared on the same basis, and promotion by direct mail, or newspaper advertisements, or solicitation on the floor can be compared as to quality. These various comparisons which grading makes possible enable the credit department to be operated more intelligently and purposefully.

When several people are employed in a credit department, analysis of the grades assigned by each can be helpful in comparing their operations. Comparison of the actual experience of accounts can be made

[3] Some concerns, such as some personal finance companies and commercial banks, have a series of minimum criteria or hurdles that they use instead of or similar to the procedure as has been outlined above. If the potential borrower misses any of these hurdles, he gets no loan. If he gets over each hurdle, or meets the minimum criteria, he gets the loan.

with the grade initially assigned, and more uniform judgments may result from this educational experience.

The development of the grading technique and learning how to apply it is in itself a useful educational device. Credit analysis can become better because of the emphasis on improving the grading skill and comparison of actual experience with predicted experience will help in self-criticism and self-improvement. Also newer employees will learn the art of making sound credit decisions quicker when their decision making is channeled by the grading system. Consideration of the credit qualities and their measurement relative to payment probability help the new employee develop his analytical skill and improve his judgment.

SETTING THE CREDIT LIMITS AFTER THE DECISION[4]

The term "retail credit limits" is understood by credit personnel to refer to the maximum amount of credit which it is desired to permit the customer to charge. It has been suggested that a better term would be "guide" or "line"; since the limits are not considered as absolutes, but merely as guides in the handling of the account. They may be changed rather freely or even exceeded should circumstances warrant it. Regardless of what they are to be called, their usefulness in the operation of the credit system should be understood.

At the time an account is originally opened it is subjected to the most complete review and examination which it is likely to have for some time. At that moment it may be possible for the credit manager, or credit analyst, to set a more definite quantitative limit than he is likely to be in a position to fix at any subsequent time. He has just completely analyzed all the information available; he has thought more carefully about the payment possibilities of the account than he is likely to do at any future time. Why not at this point, state specifically the dollar amount for which he thinks the customer is reasonably good? Further, the effort to state specifically the amount which he would accept from the customer, will make the credit manager subject the account to a more careful and searching analysis than if he were merely to think of it in general te.ms. He must commit himself to a specific dollar figure. This necessarily makes for more careful and penetrating analysis than otherwise would be the case.

Are there any other advantages to the use of credit guides in addition to this stimulus to more penetrating analysis? By the use of credit

[4] Most of the discussion in this section applies only to the regular 30-day charge account.

guides, the manager is relieved of the responsibility of passing upon day-to-day transactions. His judgment is exercised at the opening of the account. If the judgment is sound, it will continue to control the account for subsequent use without further examination by the credit manager. Thus, during the normal life of the relationship, responsibility for additional charges to the account may be delegated safely to other personnel. This is a safe practice since they are merely following the routine procedure of approving the day-to-day sales within the control limit which has been established by the responsible executive, after the exercise of his most careful judgment. This relieves him of much of the routine work of handling the daily transactions. Further, being relieved of this routine work, he can more carefully perform the other difficult tasks which fall to his position. If he were to be responsible for routine tasks, as well as the major decisions on policy and other difficult problems, it is probable that he would perform the routine rather carelessly, attempting to approve day-to-day purchases from memory or after only a rather cursory examination of the credit file. By setting limits, the judgment is carefully reached, and future transactions are maintained in accordance with this original judgment by a rather routine, matter of form, check. In fact, even though a credit manager were to do all the authorization himself, he probably would find it a convenience and an economy in the handling of the routine portion of the task, to set limits and follow them.

Also from the standpoint of the customer, it is probably desirable to use limits, because this practice will tend to hold down his temptation to overbuy or commit himself beyond his ability to repay. This is avoided by the use and enforcement of the limits. True, he may not regard this as an immediate favor; in the long run, it may so work for him. One of the major sources of loss in the operation of a credit department is the acceptance of more credit than should have been accepted from accounts already on the books. There is a natural tendency for accounts to creep gradually; that is, to increase in size by a number of small purchases, or by methods of payment which do not completely liquidate the account. This leaves an increasing balance to carry over into the following month. Additional purchases are added to this account; and although a payment is made on account at the end of the month, a still larger balance is carried into the next month. This process of paying and increasing the amount rather gradually tends to lull the credit manager into a false feeling of security. Rather gradually the account is permitted to increase in size until he suddenly realizes that it has reached an amount larger than he would have thought the ac-

count good for, had he exercised his judgment in this respect or reviewed the account as a whole.

Further, the use of credit limits permits finer control of the account during the day-to-day operations. Suppose a person of rather weak credit desires to open an account. While the credit is not strong enough to convince the credit manager at the time of opening the account that he should carry it on an unrestricted basis, it may be believed that it is not bad enough to reject and that the customer is deserving of a trial period. Without the use of limits it is hard to enforce this period of trial. By the use of limits those accounts can be easily handled on such a basis. They may be opened with a very small limit, or with no limit, and put on a straight refer basis. This way the account will have every credit purchase scrutinized from a credit standpoint and, pending the period of trial, will be very closely supervised. After the period of trial the account may be put on a larger credit limit, or on an unrestricted basis and carried in normal fashion. Or we may have an account which is opened with a reasonable credit limit, but which has behaved in an unsatisfactory manner. Without limits it is hard to correct the handling of the account and approve day-to-day purchases in accordance with the manner the customer has treated the obligation. By using limits this account may be handled on a straight refer basis, or as an overlimit account, and every transaction will be carefully scrutinized.

Another situation arises when an account becomes delinquent. With the use of limits this delinquent account may be handled by placing every transaction on an approval basis. Thus small additional purchases may be charged, without imposing upon the customer the necessity of explaining how he plans to handle this account, and without exposing the store to the loss of customer good will which might arise from refusal to add fifty cents or a dollar on an account which is just slightly past due. But it avoids permitting a $30 or $40 addition to this account, if it is believed that this amount would place it beyond the customer's ability to liquidate in a reasonably short period of time.

It can be seen from this discussion that credit limits can be used as a very flexible means of controlling the account. Accounts that become delinquent may be cut off from further credit or handled on an individual basis. If accounts become too large they may be carefully watched. Accounts that are weak to start with may be watched from the opening of the account. Nor do they impose any restraint upon the making of any sale to customers because of the fact that they are overlimit; or that the limit was not set quite high enough, because the limit can be freely raised; or the account can be carried on an overlimit basis,

until payments by the customer reduce it to the amount which the store is willing to accept freely.

Although the use of limits is well recognized and their advantages are quite evident, it is difficult to recommend highly any one method for fixing the limit. Methods are necessarily rather inexact, and in many instances arbitrary. One method of setting limits is to assign arbitrarily the account to one of a number of classifications. The credit manager may be in the habit of using such amounts as $25, $50, $100, $200, or $500, or whatever the customary limits are which he uses. He attempts rather roughly to put the account into its proper classification as being a $50 or $100 or $25 or $10 limit account on the basis of the general impression left after careful analysis of the account.

Some credit departments attempt to limit the account to a certain period of time; that is, a month's purchases, a week's purchases, or some definite time. In some lines of trade this makes a normal sort of limit. Thus the milk company will accept credit equal to about one month's purchases. If they are attempting to control the account a bit more exactly, they may calculate the quantity which would be purchased over a month by a family of the size in question. This would give them a dollar figure, rather than just a period of time. The utility companies, such as the water, light, or telephone companies, are likewise almost compelled by the nature of their business to accept as a limit the quantity which may be used between meter reading and statement time. They may, of course, reduce the risk exposure somewhat by requiring a meter deposit or some protective measure involving advance payment, but in many instances these are being abandoned. A period of time constitutes a rather natural limit for the operator of, say a filling station, or the retail grocer. In some cases department stores and clothing stores have a tendency to arrive at limits by a calculation of the normal consumption in their lines which a family of the income and size in question might use during a period of time; this amount constitutes the limit. If the grocer, for example, were to figure that a family of a certain size and income would consume $100 worth of groceries in the course of a month, that he is willing to carry them for a period of sixty days, and that he may expect to get half of their grocery business; he would limit the account to $100. Upon exceeding this limit the family would be urged to make payment, or their limit would be raised, or their purchases would be restricted.

Another very common and practical procedure is to start low and raise with experience.[5] Customers will be started with a low limit of

[5] It is worthwhile to note that this procedure can be dangerous. Without having in mind a reasonable limit for the individual customer, the creditor may grant an excessive amount

$25, or enough to take care of the first purchase. As experience with the account accumulates, as they prove their ability to pay larger amounts, the limit is raised to take care of their purchases. If the experience is unsatisfactory and they do not prove capable of taking care of the purchases they have made, the limit either is held so as to restrain their purchases or it even may be lowered.

Some credit men in the course of the credit interview will persuade the customer to fix his own limit. Some of them accomplish this by asking, "What do you want as a limit on your purchases?" or, "Do you have any amount you want to place as a limit on your purchases?" Others will approach it a little more tactfully by asking the question, "About how much do you think you will buy in the course of the month?" After the customer has replied a suggested amount, the next statement may be, "Shall we then consider this as being the limit you place on your purchases?" or "Shall we then consider this as being the indicated maximum amount of your requirements?"

In this discussion it is not intended to imply that uniformity is to be sought, or is desirable, in connection with the quality standard which the creditor firm follows in determining the quantity of credit desirable to accept from any one debtor. These are matters to be determined by the individual firm and to be enforced through the operation of the credit department.

The policy relative to the quality of credit to be accepted is one which should be adjusted to the general sales policies and must be consistent with the patronage appeal, the location, the line of goods carried, and the local and general business conditions.

The policy relative to the quantity of credit to be accepted from any one debtor should be adjusted to the financial resources of the creditor and the credit standing of the debtor.

REVIEW AND DISCUSSION QUESTIONS

1. Explain the statement, "Unfortunately the pressures of time and of costs and the desire for sales often cause inadequate investigations and faulty decisions."
2. What is the critical part of credit work? Why?
3. Distinguish between bad debt losses and charity cases.
4. What is meant by the expression, "evaluating and analyzing credit information."
5. Why is credit a relative matter? Explain your answer clearly in view of the discussion in this chapter.

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based purely upon payment habits which might be good until the point at which the customer is in "over his head."

6. Define the expression, "grading the credit."
7. What qualities are usually graded in the open charge account grading form? In the cash loan grading form? In the sales finance credit grading form?
8. How do you account for the variations in these three forms?
9. What does the grade of A or good stand for in the grading forms? In the final summary over-all appraisal?
10. In the sales finance credit grading form, there is an "appraisal before investigation" and a "verified or developed by investigation." Explain the differences between these.
11. Explain the procedure to follow in using the grading forms.
12. Why is it recommended that a numerical grade *not* be given to each quality?
13. Contrast the grading of the credit and the grading form used for this purpose.
14. Explain how the credit grade may be used in actual operations.
15. What are the advantages of setting credit lines or limits? The disadvantages?
16. What methods may be used in setting credit limits in a retail store?
17. What are the advantages of each method? The disadvantages?

Open Account Credit Problems

Following are a number of retail open-account problems in which you are asked to determine whether to accept the credit or to refuse it. The credit information supplied in some of the cases is quite limited. Despite this limitation you are asked to grade the credit on those credit qualities which the information available permits you to grade, and to indicate the information which has been verified. You also are asked to come to a definite decision as to acceptability or to state the conditions which would make it acceptable.

18. Mr. C. M. has made purchases in a department store which amount to $32. He desires to open a 30-day regular charge account. His application says he is single, a bartender in a local club, 35 years old, and earns $325 per month. He has held this position for six months. For the previous five years he was employed by several nearby hotels and bars. The local retail credit bureau telephone report reveals the following:
    Loan company—$55 chattel mortgage, slow.
    Loan company—$122, could not collect, P & L.
    Department store—paid as agreed.
    Clothing store—H.C. $46, very slow.
19. Mrs. J. F. has selected a new cocktail dress costing $55 and asks to open a charge account. She states her husband's occupation to be an air force first lieutenant, and they have lived in the community two years. Previous resident addresses are a series of military establishments. She appears to be about 30 years of age. The local credit bureau relates the following record:
    Bank—satisfactory account.
    Department store—30–90 days.

Furniture store—1–4 months.
Department store—1–5 months.

20. Mr. B. W. is 29 years of age, married, and works in a Safeway grocery store. His income is $275 a month. He has a credit limit of $30 with the store and a balance of $8.50 which is 90 days past due. His wife is not employed. Mr. B. W. has purchased a power lawn mower in the hardware department costing $59. He will not agree to outside financial arrangements, nor does he want to purchase the lawn mower on the budget account which is available for any purchase over $50. His insistence to charge this item to the present delinquent open account results in a request for a new credit report as follows:

    Doctor—$115 for collection, 1 year.
    Loan company—$65 slow, but finally paid.
    Department store—$15 P & L last year.
    Had automobile accident in 1950 and was charged with driving while intoxicated.

21. Mrs. M. C. has selected a $30 cloth coat and asks to have it charged. During the credit interview required at the store prior to opening an account, Mrs. M. C. says that she is a widow and is working as a housekeeper. She says she has been employed by the same family for two years. The local credit bureau reports the following information·

    Department store—$30, 6 months.
    Dress shop—$26, prompt.
    Department store—no record.

22. Mrs. C. R. has selected a chair in the home furnishings department of a local department store. This chair is priced at $129. She desires to have the purchase charged and delivered during the next three-day period. Mrs. C. R. is the wife of a young medical doctor who has been in the community for the past three years. They have had an open account with the store for two years with a high credit of $75. Experience has been fair to 90 days delinquent. The credit manager requests a new report from the local credit bureau as a basis for a sounder decision before releasing the merchandise for delivery:

    Employment—respected and capable young doctor.
    Bank—good for $500.
    Bank—auto loan $1,300, monthly payments of $70, occasionally slow.
    Department store—prompt.
    Drug store—satisfactory.
    Clothing store—fair.

CASH LOAN PROBLEMS

Following are a number of cash loan problems in which you are asked to determine whether to make or refuse the loan. In some of these problems the credit information is quite limited; still it is all that is available at the present time. You are asked to grade those credit qualities which the information available permits you to grade and to reach a decision.

23. Mr. J. G. requests a loan of $450 from a commercial bank. He states the purpose of the loan is to complete the purchase of a 1953 Chevrolet truck, pick-up body. He can buy the truck for $675; the down payment is to be $225; and he wishes to borrow the balance. Security offered is a lien on the truck. Facts supplied by the applicant: age 22; married, two dependents; occupation, farms part time working 40 acres of land on shares; also works part time for a grain elevator earning about $100 a month. The following credit information is obtained from the local credit bureau:
    Farmer, working mother's land, owns six head of cattle and three hogs.
    Furniture store—account paid as agreed.
    Department store—account approved, credit not used.
    Bank—maintains savings account which is handled satisfactorily.
24. Mr. G. M. requests a loan of $500 from a personal finance company. He states the purpose of the loan is to meet living expenses and to repay a $300 loan from a credit union. Facts supplied by the applicant: divorced, no dependents; occupation, conductor on Burlington Railroad for 12 years; income, $550 a month. The following credit information is obtained from the local credit bureau·
    Loan company—high credit $150, loan paid by co-maker.
    Credit union—high credit $1,100, applicant owes now $1,100, co-maker paying loan; applicant drinks and may lose job shortly.
25. Mr. B. B requests a loan of $300 from a personal finance company. He states the purpose of the loan is to pay current bills and taxes. Security offered is a lien on household furniture. Facts supplied by the applicant: age 52; widower, two dependents; occupation, laborer at industrial plant, wages of $65 a week; seven years employment at same plant. The following information is obtained from the local credit bureau:
    Owns home valued at $7,000, balance on mortgage $1,000.
    Wife died two months ago.
    Employed as laborer at industrial plant, earns about $250 a month, employed at this plant about six years.
    Grocery store—high credit $22; applicant now owes $5.25 and has bought on credit for 11 years; applicant always pays as agreed and is considered excellent account.
    Coal company—high credit $78; applicant now owes $55, pays monthly as agreed, and has bought on credit for five years.
    Arrested in 1950 for carrying concealed weapon, fined $50.
26. Mr. D. W. requests a loan of $125 from a personal finance company. He offers as security a wage assignment. Facts supplied by the applicant: age 26; married, one dependent; occupation, painter, salary $80 a week. The following information is obtained from the local credit bureau:
    Employed as painter, regarded as good worker.
    Furniture store—high credit $100, balance owing nothing, paid $10 a week as agreed.
    Department store—high credit $30, $30 now owing, agreed to pay $5 a month.
    Jewelry store—high credit $115, balance owing nothing, paid as agreed.
27. Mr. B. P. requests a loan from a commercial bank. He states the purpose of the loan is to pay living expenses. Facts supplied by applicant: age 39;

married, separated, no dependents; occupation, chief chef at Plaza Hotel; income $400 per month; no indebtedness. The following information is obtained from the local credit bureau:

Cook, income $100 a week.
Coal company—gave $10 bad check, took three months to collect.
Clothing store—high credit $26, paid as agreed.
Clothing store—high credit $25, paid as agreed.
Dentist—$65 account, one year old, collection account.
Gas company—$15, finally paid
Newspaper clipping, arrested for drunken driving, 1946.

Sales Finance Credit Problems

Following are two sales finance credit problems in which you are asked to decide whether you would buy or reject the credit, if you were the manager of a sales finance company. The credit information may appear to be quite limited; still it is all you have at the present time. You are asked to grade the credit on those qualities which the information available permits you to grade. Remember it is assumed that the paper is purchased on the basis of a repurchase agreement and the credit standing of the dealer is fair.

28. Mr. J. H. desires to purchase a five-year-old Pontiac coupe. The terms are: cash delivered price $785, down payment $220; unpaid balance $565; finance charge $99.40; note $664.40 payable in 20 installments of $33.22. The purchaser's statement includes the following: age 26; married, three dependents, lived in town 20 years, at same address for three years, employed by the Ready Bakery for six years, salary $255 per month; references are local bank and furniture company. The following information is from a credit bureau telephone report:

    Works at bakery; is careless in the administration of personal affairs.
    Owes hospital $104; supposed to pay each week, not balanced yet.
    Furniture repossessed; never redeemed.
    Motor company finally paid a small bill.
    Wife sued for divorce two months ago but couple is now reconciled.

29. Miss G. W. desires to purchase a new Oldsmobile coupe. The terms are: cash delivered price $3,650; trade-in allowance $1,525 and cash down payment of $925; unpaid balance $1,200; finance charge $186; note $1,386 payable in 18 months of $77. The purchaser's statement makes the following information available: age 29, single; lived in town for 29 years; employed by Black Wholesale Company as a bookkeeper for six years; salary $350 a month; prior to that worked as a bookkeeper for six years; owns a vacant lot, no other property; references are General Motors Acceptance Corp., a commercial bank, a building and loan association, and a jeweler. The investigation by telephone reveals the following:

    Employer—employed for years; good worker.
    Jeweler—known years; recommend; moral risk excellent.
    Building and loan association—recommend; do not think she would contract for anything she could not pay.
    Commercial bank—purchased car two years ago to be paid in 16 payments of $35.71; has made each payment promptly.

CHAPTER 14

Credit Management Techniques

CREDIT MANAGEMENT has come a long way over the years. It has had to face—and still does in some instances—the fact that to many people and to many firms credit occupies a negative role in business operations. This position in which credit has found itself on various occasions often was the fault of the credit people themselves. For a number of years this negative kind of thinking contributed to a lack of fresh and creative ideas, constructive imagination, and positive leadership. When such conditions prevail, "rigor mortis" tends to set in and the "right kind" of aspiring young men and women tend to look elsewhere for positions that offer more opportunities.

Fortunately in recent years credit management has come to be recognized as the positive and constructive force that it is, and a brand of leadership has appeared that has raised credit management to the status of a profession. More than ever before, credit people as a group are demonstrating technical competence in all the important phases of credit administration. They have recognized, moreover, that good credit management involves more than technical knowledge and includes an understanding of the credit aspects of accounting, law, human relations, and business management—to name a few of the related subjects.

RETAIL CREDIT MANAGEMENT

Once a retail store has decided to include credit among its selling tools, it then is faced with the task of setting up a credit department, securing the services of competent and well-trained[1] individuals to carry

[1] The training of personnel is a vital and pressing problem to credit management. Some retail concerns have followed the policy of "on-the-job" training for their new employees. Some have sent their employees, both new and experienced, to various types of

out the credit activities, and to establish a credit policy to serve as the cornerstone of sound credit administration. It must be recognized, of course, that in smaller retail stores the owner-manager usually is "the" credit department, "the" credit executive, and "the" policy determiner. Such is to be expected in such firms as the volume of sales and profits generally would not justify the employment of an individual to devote his or her full time to credit activities.

Regardless of whether the credit person is a full-time employee or the owner-manager of a retail firm, the present-day complexity of "good" credit management requires that this person have a sound training (or its equivalent acquired through practical experience) in credit and collections fundamentals, accounting, business law, salesmanship, economics, and office management techniques (if this person is running a separate credit office). Likewise, an interest and ability to follow and understand current economic conditions and governmental money and credit policies are valuable traits to be found in a credit person, especially one who is responsible for an excessively large volume of retail credit business.

Organizations of Retail Credit Managers

It was in 1912 that the retail credit managers recognized the need for closer co-operation between themselves and with the organizations that furnished them consumer credit data. As a result, the Retail Credit Men's National Association was formed. In 1927, the name of this trade association for retail credit granters was changed to the National Retail Credit Association, the name by which it still is known today. Through its local, state, and district merchant associations, the National Retail Credit Association conducts an extensive and continuing program of education and service for the personnel of the credit departments of retail firms.

Another organization made up of retail credit personnel is the Credit Women's Breakfast Clubs of North America. Started in 1934, this active group has grown to a membership of approximately 14,000 women engaged in credit activity in some 415 cities over the United States and Canada. Edith Shaw, who was the founder of this association, believed that such breakfast clubs would be forums for mutually helpful discussion topics, classrooms for a study and review of changing retail credit techniques, and sororities for social contacts and acquaintances. Such a

centralized training arrangements. Some of these "schools" have been run by private individuals who have conducted the courses sponsored by the local retail credit men's association; some have been set up with the assistance of the extension divisions of universities and colleges located in their areas.

belief has been borne out by the fact that these clubs have been successful in developing close contact among credit women, in establishing better relations between credit managers and local credit bureaus, and in stimulating an increasing interest in the continuing education of credit personnel.

A third organization of retail credit personnel is in the National Retail Merchants Association (Credit Management Division). This association numbers more than 10,000 department, specialty, dry goods, and apparel stores among its members. Since 1934 when it was established, the Credit Management Division of this association has furnished a special research service to the credit managers of member stores. Through meetings, surveys, and publications (such as the monthly *Credit Currents* and the yearly *Credit Management Yearbook*), this Division constantly works to keep its members up to date on all new developments and changing techniques in the retail credit field.

Organization of Retail Credit Departments[2]

The particular organization in any store is a product of many factors. Obviously what is suitable for the large store is impractical for the small store. The influence of ownership and personalities also can be responsible for varying types of organizational arrangements.

In the single-proprietorship store, the owner or manager is the "jack-of-all-trades." In addition to his other multifold duties, he has supervision of credits and may be assisted by one of his personnel in collecting slow accounts.

In the small department store, the credit activities may become a staff function under the authority of the treasurer-controller.

As the department store becomes larger and more departmentalized, credit activities tend to become the responsibility of the controller who is the head of one of the four or five major divisions. The actual operating head of the credit section of the controller's division is the credit manager. The activities of this section may be divided into interviewing, promotion, authorizing, and collection. The interviewing personnel will gather data about applicants for credit and help determine whether or not credit shall be accepted. The authorization people shall have responsibility for certain phases of identification and authorization. The promotion of credit may be assigned to one or more people, whereas the collection responsibility is to keep slow accounts on a paying basis or to stop the acceptance of credit from bad risks.

[2] Adapted from D. J. Duncan and C. F. Phillips, *Retailing, Principles and Methods* (5th ed.; Homewood, Ill.: Richard D. Irwin, Inc., 1959), pp. 154–80.

In the typical chain-store organization, the controller has responsibilities similar to those of the department store controller. A major one of these responsibilities is credit. However, handling credit today has become such an important function that the top credit manager of a credit organization frequently has a staff of workers (not counting the credit staff in each store) as large as the entire personnel of the controller's division of a few years ago.

Basic Functions of the Retail Credit Manager

Regardless of the type of retail store involved and the type of organization under which the retail credit department of the store operates, there are certain basic functions that must be performed by the retail credit manager in his efforts to have his department accomplish its duties. These basic functions usually are considered to include the following:

1. Maximizing sales and profits.
2. Minimizing bad-debt losses.[3]
3. Efficient utilizing of investment funds.
4. Co-operating with other internal and external departments.

Maximizing Sales and Profits. It should be remembered that credit should be introduced and continued in use in a retail store only as long as it increases the volume of sales and in turn profits. Credit is a "means to an end," in that a store does not (or should not) accept credit in its operations unless such a policy is to the store's advantage. Of course, if asked, some retailers would reply that they are using credit simply because competition is forcing them to do so. However this is the same thing as saying that unless credit was used, sales and profits in their stores undoubtedly would decline.

Minimizing Bad-Debt Losses. The credit manager is faced not only with the task of using credit as a tool to sell more goods and to make more profit, but he also is simultaneously forced to watch the trend of bad-debt losses that occur. In no way is this to infer that a low bad-debt loss automatically is a sign of high sales and profits and of efficient credit management. In fact, it is possible that an exceedingly low bad-debt loss may signify that the store is accepting only the best credit risks and in a sense is operating simply on a "deferred" cash basis. Thus the retail credit manager constantly walks a tightrope, in that he must

[3] Some credit managers may feel that this is only part of the story—that the real attempt should be to minimize all credit expenses which include bad-debt losses. Such an approach is realistic but it raises the question of what are strictly credit expenses and what are general office operational expenses.

determine how much risk he will accept in order to expand his sales and profits to a maximum and at the same time hold a tight rein over his bad-debt losses. Consideration also must be given to the fact that this determination will (or should) vary depending upon the type of credit being accepted—open charge, revolving, or installment credit.

Efficient Utilization of Invested Funds. Once credit is accepted by a retail store, it automatically becomes an account receivable on the books of the retailer until the account is paid by the customer, or in case of nonpayment it may be changed to a note receivable or charged off as a bad-debt loss. Of course, some accounts may be sold to some financial institution.

The retail store, having invested its funds in its inventory (assuming that the store pays its own bills quickly in order to take advantage of any cash discount) thus finds that these funds are tied up in the accounts receivable representing the goods that have been bought on credit and that still are owed for by the customers. Thus, the retail credit manager has the responsibility of handling and accounting for these invested funds—a responsibility that is just as vital and important as that of a retail buyer in deciding what inventory to invest in or that of a financial executive of the firm in deciding upon what kind of securities to buy in order to secure a return on any surplus funds.

Co-operating with Other Internal and External Departments. The day is long past when a credit manager "sits on his credit information" and refuses to share his gathered data with the other departments of his retail firm. After all, such credit information can be used to improve the operations of the entire store, as the credit policy being followed should be co-ordinated and tied in closely with all the other policies adopted by the store management. Thus there is an ever-present need for close co-operation between credit operations and those relating to sales, merchandise returns, financing, accounting, delivery, and so on.

Likewise the retail credit manager has learned that the sharing of his information with credit managers of other retail firms through the local retail credit bureau or through direct interchange will enable him through reciprocity to make better and more reliable credit decisions than if he works alone in his investigations. Thus directly or indirectly, he more and more is co-operating with his fellow credit people in the mutual exchange of credit data.

Performing These Functions. To perform these functions properly and in an efficient manner will require skilled and competent individuals, trained and experienced to keep pace with our increasingly dynamic and complex economy. It is essential that these individuals

FIG. 14–1. Policy for retail credit management.

HUDSON'S STATEMENT OF POLICY

Hudson's sells on credit terms for two reasons—to increase our sales volume and to give service to our customers. In doing so we are guided by Hudson's high ethical standards and the principles of sound business practice.

WE BELIEVE IN CREDIT. We regard it as a selling tool without which our business would be seriously hampered. We should use it to a greater advantage than we do—to attract new customers—to do more business with our present customers. We want and need credit sales volume.

WE VALUE OUR CREDIT CUSTOMERS. We consider their patronage no less desirable—no less profitable than that of cash customers. No customer need ever be embarrassed to buy on credit at Hudson's.

WE OFFER FLEXIBLE PAYMENT PLANS. Besides the charge account we offer Convenient Payment Plans ranging over periods of from three to thirty months depending on the merchandise purchased—the risk involved—and the customer's needs. Most every sale can be arranged on terms convenient to the customer. We are glad to have customers use these plans.

WE ARE WILLING TO PROMOTE OTHER SOUND CREDIT PLANS. Just as soon as we are sure that new plans are *sound* and that they will be of *real* benefit to both our store and our customers—we will make them available.

WE ARE AS LIBERAL IN APPROVING CREDIT AS GOOD BUSINESS PRACTICE ALLOWS. We do not demand gilt-edged securities to establish credit. Most customers can qualify. Actually, all we ask is a steady job (or income)—some evidence of having lived within income—and no record of past due or unpaid accounts.

WE DO NOT PROMOTE "FREE" OR "EASY" CREDIT. We will not encourage the Hudson customer to buy beyond his ability to pay or to live beyond his means. This results in excessive debt and ensuing hardship. Hudson credit is a service and must be of ultimate benefit to both the customer and the store.

WE ASK ALL CUSTOMERS TO PAY ACCORDING TO TERMS. We believe it most fair to ask all to pay on the same basis. The paid up customer is free of debt—open to buy and a potential customer for more merchandise.

WE ENCOURAGE SALESPEOPLE TO LEARN MORE ABOUT CREDIT PLANS. We want them to use credit as a selling aid. While we will not suggest "easy" credit, we do want our customers to know that sound, reasonable, and convenient plans are readily available. We feel

FIG. 14–1—*Continued*

that often the salesperson is best qualified to suggest the proper credit plan.

WE INTEND TO KEEP OUR SALESPEOPLE INFORMED. We will discuss credit plans and explain such services through departmental meetings, training bulletins, the Memo to Management, the HUDSONIAN, and special publications.

WE WILL PUBLICIZE THE ADVANTAGES OF HUDSON'S PLANS AND THE REASONS FOR USING THEM. We will include down payments and monthly payments or liquidation periods. We want our customers to know about the advantages of our plans and to understand just how conveniently credit can be established and used.

Courtesy of R M. Grinager, Credit Manager, The J. L. Hudson Company, Detroit, Michigan

work within the framework of a clearly defined and positive credit policy, which is the cornerstone of sound credit administration. At the same time, if the facts were known there are a surprisingly large number of retail firms attempting to carry on credit activities without any specifically defined policy or with an entirely inadequate policy. In these instances credit management in carrying out these four functions is forced to work and to govern itself by expediency rather than by clearly thought out and consistent principles and objectives.

A credit manager is entitled to a written statement of policy—a policy that should be accepted and clearly understood by the other executives of the firm. See Figure 14–1 for such a policy provided for retail credit management. Such a spelled-out policy statement should include at the minimum an accurate description of the types of credit plans in effect at the retail establishment, the terms of each of these types of plans, the basis for accepting the credit of a customer, the willingness with which it will be accepted, and the relationship of credit to the other major policies followed by the store. Some policy statements on credit will be found to be more detailed and more descriptive than the minimum just described.

A successful credit policy should strike a definite note for positive thinking, positive creativeness, and positive action. Often the words that are used in carrying out a credit policy can be of great importance in arriving at the desired objectives. Such statements as "dunning," "delinquency," "rejected," "turned down," "problems," and so on have been contributing factors in many instances to negative thinking on the part of credit management. Positive wording can be an influential factor in positive thinking and positive action.

Techniques of Identification and Authorization

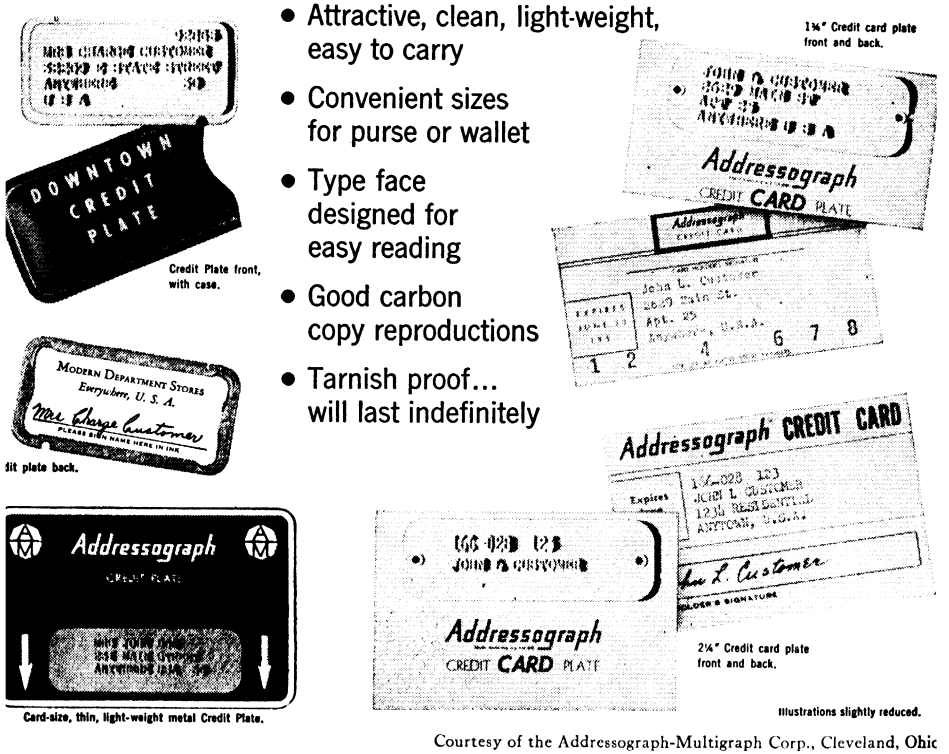
After a retail charge account has been approved, there must be some system set up whereby credit management may control the day-to-day purchases of individuals using their credit. There are really two phases in connection with this control of day-to-day purchases.

The first may be called the identification phase. This is the technique of making sure that the person purchasing is the party who has an account and is not an imposter—namely, some one attempting to buy upon some one else's account or against a nonexistent account. Identification is especially acute in connection with charge-take purchases—that is, purchases which the customer wishes to take with him. With charge-send purchases the task of identification is much simpler, because some measure of assurance is afforded through delivery of the purchase to the address of the party having the account. This assurance is, of course, absent when the customer takes the goods with him, and thus it is important to protect the store against possible fraudulent purchases. Considerable value often is represented by articles which may be taken by customers and, of course, no store can afford to expose itself to the losses that may follow if customers are permitted to remove valuable merchandise from the store without some measure of control or check.

The speed element further complicates this activity in that the customer, after having made a selection, does not wish to be delayed in receipt of the merchandise. He may, at his own sweet time, ask to be shown every article in stock and spend hours making up his mind as to what he wants. But after this decision is once reached, he wants the article instantly; therefore, any identification system must be speedy if it is to avoid customer ill will. Further, the problem of identification is one which must be handled with the least embarrassment to the customer. Certain positive means of identification are not readily available because they apparently accuse the customer of lying. He knows perfectly well that he is Mr. John Jones and doesn't see why anyone else should doubt this evident fact. Therefore, the best identification systems are those which do not flatly reveal to the customer that this process is being attempted.

The second aspect in handling the day-to-day charges to customers' accounts is the authorization phase. Authorization is the control of the quantity of credit used by the customers. The account is open, but this does not mean for an indefinite amount of credit. For each customer there must be some quantity of credit which is the maximum the store is willing to accept, and some means of control must be maintained of

FIG. 14–2. Illustration of credit card plate.



Courtesy of the Addressograph-Multigraph Corp., Cleveland, Ohio

the day-to-day purchases if the total is to be kept within or near this established maximum point. This quantitative limit may be fixed by the credit line decided for the account at the time the account is opened or by the credit guides used by the store. To enforce this, there must be some checks upon the freedom of use of the credit account. One system of authorization then may require each purchase to be approved by the credit department. Under this arrangement, there is no opportunity for the account to amount unconsciously, or without the credit manager's knowledge, to a sum greater than he would be willing to have charged to that particular customer. Here also is involved the question of how to handle the transaction without losing customer good will. If either the identification or the authorization takes too long, the delay may cause customer resentment. On charge-send purchases, there is opportunity for a more leisurely procedure as the delivery schedule is not as pressing as the customer's insistence upon having the parcel quickly placed in his hands and upon being able to leave or shop elsewhere in the store with no further delay. In addition to the customer's reaction to this, there also is the sales effect. After the customer has made a

FIG. 14–3. The Charga-Plate.®



FARRINGTON PLASTIC CREDIT IDENTIFICATION CARD — TYPE "F"

Durable — Lightweight — Attractive

Farrington's Plastic Credit Identification Cards are of laminated construction which provides protection to the printed plastic card — gives it a greater brilliance of color — in addition to reinforcing the embossed characters. This means clearer impressions because of stronger plastic. In addition Farrington's plastic credit cards are lightweight and amazingly durable. They are available in single or multi-colors with an unlimited choice of layouts and designs to suit customer requirements.

Reflects Company Personality — Provides Tangible Recognition To Valued Customers

The lettering, layout, design, and color of your Farrington plastic credit cards conform to the advertising pattern that identifies your company. The attractive appearance, associated with the customers' own embossed name, is a direct endorsement of the fact that your company places a real value on his or her business. Farrington credit cards also provide your customers with the advantages of new improvements — indicating store leadership.

Courtesy of the Farrington Manufacturing Co., Needham Heights, Massachusetts

selection and the sale has been completed, the more rapidly he moves to some other section of the store, the more customers who can be served by this sales section. Thus customers who have completed their shopping, or made their selection, are not contributing to further business as long as they are merely waiting for their purchases.

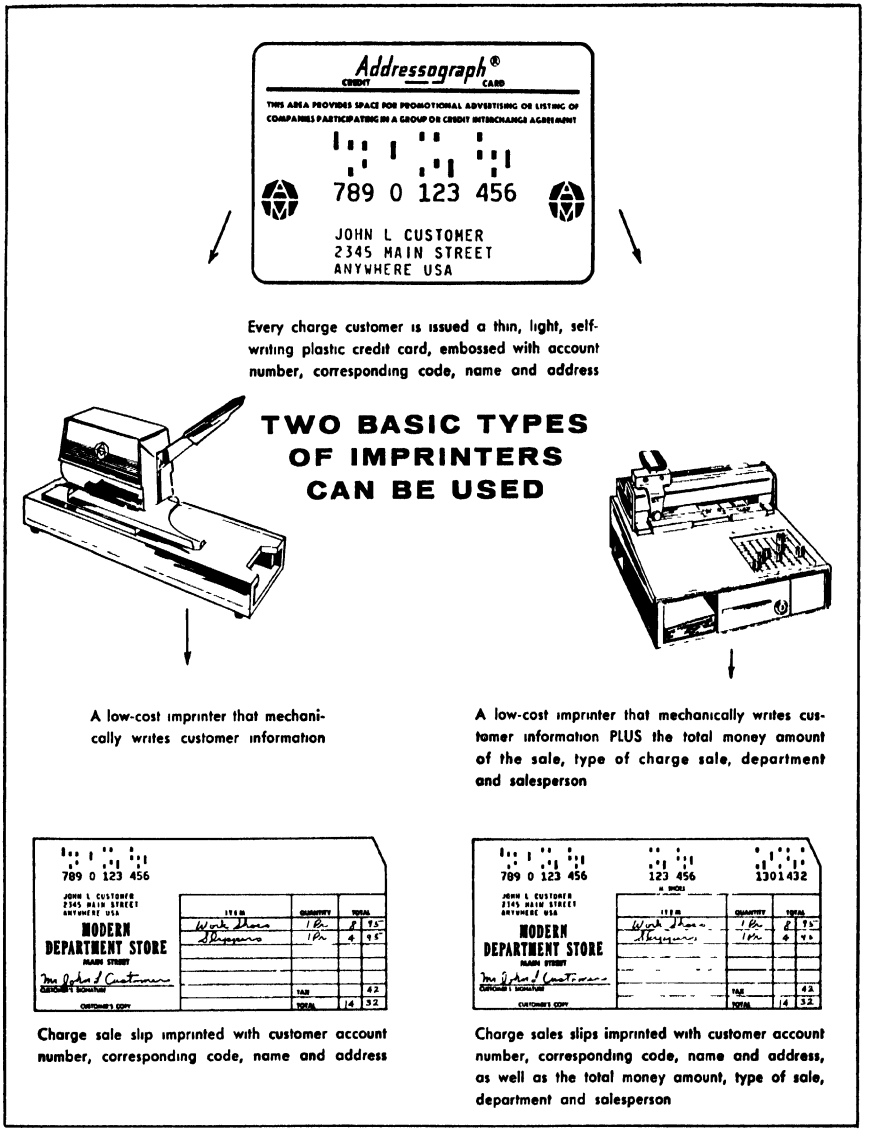
Identification by Credit Plate and Other Devices. Identification is often combined with authorization. While it is wise to attempt to keep them apart, at the same time it should be recognized that in some systems both identification and authorization are solved at the same time. Identification may be made by issuing credit plates, or cards, or some similar token (see Figure 14–2). The oil companies with their cour-

tesy cards or credit cards are really handling the problem of identification. Certain retail stores issue their customers credit cards which, upon being displayed to the sales person, serve to identify the customer. Some of them have issued metal devices in the form of key ring tags or similar tokens.

One of the better known devices is the credit plate, as illustrated in Figure 14–3. While perhaps the most commonly known of these types of plates is the Charga-Plate® of the Farrington Manufacturing Company, other companies such as the Addressograph-Multigraph Corporation are now equally competitive and important in this field.[4] The credit plate is an embossed metal or plastic plate which carries on its face, in raised letters, the customer's name, address, account number, and sometimes the approved line of credit in code. This plate may be enclosed in a little leather or plastic container. At the time of making purchase the plate is handed to the salesclerk and is inserted in a press. This press is forced down upon the pages of the sales book which have been properly interleaved so that it makes both an original and several carbon impressions. Thus the customer's name, address, and account number are imprinted upon the sales ticket and the various duplicate copies. Presumably, this device identifies the customer having a charge account. The plate has a further advantage in that the sales ticket correctly carries the customer's name, address, and account number. Thus in entering charges upon the accounting records, the use of the plate makes certain that the entry is made properly. This is better than permitting the clerk to make this record, because the customer may respond by merely giving the initials when the account is carried in the first name, or give the first name and not the middle initial, or the clerk may misspell a name and thus make it difficult for the accounting department to post the entry properly. Thus it not only fulfills the problem of identification, but it is of considerable aid in the posting process. It also is liked by the customers because it is convenient to carry and actually speeds up the handling of the transaction because they are not

[4] The Addressograph-Multigraph Corporation has just developed a new system involving its credit plate. It is claimed that this system will help cut retail firms' accounting costs. The purchaser of this system will issue his charge customers a thin, light, self-writing plastic credit card, embossed with account number, corresponding code, name, and address. As part of this system, the Addressograph-Multigraph Corporation has placed on the market two basic types of imprinters that can be used in conjunction with this embossed credit card One imprinter, which is the lower in cost, mechanically writes customer information and the charge sale slip is imprinted with the customer account number, corresponding code, name, and address The other imprinter, which is higher in price, mechanically writes customer information (customer account number, corresponding code, name, and address) plus the total money amount, type of sale, department, and salesperson. See Figure 14–4 for a graphic illustration of some of the most important aspects of this new system.

FIG. 14–4. New credit plate system.



Courtesy of the Addressograph-Multigraph Corp., Cleveland, Ohio

forced to spell their name each time they make a purchase or to repeat it in the presence of others. This is sometimes embarrassing to customers who are not accustomed to giving their name freely in a loud voice for all to hear.

The use of these various means of identification such as coins, cards, or plates has the disadvantage that they may be lost by the customer,

may be picked up by someone else, and the customer may not notify the store of the loss. They may be forgotten and so the customer is purchasing without the means of identification with him, and some other alternative means must be supplied. Also, when an account is closed or suspended, it is sometimes difficult to secure possession of this means of identification which has been issued to the customer.

Identification by Signature. Another technique of identification frequently used is for the customer to be requested to sign the sales ticket. This ticket then is sent to the credit department where it may be compared with the customer's signature which is kept on file there. The signature is required in some instances where it is not actually compared as a means of identification but does help in case there is any question about the account and a lawsuit becomes necessary. Should the customer claim that he did not make the purchase, the signature on the sales ticket may be sufficient evidence to convince him that he actually made the purchase. If he is not convinced by this, it will be good evidence in case it is necessary to institute legal action. Also in those stores which return the original sales slips with the monthly statements, the customer is confronted with his signature and generally does not raise any question as to whether the charge is actually his. This has drastically reduced customer inquiries to the credit department as to the accuracy of the amount shown on the statement.

Identification by Personal Recognition. In some stores, frequently the smaller stores, the identification is handled by personal recognition on the part of the clerk or manager of the store, and there is no need for more elaborate systems of identification. In some large stores, the floorwalker performs the identification function and does this by his personal nodding acquaintance with great numbers of customers, supplemented by his judgment in detecting impostors whom he may recognize by their attitude or actions. Undue nervousness may tend to make him suspicious and probably suspect the person is not the one he is claiming to be.

Waiver of Identification. Although it can hardly be called a system, in some stores this task of identification is handled by being waived. Thus on purchases below a certain amount, say $5.00, the clerk is authorized to accept the customer's own word as complete identification. Only on larger purchases is the signature on the sales ticket transmitted to the credit department for more positive identification. This may handle the identification problem, or at least avoid considering it a problem, in the great majority of purchases.

Authorization. Having discussed the major aspects of identification, consideration will now be given to the authorization phase of operation. As mentioned earlier, authorization is an attempt to control the use of the account; the quantitative use of it. The basic device that facilitates the solution of this operation is the use of credit guides or credit lines (in some stores the term "credit limits" is used). When an account is opened, a line of credit usually is established.[5] This then is used by the authorizer as a guide indicating whether or not additional charges may be accepted. For example, an open charge account may be started with a $50 maximum; it now has a $45 balance outstanding and the authorizer is asked to approve the release of an additional $10 purchase. A rapid comparison of the account indicates that this would send it over the $50, and the authorizer may have standing instructions to refer such questions to the credit manager. The credit manager can, through analysis of the credit file, consider whether the account should be permitted to carry the additional $10. This discussion should illustrate the use of credit lines or guides. They merely reflect the judgment as to the quantity at a moment of time and are not to be construed as final determinants of the maximum credit which will be accepted. Lines thus used and maintained on a flexible basis will not interfere with further purchases. They merely give some means of control which may be exercised by the store management.

Sales Floor Authorization. In those stores in which a great number of charge accounts are handled, it would be rather inconvenient for the authorizers to compare the current purchase against the outstanding balance of the account each time a purchase is made. In order to speed up the process of authorization, there are many cases in which it is found advisable to permit authorization in the sales section. This may be done by permitting the floorwalker to release the merchandise, and he will combine this with the identification function. At other times, or in certain sections of the store, the salespeople themselves may be permitted to release merchandise up to say $5.00 or $10.00, or above. This often varies depending upon the season of the year, the busier the time the higher the floor-release limit. In sections where there is a great volume of charge-takes on small purchases—such as cosmetics, hosiery, or some of the other impulse goods handled usually on the first floor—the closing of the transaction is speeded up by permitting the salespeople to release up to some predetermined floor-release limit.

[5] Variations from this are, of course, noted in the flexible or chart plan of revolving credit, as described in an earlier chapter.

This makes for customer good will and also increases the flow of traffic through the store It further saves the credit department the burden of handling a great many small charges.

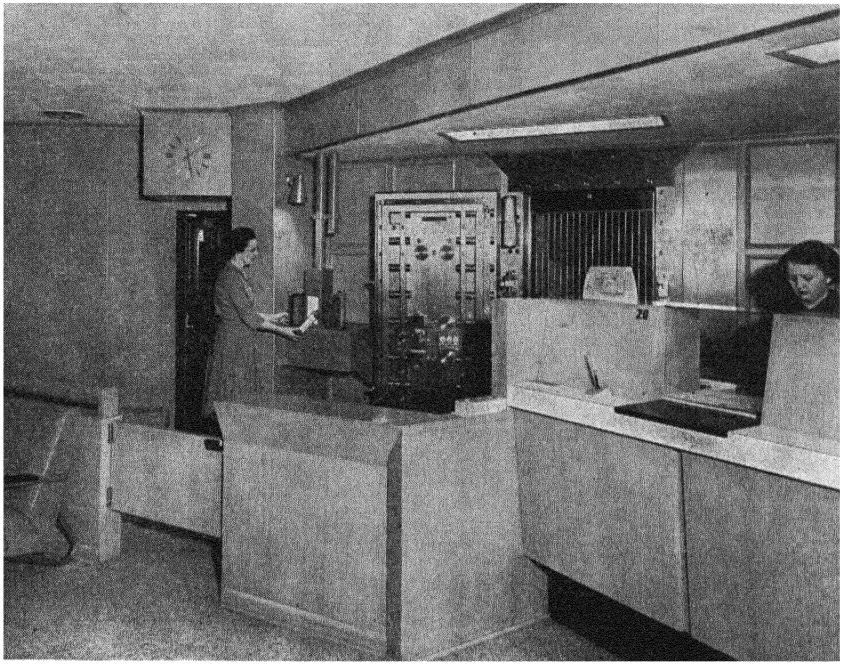
The credit plate, in addition to serving as a means of identification, also may be used as a device for authorization The restriction of plate issuance to customers with fairly high credit often permits the release

FIG. 14–5. Pneumatic tube systems. Retailing was one of the first business areas to recognize the advantages of pneumatic tubes as a customer convenience and to aid sales-handling work.



Courtesy of the Glover Company, Detroit, Michigan

FIG 14–5—*Continued.* Banks have used pneumatic tubes advantageously for years and have found that they fit in well even with such innovations as electronic data processing, drive-in banking, and charge account services



Courtesy of the Glover Company, Detroit, Michigan

of merchandise upon the presentation of the plate up to fairly large amounts, in some cases as large as $25 or even above Thus the plate acts both as release and authorization, as well as an identification of the customer

Off-the-Floor Authorization. In those instances in which authorization is accomplished "off-the-sales-floor," some means of communication between the sales floor and the credit department are necessary. It was previously indicated that identification may be handled by a signature on the sales ticket This function of identification may be combined with authorization because in order to authorize the charge, the ticket generally is sent to the credit department The signature may be compared at the same time the quantity is being approved by the authorizer

One means of getting the tickets to the credit department is by means of the pneumatic tube system, as illustrated in Figure 14–5. In some stores, each sales section is connected with the credit department authorizers by means of tubes. When the sale is completed the slip is folded,

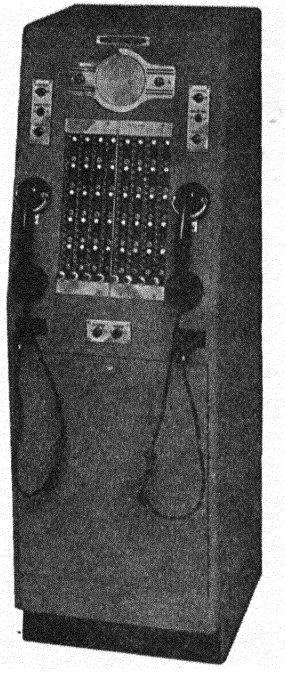
put in the container, and sent through the tube system from which it is routed to the authorizer who handles this account. Usually the tube system of authorization will be combined with centralized cashiering and cash handling procedure. When this is done, the containers which go to the authorization section are separated from those going to the cashier—that is, those containing cash. Different colored containers may be used and classified manually, or they may be automatically handled by using carriers that have different projections which mechanically switch them to the proper stations. In some large establishments containers are sorted in the credit department and sent to the girl handling that division of the alphabet. This often is accomplished by means of a belt conveyor. Of course, all containers must be numbered in order that after the authorization clerk has checked the proposed charge against the account and properly authorized the transaction by placing a rubber stamp or some such symbol on the sales slip, they will be returned to the proper sales section.

After having made the sale and inserted the sales slip in the container, the clerk dispatches the tube and then may proceed to wrap the package. If the system is working efficiently, the customer never is aware of the fact that he has been both identified and his credit authorized by the credit department. He may sometimes wonder why the sales slip was sent away, but he will think that it is just a part of the organization's procedure which does not concern him and hardly realizes that there has been an approval of the release of the merchandise accomplished in the time while his package was being wrapped.

Another method of handling this portion of the task of authorization is by means of the authorization or "o.k." telephone. This is illustrated in Figure 14–6. When using the telephone system, each sales section is connected directly with the authorization section of the credit department. After the sale is made, the sales clerk inserts the sales slip in a receptacle in a telephone, calls the credit department, and repeats to the authorizer the name and address of the customer as shown on the sales slip. If the authorizer finds the account as listed in her files and if the purchase is within the limit which she is permitted to approve, she indicates this approval by punching a release button which perforates, or in some other manner stamps, the sales ticket. If the credit is not authorized, the customer usually is asked to step up to the credit department. Generally it is considered unwise to allow the sales clerk to take up questions of credit with customers, since noncredit personnel are not usually competent to do so as tactfully as would be possible in the privacy of the credit department.

There also are installations of the telautograph system in retail stores over the country. This system, through electrical transmission, transmits to the receiving end both the name of the customer and the amount and preserves a permanent record of all approvals on both the sending and receiving portions of the mechanism. However, this system generally is considered too costly to be very widely applied except in the very large retail establishments.

FIG. 14–6. Authorization or "O K." telephone.



Courtesy of the National Cash Register Company, Dayton, Ohio

Charge-Send Authorization. Previously, mention was made that the identification phase is far simpler in the case of charge-send purchases than in the case of charge-take purchases. It likewise is true with authorization that the time problem is not nearly as pressing with charge-send purchases. The procedure developed should be integrated with the delivery room procedure. One method is to have the parcel held in the sales section, and the authorization is handled in much the same way as it is with a charge-take. If a tube system is used, the sales slip is sent to the credit department and is handled as a regular charge-take, except that under pressure precedence is given to takes rather than sends In the case of a telephone system, the telephone is used to com-

municate with the credit department, but the salesperson will do this during slack periods and thus there will be less burden upon the credit department than otherwise would be the case. When the sales slip is returned from the credit department or stamped by the telephone, it is inserted in the parcel which then is routed to the delivery room.

Another system is to send the parcel to the delivery room, meanwhile sending the sales slip to the credit department. The sales slip must be matched with the package in the delivery room, and no parcel can leave the store until the credit department has sent down the sales slip. While this may slow up the delivery process, it is a convenience to the credit department.

A third method, which places even greater emphasis on speed, is to send the parcel to the delivery room and the sales slip to the credit department. The parcel is moved through delivery as quickly as possible. In the event the credit department does not wish to approve the sale, it is their responsibility to send down a withdrawal order and pull the parcel from the outgoing deliveries prior to the time it is scheduled to leave the store. If the credit department personnel do not act rapidly enough to catch the parcel before it leaves the store, that is their responsibility and they, rather than the sales department, are charged with the laxity. This again emphasizes speed in handling.

Special attention should be given to the procedure of handling alterations on clothing that is charged. It is obvious that the charge should be authorized before any attempt is made to start the alteration work. Otherwise, the store faces the possibility that a garment will be altered to fit one individual, but this individual may not be a desirable credit risk.

Time and Expense Problems. It may be noted in this discussion of both identification and authorization that when they present themselves in the handling of charges to retail accounts, emphasis generally is placed on speed and cost of handling and on the maintenance of customer good will. At times this necessarily means a relaxation in the credit safeguards. Most stores believe that this is justified, since the economy in handling and the saving of time and money may more than compensate for the small number of cases in which advantage is taken of a more lax system. It also should be noted that the systems described here are primarily large-store systems. In many of the smaller stores the same results can be accomplished with much less formal procedure because of the personal acquaintance which will exist between the store manager, or owner, and the bulk of his customers. In any event, whether the system is very formalized and routinized, or whether

it is a rather informal and nonroutinized system, the essential features of the task remain the same. There must be both identification and authorization.

SERVICE CREDIT MANAGEMENT

There really is little basic difference between retail stores and service concerns in the management of their credit activities. Generally the credit accepted in the service type of operation is for a relatively short period of time. However, there are numerous instances of installment and revolving credit plans being used by firms and individuals accepting service credit from their customers. Like the sale of goods on credit, the sale of services on credit requires identification and authorization. The aspect of identification is usually less of a problem than it is for a retail store in that the service itself generally is performed by the same person accepting the credit. He likewise can decide quickly whether to accept the additional credit desired by the customer. Thus, authorization is carried out in many instances without separate formalized procedures.

CREDIT MANAGEMENT IN MONEY-LENDING INSTITUTIONS

In institutions loaning cash to individuals, identification does not involve the difficulties that it does in the sale of goods and services. Since lending money to consumers is usually a one-time operation as opposed to the numerous purchases placed on a charge account by a customer, the institution has the task of identifying only once the person seeking the loan. Likewise, on such loans the decision simply is made as to whether or not to make the loan and for what amount. Thus, the decision of whether to authorize additional amounts to be loaned to a customer does not usually arise. Thus identification and authorization, as discussed for the credit management activities in retail stores and service concerns, do not present equivalent actions in financial institutions.

REVIEW AND DISCUSSION QUESTIONS

1. What is meant by the term "credit management"?
2. Distinguish between retail credit management, service credit management, and credit management in money-lending institutions.
3. Discuss the problem of how to train retail credit personnel. Check with your local stores and see what methods are in use.
4. What is the National Retail Credit Association? Trace its history.

5. What are the purposes of the Credit Women's Breakfast Clubs of North America?
6. Explain the activities of the Credit Management Division of the National Retail Merchants Association (NRMA).
7. Describe the organization of the credit department of the typical large department store.
8. What are the basic functions of the retail credit manager? Describe each function clearly.
9. Explain the term "efficient utilization of invested funds."
10. How can the retail credit manager co-operate with other internal and external departments?
11. Evaluate the credit policy shown in Figure 14–1.
12. Distinguish clearly between identification and authorization. Between charge-takes and charge-sends.
13. What techniques of identification may be used? Explain each.
14. What techniques of authorization are found in retail stores? Explain each.
15. In "off-the-sales-floor" authorization, what methods are used to send and secure information from the credit department. Describe each method.

CHAPTER 15

Salesmanship as Applied by the Credit Department

STIMULATING profitable credit sales is an important but oftentimes neglected function of the credit department. Credit has become an almost indispensable convenience or necessity in our scheme of living. So commonplace is the occurrence of credit transactions that we are apt to regard passively the solicitation which can build the number of profitable accounts. Little success in this activity can be expected unless the principles of salesmanship are applied to this key function by the credit department. The building of the number of active accounts takes on significance when we (1) evaluate credit customers sales-wise, and (2) examine the natural causes for loss of these same customers.

Should Credit Customers Be Sought?

The proportion of sales volume which vendors can directly attribute to credit customers varies considerably from store to store. Many of the nation's retail stores do not sell on credit, but it is estimated that about one third of all retail sales are made on credit. Many merchants, particularly those selling very high-quality or prestige merchandise, report credit sales as representing 80 per cent or more of their total sales volume. Department stores typically account for a heavy volume of credit sales with many of them known to do more than one half of their volume on credit. Sears, Roebuck & Company has more than 7½ million credit customers with active accounts on its books, and slightly more than 40 per cent of its total sales volume is transacted on credit. These data indicate, in general, the quantitative importance of credit customers.

Why is the typical credit customer important to a retail store? Prop-

erly used the selling of merchandise on credit can increase the sales volume of a particular store. Whether or not sales volume increases and a greater dollar profit accrues depend to a large extent on several things. First, if an increase in dollar profit is to result, the costs of opening, controlling, and collecting the accounts must be kept low relative to the merchant's gross margin. Quite obviously, those expenses which accrue at a more rapid rate than the resulting rate of sales may cause losses rather than gains. Merchants who intelligently analyze the pitfalls of consumer credit and wisely adopt credit policies to overcome them can enjoy the benefits generally associated with credit customers. Second, credit customers can increase sales volume because as a group they (1) are closely tied to those stores at which an active account is maintained, (2) have less resistance to price, and (3) have a tendency to buy a higher quality of merchandise.

Credit customers appear to form a habit of buying at those stores where they have credit privileges. This follows from the logical assumption that credit customers have little reason to be shoppers as are cash customers. Cash customers are restricted in the amount of their purchases and hence can be more easily attracted by offers of other merchants. Conversely, credit customers become well acquainted with the offerings of the stores in which they buy on credit. They become better acquainted with the personnel, are susceptible to the quality of merchandise offered, and are generally regarded as preferred customers of the store. These factors create good will and a high degree of loyalty in the customer's mind. The ease and convenience in the use of a credit account and the attitude displayed by the store toward credit customers contribute toward the development of a credit-customer group which habitually trades with the same merchants. The average sale to the credit customer is very likely to be larger than would be the case were he required to pay cash. It is a well-known fact that credit customers are less price conscious. They are not compelled to be as cautious as the cash buyer who fears the embarrassment of being short of funds. The credit customer can make purchases on any day during the month and, not having to wait for pay day, is free to the dictation of his desires and not his cash on hand. Consequently it is quite clear that this same customer will be less price conscious and may buy larger quantities than he would if he had to pay cash immediately. This and the former point just made lead us to believe that credit customers buy a higher quality of merchandise. Another reason this is true is the fact that the credit customer is a *selected* customer. By means of a selection process, some customers have been preferred to others and the less able customer has

been excluded. This select and preferred group are the buyers of the higher-quality lines of merchandise. The credit customer then buys more merchandise at a higher price, and sales volume is increased.

Even though credit customers are a distinct advantage to a store, there are problems which naturally arise. Once having built a profitable credit-customer group, the merchant will soon become aware that accounts become inactive for a variety of reasons. Customers die; go elsewhere to trade; change residence; meet with misfortune; have fluctuations of income; and change from credit to cash customers on their own volition. The proportion of accounts which become inactive each year is conservatively estimated at slightly more than 10 per cent. This ratio is in agreement with department store experiences, but may be high or low depending on the type of vendor offering credit. Whether the proportion of accounts is high or low makes little difference, as the fact remains that sales promotion must be applied continuously in order to build a profitable credit-customer group. The remaining sections of this chapter cover some of the more accepted and successful credit sales promotion methods in use.

How to Get Credit Customers

New credit customers may come from any one of three sources—present cash customers, potential customers presently residing in the store's trade area, and new residents in the community.

Present cash customers are frequently a source of existing credit accounts. A cash customer possibly has already gained a favorable impression of the store, its personnel, and its quality of merchandise and services. Aggressive credit managements have been alert to the possibility of converting cash customers to credit customers. In doing this they adopt methods of account solicitation which make it convenient, pleasant, and complimentary for the customer. Much of the effort in converting these customers is applied in the retail store. Salespeople can be of valuable assistance here and perhaps are the principal force in motivating a good cash customer to open a credit account. Salespeople on the other hand, need to be trained in the art of account solicitation. They must have a thorough understanding of the store's policy with regard to the various credit plans as well as an appreciation of how a credit account can better serve their customers. Trained salespeople can then answer customers' questions more intelligently and approach them with appropriate phrases of solicitation more effectively.

Today it is customary for vendors of goods and services to advertise for credit customers. See Figures 15–1 and 15–2 for examples of letters

FIG. 15–1. Letter sent to new open-charge customers.

OFFICERS AND DIRECTORS
R E CAMPBELL Chairman of the Board
JOHN M CAMPBELL President
E PHILLIP WATKINS Vice President
SAMUEL E HAUPT Vice President Secretary
HAROLD H HINDS Treasurer
KATHARINE C MILLER

NEW YORK
130 WEST 51st STREET
CHICAGO
913 MERCHANDISE MART
LOS ANGELES
844 SOUTH BROADWAY
800 WEST 6TH STREET

MILLER & PAINE
INCORPORATED
LINCOLN 1, NEBRASKA

Thank you for giving us the opportunity to open an account in your name. It is a real pleasure to include you among our many thousands of reliable charge customers.

Your account will be billed by the (billing date) of each month and your statement will list all charges and credits placed on your account during the thirty days preceding your closing date of the (closing date). Our regular accounts are payable in full within fifteen days from the date billed.

We invite you to make our store your shopping center and a meeting place for you and your friends. At any time that we may be of service, please let us know.

Cordially yours

Credit Manager

Courtesy of Miller & Paine Department Store, Lincoln, Nebraska

FIG. 15–2. Letter sent to new-open charge customers.



QUALITY APP[illegible]EL **ben Simon's** FOR MEN, WOMEN AND CHILDREN ★ SINCE 1902

TELEPHONE 2-4405

LINCOLN 1, NEBRASKA

One of the first things I look for when I reach my office in the morning is the daily list of new charge customers. Today, I was exceptionally pleased to see your name.

I want you to know that we sincerely appreciate your good will, and we hope to win your confidence by meriting it. I wish to thank you and express the wish that this may be the beginning of a long and pleasant business relationship.

It is the foundation policy of Simon's that "no transaction shall be considered final unless the customer is entirely pleased and satisfied."

Should you find yourself in need of any assistance which may add to the pleasure of your shopping at Simon's, please do not hesitate to call on me personally.

Sincerely yours,

Harry Simon
President
ben Simon's

HS:mb

Courtesy of Ben Simon's, Lincoln, Nebraska

sent to new open-charge customers. Newspapers, direct mail, and credit account promotion within the store play an important role in the sales promotion plans of merchants most successful in this activity. The tone and characteristics of the several methods of advertising for new credit accounts are most effective when patterned after the over-all merchandising policies of the store. Very high-quality stores can utilize refined and carefully selected copy which is characteristic of the quality, luxury appeal, and prestige expected. Merchandisers who appeal to a very large cross-section of the population invite credit customers with more aggressive and showmanlike devices. The general characteristics of these stores are exemplified further by their account-building methods. Vendors who make no class appeal and promote price to a greater extent than quality usually sell credit terms in the same manner. Of fundamental importance is that the means of account solicitation should not destroy the characteristics and general reputation of the store for which it may be well known. In recent years many department and specialty stores have placed credit application desks at strategic locations throughout the store. This is an internal form of promotion which attracts passing customers. Application blanks are provided, and an open invitation to apply for a charge account is made. These desks serve the purpose of campaigning for the cash customer who has not taken the time and effort to go directly to the credit department. At these locations the customer may either complete his application in public and deposit it at a near-by mailbox or take the application to the privacy of his home.

Special credit plans and the alteration of terms and installments will frequently bring a surge of new accounts. The recent innovation and promotion of revolving credit accounts has proved successful in attracting new accounts. These accounts have many of the same characteristics as the regular retail charge account except the customer may elect not to pay the entire balance each month. If the account is paid in full each 30-day period, there usually is no credit charge. If the credit customer wants more than 30 days to pay, he may pay as little as some nominal portion of the account and a credit charge is added to the unpaid balance. Those customers who have believed the charge account too burdensome, relative to their monthly income and other obligations, may be attracted to this type of account because of the relatively low monthly payments.

The alteration of terms and installments will most certainly add impetus to the sale of some merchandise. Durable good sales are frequently stimulated during periods of low business activity by selling customers through more convenient terms. "No down payment," "no pay-

ments until next year," and the extension of installments over more months are typical installment sales-building techniques. Promotions of this type are timed to attract credit accounts, when otherwise the incentive to enter into a credit obligation might be low.

Employee campaigns and contests can produce new credit customers. The credit department has the alternative of developing its own employee contest or gaining the assistance of one of the many sales promotion consulting firms. The advantage of professional assistance lies in their ability to overcome contest inequities, set reasonable and profitable goals to be attained, and shift from store management the responsibility for its successful execution. Despite the cost of professional guidance and execution of contests, management benefits from the professional's cumulative experience, and hence the possibility of greater campaign success, and the avoidance of most problems associated with promotions of this type.[1]

New families in the community are perhaps one of the most productive sources of new credit customers. See Figures 15–3 and 15–4 for examples of letters to newcomers. In recent years mobility of the American population has become very great. The Bureau of Census, late in 1958, reported that approximately 20 million people had changed their homes during a recent twelve-month period. This statistic merely indicates the average proportions of population movement. The movement of *families* into and from a particular community may have great variation. New families usually have great sales potential. They have immediate and long-run needs for their home to establish it as a comfortable and convenient place in which to live. Home furnishings, floor coverings, housewares, and small and large appliance departments should be particularly watchful and alert for this new customer. Most communities throughout the country have organized methods which detect the arrival of new families and whether they have purchased their home or are tenants. In locating and soliciting these customers, it is particularly essential that an early invitation be extended to visit the store and use its services. Otherwise, this valuable source of credit business may be lost to other stores that made their approach soon after the family's arrival in the community. Whatever the method used, it should function to associate the new family with the store before competitors have the same opportunity. No department store or specialty

[1] A few companies which specialize in credit promotion, customer relations, and other types of sales promotion are: Trayton H. Davis and Associates, Inc., Milwaukee, Wis.; A. J. Wood and Co., Philadelphia, Pa.; Lester Broxman Co., New York; and Amos Parish Co., New York.

FIG. 15–3. Newcomer letter.



Welcome to Lincoln...city of comfortable homes - fine churches - excellent schools - and friendly people. We hope that you will be very happy here.

We would like to do our part to help you feel "at home" in our store, and for your convenience we have opened a Gold & Co. charge account for you. Your personal CHARGA-PLATE token is enclosed.

YOUR ACCOUNT IS OPEN AND READY TO SERVE YOU. When you make a purchase just hand your CHARGA-PLATE token to the salesperson and say "Charge it". You will be delighted with the efficiency of CHARGA-PLATE service.

Your statement billing date will be about the of each month under our cycle billing plan. Accounts are due in full within 15 days after the billing date, and you are entitled to the nationally known S&H GREEN STAMPS when so paid, if requested with your remittance.

Do come in and use your account soon. Make Gold's your downtown headquarters..."You'll enjoy shopping at Gold's."

Cordially,

GOLD & CO.

D. K. Boldt
Credit Manager

The enclosed leaflet tells of other credit plans available at Gold's. For further information please phone or call at our 4th floor credit office.

Cp-1

Courtesy of Gold Department Store, Lincoln, Nebraska

FIG. 15–4. Newcomer letter.

OFFICERS AND DIRECTORS
R E CAMPBELL Chairman of the Board
JOHN M CAMPBELL President
E PHILLIP WATKINS Vice President
SAMUEL E HAUPT Vice President Secretary
HAROLD H HINDS Treasurer
KATHARINE C MILLER

NEW YORK
120 WEST 31ST STREET
CHICAGO
613 MERCHANDISE MART
LOS ANGELES
840 SOUTH BROADWAY
808 WEST 8TH STREET

MILLER & PAINE
INCORPORATED
LINCOLN 1, NEBRASKA

Isn't it exciting to move to a new town? We are glad that you have come to Lincoln and we here at Miller & Paine want to extend a cordial welcome to you. We are certain you will enjoy Lincoln's friendly people and its many advantages.

Getting settled in a new home can be rather strenuous and we would like to help make this transition easier for you. An account has been opened for your convenience and a charga-plate token is enclosed. Please feel free to use it at once.

For 80 years, Miller & Paine has had the pleasure of offering its customers dependable merchandise which is style-right and value-right along with prompt and efficient service.

Please use freely all of our store facilities and call upon us for any service which will make your shopping pleasant and enjoyable.

Cordially yours

Credit Manager

Courtesy of Miller & Paine Department Store, Lincoln, Nebraska

store in the home furnishings line can afford to neglect training their salespeople in the techniques of prospecting for this high-volume potential.

How to Get More Sales from Credit Customers

A well-organized and successful campaign for the promotion of credit sales must include solicitation of present credit customers. Present credit customers need almost continuous solicitation to keep their accounts active and sufficient in dollar volume. See Figure 15–5 for a letter used for solicitation purposes.

Inactive credit accounts come about for a number of reasons. The customer may have had an unfortunate experience with the store's merchandise or sales personnel; he may be buying in some departments with apparent satisfaction and not in other departments, but goes elsewhere and buys the same merchandise: he may have been the subject of an aggressive collection method or he presently is overdue on his account; or, the customer becomes indifferent for no apparent reason. Of the various methods for increasing credit sales, direct mail and personal solicitation can be effectively employed in some of the above situations. See Figure 15–6 for such an illustration. When the reason for inactivity rests with the collection department, the problem is within the store and not within the customer. If the collection effort is too strict or too lenient, a loss of sales will occur. A very high percentage of customers are concerned about their indebtedness, and particularly so if they are delinquent. The collection policy which has as its sole objective a high collection ratio may very well destroy the good will of the store. To achieve the goal of a high collection ratio, without properly evaluating the result on sales volume, is indeed a short-sighted policy. On the other hand a collection policy which is too lenient is likely to result in a large number of overdue accounts. In either case a loss of sales will be experienced. The customer who harbors resentment and ill will is of no greater sales potential than the customer who is overburdened with debt and sensitive to his obligations. The best collection policy to adopt will be that which collects the amounts due and still preserves the good will of the store. Great consideration must be given to the collection policy of the store so as not to nullify the sales-creating power held by most customers. There is an optimum type of collection policy for practically all types of creditors without which the value of repeat sales to credit customers may be lost. The collection methods suggested elsewhere in this book are designed so as to meet collection objectives and yet preserve the good will of the customer.

FIG. 15–5. Solicitation letter.

GOLD'S. of Nebraska

Lincoln's Busy Department Store

Thank you for meeting your Continuous Budget Account payments in such a prompt manner. We value your account highly and it is a real pleasure to do business with you.

And since there is "no balance" on your CBA now, we hope that you won't wait another day to get those next items on your list of wants for your home.

We want you to know that your credit is "Good as Gold" at GOLD'S, and that your CBA provides the most liberal arrangement for the new things you are wanting.

Do come in soon...see how many fresh, new ideas we have for your home. Then, select whatever you want and say "Charge it to my CBA".

Sincerely,

GOLD & CO.

D. K. Boldt

C/ty

D. K. Boldt, Manager
Credit Sales Department

Courtesy of Gold Department Store, Lincoln, Nebraska

FIG. 15–6. Letter to inactive credit account.



Courtesy of Jos. Kuhn and Co., Champaign Illinois

An analysis of credit customer accounts will reveal many interesting facts to management. Some accounts have a large amount of activity, and the average monthly credit purchases contribute importantly to the total sales volume of the store. Some of these same accounts may also be those which reveal trading on a store-wide basis. Those customers who concentrate their purchases with a particular store and in many of its departments may be regarded as the "ideal" credit customer. A sizable number of accounts, however, will not measure up to the "ideal" account. Some accounts are used on rare occasion, purchases are few, and amounts charged are small. Still other accounts remain inactive for months and even years for no apparent reason. The task of building

credit sales volume through the occasional customer or through those with an inactive account presents a difficult promotional problem. Direct mail, personal solicitation at the home, and the solicitation by salespeople in the store are the more effective methods in these cases. Care must be exercised so that customers solicited are also those which have the credit qualities that make it possible for them to become good credit customers. The small accounts and those used only on rare occasion may best be approached by praise, "thank you" letters for past patronage, and "how can we better serve you" technique. When the customer is subjected to this treatment, he may gain the impression that both his past and future business are of utmost importance to the store. This same customer may need frequent invitations to visit the store and gentle reminders on how his credit account can function as the means by which purchases can be made.

Well-informed salespeople can be of invaluable assistance in raising the average dollar volume of credit accounts. Customers have their closest personal contact with the store through the salesforce. Hence, it becomes imperative that the salesforce be instructed in the use of credit as a sales tool. When the sales personnel are completely informed on the offerings of the store and the value of credit as a sales tool, they are well equipped to suggest particular departments and specific merchandise to their customers. Special store-wide and departmental sales events, new merchandise, arrivals, demonstrations, and shows should always be the subjects of suggestion to credit customers. If salespeople are trained to suggest special events in their own and *other* departments, and such suggestions become a part of their selling, both high-activity and low-activity accounts will be affected in a positive direction.

All too frequently salespeople fail to appreciate the significance of credit as a selling tool. If the salesforce understands management's attitudes with regard to credit and the reasons various credit plans are put into operation, they may be more willing to emphasize credit to their customers. They must, however, be told that (1) consumer credit is a selling tool without which the business would suffer; (2) no customer should ever be embarrassed in the use of his credit, but encouraged and complimented on his wise and prudent choice; (3) reasons lie behind all of the various credit plans and a plan is in operation for almost every customer; (4) free and easy credit is not the policy of management, but that sound beneficial credit plans are offered to good customers; and (5) salespeople themselves should learn more about the wise use of credit, and how different credit plans are co-ordinated with the store's merchandising policies. While only a few firms are

known to do an effective training job with their salespeople, this means of stimulating credit sales, reviving inactive accounts, and increasing the average amount per account cannot be overemphasized.

There are numerous other opportunities to stimulate credit sales. The new account interviewer, the collection clerk, the cashier, the adjuster, and others have a constant opportunity and responsibility to cultivate credit sales through improved customer relations. In particular they should not overlook the sales opportunity when an installment account is completely paid and the possibility of using "add-ons" to boost sales. This group, lacking in a credit-sales attitude, can also nullify all the advertising and promotional devices which attracted customers to the store. Their role should be that of building customer relations leading to successful credit-sales promotion. Customer indifference and inactive customer accounts too frequently are traced to the tone of clerical personnel within the credit department. It remains that training programs must be designed and initiated for this important group as well as the salesforce.

Good Will Activities

The credit-sales promotion task, when properly segmented, will include an area of good will activities. For the most part these activities can be accomplished by letters and acknowledgments to good credit customers on special occasions. See Figure 15–7 for an example of a "thank you" letter. The credit department has numerous opportunities to compliment the good credit customers, say "thank you," and praise them for their value to the store. Several occasions on which good will letters are particularly desirable are:

1. When the credit customer initially opens an account.
2. During special seasons such as Christmas, Thanksgiving, "back-to-school" days, Mothers' Day, and Fathers' Day.
3. When the customer's account has its first, fifth, tenth, fifteenth anniversary or more.
4. On the birthday, wedding anniversary, or other pleasant occasion in the customer's life.
5. To acknowledge the payment in full of an installment account.

It should be noted that the above listings emphasize anniversaries and occasions in the life of the *customer* and not events in the history of the retail store. From a psychological standpoint, it is vastly more desirable to place emphasis on events of immediate and personal interest to the customer rather than the anniversaries of the store. See Figure 15–8 for an example of a letter insert that emphasizes the store's an-

FIG. 15–7. "Thank you" letter.



STRAWBRIDGE & CLOTHIER

MARKET AND FILBERT AT EIGHTH, PHILADELPHIA

PHILADELPHIA • ARDMORE • JENKINTOWN • WILMINGTON

Mr. John Smith
100 Main St.
Phila., 1, Pa.

Dear Mr. Smith:

Our verbal "thank you" at the time you pay your bill seems hardly adequate to express our appreciation, not only for your purchases at Strawbridge & Clothier ... but for the very prompt payment noted on your account.

Since Strawbridge & Clothier has grown so big, we feel it necessary occasionally to remind ourselves that keeping store is far less a matter of price tags and records than it is people ... we on this side of the counter and you, our customers.

We would enjoy being able to shake your hand and thank you personally. Since we cannot do that it is a pleasure to send this written note of appreciation for making storekeeping the satisfying business it is when we deal with people like yourself.

Sincerely,

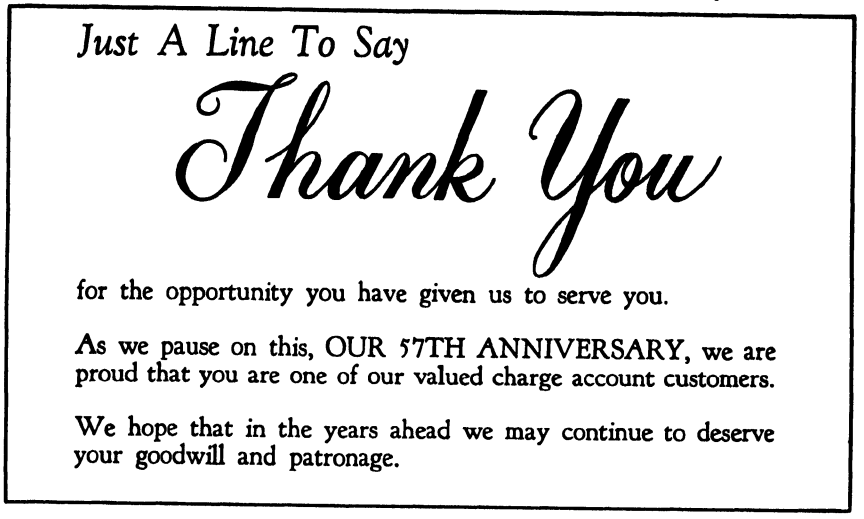
STRAWBRIDGE & CLOTHIER

Frank M. Layton
Credit Manager

FML/hml

Courtesy of Strawbridge & Clothier, Philadelphia, Pennsylvania

FIG. 15–8. Letter insert emphasizing store anniversary.



niversary. Furthermore, good will letters should exemplify some prestige element, and it is suggested that the letterhead and signature be that of one of the senior executives of the firm, thus further impressing the recipient.

Special advance sales to credit account customers are another promotional and good will activity employed by a large number of retail stores. In addition to the advantages of better selection of merchandise, more pleasant shopping conditions, and the convenience of using his credit at advance sales, the credit customer is imbued with his value to the store. He enjoys the created impression that he has a close association with the merchandiser. Because customers are restricted to those with credit accounts, he places himself in a distinctive class.

The occasion of customers' misfortunes should not be overlooked in planning good will activities. Accidents, sickness, and temporary unemployment frequently set up obstacles to prompt payment of accounts. A sympathetic and understanding attitude toward such circumstances will do much to cement customer relationships. If these circumstances are handled properly, the credit manager can expect with the passing of the misfortune, that some recipients of this treatment will reciprocate by concentrating an even greater share of their purchases with the store.

It may also be desirable to station credit department representatives throughout the store. Some stores may find this to be impracticable and designate certain key salespeople as "credit sales representatives." In either case this plan can contribute to good will and an increased credit volume. The new credit customer, when referred by a salesperson, is

more likely to find his way to the credit department when escorted to it. The credit department representative can first, welcome the new credit customer to the store and carry on a casual polite conversation; second, he can escort the customer to the credit department where the customer is introduced by name to the credit interviewer and the various credit plans. Some credit representatives are authorized to complete credit applications and other necessary papers on the sales floor. This is particularly important when the sale of "high-ticket" items is involved. To *send* the customer to the department may result in his finding his way out of the store and into the surroundings of competitors.

Selling the Credit Department to the Organization

To achieve the greatest total benefit from a credit department, its purpose, objectives, and policies must be co-ordinated with and understood by all segments of the firm. Management must know what contribution the credit department makes to the total merchandising effort. Throughout this chapter and other sections of this book it has been stated that the credit department can increase sales volume; it can increase the volume from present customers; through promotion it can increase the number of credit customers; and it gives sales people another selling tool. In accomplishing these objectives a profit is going to be expected by management. Profit is one of the aims of a credit department too, as it functions to increase sales volume at low operating costs. As another store service, credit stimulates good will and sales volume. The objectives of management and the aims of the credit executive are one and the same. Credit executives need only to take a positive approach toward their responsibilities and co-ordinate credit functions with those of management. In such an approach management sees an indispensable service to their customers which importantly contributes to the over-all aim of the business.

The credit department function must be co-ordinated with all other departments and personnel. Credit managements depend on close co-operation of other departments for the greatest effectiveness of their function. Merchandising, store operations, sales promotion, controller, and personnel divisions are interrelated and co-ordinated to achieve most effectively the objectives of the firm. The total effectiveness can be nullified by malfunctioning of any segment within the various divisions. The credit department is particularly susceptible to malfunctioning because of the false impressions, prejudices, and traditions associated with consumer credit. These problems cannot be overlooked when credit management strives for complete co-operation with other departments.

It becomes necessary that sound credit policies be adopted and the need and impact of such policies be related to all pertinent personnel. In the last analysis, no other department is as personal as the credit department in the mind of the consumer. This same department is the most frequent in contact with the customer in his home. The strategic position of this department relative to the customer's image of the store is a valid reason for credit education and competence of merchandising personnel.

REVIEW AND DISCUSSION QUESTIONS

1. Distinguish between personal salesmanship and credit salesmanship.
2. Visit several of your local stores to determine whether their credit departments are doing any "selling."
3. Do you believe that credit customers should be sought? Why or why not?
4. Why may credit customers be of more advantage to a store than cash customers?
5. From what sources may new credit customers be obtained? Explain each source.
6. What is meant by the expression, "the alteration of terms and installments"?
7. Why are new families in a community often one of the most productive sources of new credit customers?
8. How do you suggest getting more sales from credit customers of a store?
9. Check with your leading local department store to see what procedures are being followed to reactivate "dead" credit accounts.
10. Why should salespeople appreciate the significance of credit as a selling tool?
11. Enumerate the most important good will activities in which a store may engage. Which ones do you believe are the most advantageous? The least?
12. Why is it necessary to "sell" the credit department to the rest of a retail store's organization?

CHAPTER 16

Collection Policies and Practices

COLLECTIONS ARE an inherent part of any credit business. As long as a retail store, a service concern, a financial institution, or a professional man accepts the credit of customers, then there always will be the need for some type of collection work. As pointed out previously, credit has limited acceptance because of the risk and time elements involved. And accompanying these two elements of risk and time is the natural but unfortunate factor of nonpayment of indebtedness in certain instances.

It should be recognized that as its ultimate accomplishment any collection system to be successful must get the money. This objective becomes less obvious and much more difficult to attain when the additional requirements of retention of good will, rehabilitation of the debtor, promptness of payment, and economical operation are added. If promptness is made the major objective, it may be attained by handling all collections immediately. However, the methods selected and used may be very costly and may simultaneously lose good will. On the other hand if retention of good will is made the major objective, the appeals and techniques used will be very gentle, even delicate, and collections will tend to be slow in starting. Which approach proves to be the best for rehabilitation of the debtor will depend in large measure upon the type of individual customer involved.

Mention should be made at this point that the word "collections" does not mean the same thing to all people, not even to all credit personnel.[1] There is a so-called intermediate area that is the subject of varying interpretation. Thus, does the collection effort start at the moment

[1] Some credit managers state that the collections begin when credit is first granted or an account is opened. Thus, under this type of reasoning collections appear to begin with the clear understanding on the part of the customer regarding the terms of payment.

that the customer is reminded in some manner of his indebtedness, regardless of whether or not the credit period agreed upon has expired? Advocates of this view consider the statement which is sent to the individual, pointing out that such an amount will be due on such a date, as part of the collection efforts of a firm. It would appear inconsistent to subscribe to such a view, and in this book the word "collections" will refer to those efforts made *after* the credit period as agreed upon by the debtor and creditor has expired, but it will not include any efforts made before the end of this credit period. Thus, collections will start only in case of nonpayment of indebtedness in the time period established prior to or at the time of sale.

CONSUMER CREDIT INSURANCE[2]

Before discussion of "regular" collection policies and practices, it is important to recognize a type of collection followed in certain consumer credit transactions. This type is consumer credit insurance.

During recent years, there has been a very rapid rise in the use of life and disability insurance in connection with consumer credit transactions. This special kind of insurance, called "consumer credit insurance," is now offered to debtors by many different types of credit-granting institutions. The insurance names the creditor as the first beneficiary, and provides that an insured person's debt will be paid in full upon his death, or that periodic installments will be paid in the event of his disability. It is divided, then, into two major categories: credit life insurance, and credit accident and health insurance.

Credit granters can make the insurance available to their customers by offering individual policies, for which the debtor pays the premium, or by offering certificates of insurance under a group policy. The cost of group coverage may be paid by the creditor, or it may be shifted to the debtors through an identifiable charge.

Nature of the Insurance

Credit insurance is written for the duration of a consumer loan or installment sale contract, and in an amount equal to the indebtedness. It is issued to debtors without benefit of a medical examination, with no restrictions for physical impairments or occupational hazards, and with a uniform charge regardless of the insured person's age.

[2] For a more complete treatment of this important topic, the reader is referred to the unpublished dissertation of John B. Minick, *Consumer Credit Insurance in Nebraska* (University of Southern California, 1959). The material in this section is based upon Professor Minick's study.

Individual credit life insurance policies may be written either on a decreasing-term or a level-term basis. Decreasing-term coverage provides a benefit that decreases as the installment debt is reduced, so that the protection is always equal (or approximately equal) to the debt. If the coverage is level term, the amount of insurance in force remains the same for the duration of the debt.

There are two basic kinds of credit accident and health insurance policies: those with an elimination period, and those with a retroactive period. Under either plan, the insurance company assumes installment payments only after a stated term of disability, which is usually 14 days. The insured debtor, however, is not indemnified for the waiting period if it is "eliminated," while he is indemnified for that time if the coverage is retroactive.

Consumer credit insurance extends benefits both to the insured debtor and to the creditor who makes the insurance available. The debtor benefits from the insurance because it gives him protection and peace of mind, it permits him to make greater use of his credit, it enables to get co-signers where needed, and it is available without exclusions. The creditor benefits because the insurance serves as an added security device, and because it relieves him of onerous collection duties. In addition, good will accrues to the credit granter when the debt is created, since the insurance is desired by large numbers of consumer-debtors, and also when benefits are paid as the result of death or disability.

Origin and Development

Credit insurance was first written in 1917 by the Morris Plan Insurance Society, which was established at that time by Arthur J. Morris, of the Morris Plan banks. During the 1920's and 1930's, credit insurance developed into its present form. Decreasing-term life coverage was introduced in 1922, group credit insurance was first written in 1926, and accident and health coverage was developed shortly before World War II. The charges for credit insurance decreased steadily, many insurance companies began to write it, and a variety of credit granters began to offer it to their customers.

The years following World War II saw an extremely rapid increase in the volume of consumer credit insurance in force and in the number of companies writing it. Group insurance increased at a faster rate than individual; by 1958, group policies accounted for approximately 80 per cent of the credit life insurance in force.

The growth of consumer credit insurance in recent decades has been far greater, percentagewise, than the growth of either disposable per-

Table 16–1

CREDIT LIFE INSURANCE IN FORCE IN THE UNITED STATES
(000 Omitted)

Year	Individual		Group			Total	
	No. of Policies	Amount	Master Policies	No of Certificates	Amount	Number	Amount
1917	1	†	..			1	†
1918	17	$ 2,000				17	$ 2,000
1919	24	4,000		.	.	24	4,000
1920	22	4,000		.	..	22	4,000
1921	31	7,000			.	31	7,000
1922	35	8,000			.	35	8,000
1923	37	9,000			..	37	9,000
1924	50	12,000			..	50	12,000
1925	81	18,000			..	81	18,000
1926	113	24,000	*	4	†	117	24,000
1927	138	29,000	*	11	$ 1,000	149	30,000
1928	148	33,000	*	42	7,000	190	40,000
1929	176	40,000	*	91	17,000	267	57,000
1930	197	46,000	*	166	27,000	363	73,000
1931	166	38,000	*	241	47,000	407	85,000
1932	117	25,000	*	238	44,000	355	69,000
1933	115	20,000	*	235	43,000	350	63,000
1934	132	21,000	*	287	54,000	419	75,000
1935	171	26,000	*	388	75,000	559	101,000
1936	194	29,000	1	587	109,000	781	138,000
1937	225	37,000	2	952	179,000	1,177	216,000
1938	275	44,000	3	1,277	212,000	1,552	256,000
1939	329	51,000	4	1,705	256,000	2,034	307,000
1940	392	62,000	5	2,171	318,000	2,563	380,000
1941	445	74,000	6	2,574	395,000	3,019	469,000
1942	417	66,000	6	2,047	289,000	2,464	355,000
1943	382	57,000	6	1,474	218,000	1,856	275,000
1944	335	66,000	5	1,417	224,000	1,752	290,000
1945	561	101,000	6	1,549	264,000	2,110	365,000
1946	1,024	180,000	6	2,366	549,000	3,390	729,000
1947	1,355	291,000	7	3,490	919,000	4,845	1,210,000
1948	1,475	372,000	8	4,666	1,357,000	6,141	1,729,000
1949	1,781	482,000	9	6,170	2,049,000	7,951	2,531,000
1950	2,225	720,000	10	8,609	3,169,000	10,834	3,889,000
1951	3,033	1,110,000	12	9,355	3,708,000	12,388	4,818,000
1952	3,596	1,464,000	14	10,851	4,971,000	14,447	6,435,000
1953	4,311	1,851,000	19	13,550	6,855,000	17,861	8,706,000
1954	4,760	2,324,000	23	16,238	7,917,000	20,998	10,241,000
1955	5,001	2,379,000	27	22,965	12,371,000	27,966	14,750,000
1956	6,002	2,844,000	31	26,123	14,254,000	32,125	17,098,000
1957	6,890	3,523,000	36	27,052	16,225,000	33,942	19,748,000
1958	7,271	4,341,000	43	27,733	17,133,000	35,004	21,474,000

* Less than 500 master policies.
† Less than $500,000

Source *Institute of Life Insurance.* Individual and total 1958 figures are not strictly comparable with earlier years due to inclusion of some $630 million previously considered ordinary.

sonal income or consumer credit outstanding. This development is the result of several factors: (1) the public's desire for security, (2) the benefits provided by the insurance, (3) the increased use of consumer credit, (4) the passage of favorable state laws, (5) the great variety of creditors offering the protection, (6) the competitive selling efforts of the insurance companies, and (7) the favorable publicity it has received.

There are many indications that the majority of consumers desire to protect their debts through the purchase of credit insurance. In a mail survey conducted among 1,000 residents of Nebraska, 69 per cent of the respondents said they would purchase some type of consumer credit insurance upon the creation of consumer debt. A breakdown of the results between nonusers and previous users of the insurance revealed that 53.4 per cent of the nonusers, and 95.2 per cent of the previous users, would choose to buy the protection.

A similar survey conducted in Colorado by an independent research firm found that 91.7 per cent of previous users would purchase the insurance again. This figure closely approaches the 95.2 per cent affirmative response from previous users in the Nebraska survey.

Many other indications of high demand are found in the literature dealing with consumer credit insurance. In addition, the extremely rapid growth of the insurance (see Table 16–1) and the fact that it is offered by most credit granters are further indications of high demand for this type of protection.

Regulation of Credit Insurance

It appears to be necessary for the state to regulate consumer credit insurance because: (1) the consumer is in an inferior bargaining position and is generally not versed in matters relating to insurance, (2) the insurance companies, as a selling device to creditors, tend to grant higher commissions than necessary, and (3) unscrupulous creditors, in the absence of effective laws, might use the insurance as a means of extracting extra charges from their customers.

If abuses are to be prevented, the following rules should be in effect: (1) charges for individual and group insurance and the compensation received by creditors must be limited, (2) coverage must never exceed the amount of the debt or the term of indebtedness, (3) debtors must be free to acquire the insurance from sources other than the creditor, (4) creditors must give insured persons a statement or a copy of the policy which describes the coverage, (5) insurance must be canceled and unearned charges refunded when debts are prepaid or refinanced, (6) claims must be paid by the insurance company rather than by the

credit granter, (7) insurance companies writing the policies must be authorized to do business in the state, (8) creditors selling individual or group coverage must be licensed or authorized by the state insurance department, and (9) all policies must be reviewed and approved by the insurance department.

DEVELOPING A COLLECTION POLICY

Since a policy is generally accepted as a course of action to be followed over a period of time, it should be recognized that in developing a collection policy the firm involved should establish a set pattern to be followed in its efforts to collect amounts past due. This does not mean that once a policy is established it cannot be changed. On the contrary, changes are vital to keep any policy alive and face to face with actual operations. But the basic plan of attack should change slowly, in order that customers, store personnel, and other interested individuals can be familiar with the general procedure that is being followed.

There are four general policies from which to choose:

1. Liberal credit—strict collection.
2. Strict credit—liberal collection.
3. Liberal credit—liberal collection.
4. Strict credit—strict collection.

Experience has shown that of the four the first two are the most likely policies to be found in effect, especially in retail stores and service establishments. Often the professional man finds himself involved with the third policy, much to his dismay. And the fourth policy has appeared most often in credit transactions involving the loans of cash by commercial banks and by personal finance companies.

It should be recognized by the creditor that as long as his customers regard credit solely as a service rather than a mutual privilege, then his collection problems may be troublesome. When the customer begins to think of credit primarily as a business transaction, the collection problems of the creditor tend to become simpler; sentimentality lessens; the creditor is not as afraid to insist on payment for fear of incurring the ill will of his customers. Closely connected with this view is the growing realization on the part of creditors that no credit transaction is complete until cash payment in full is made by the debtor; that payment can be expected more readily if the indebtedness is incurred recently; that terms once established between debtor and creditor must be respected; that slow paying customers not only cost additional money for collection efforts but they also often become reluctant to return to the scene

of their earlier charging activities until their previous indebtedness is cleared.

Recognizing that unwillingness usually is a more important reason for nonpayment rather than inability, many creditors have come to realize that it is wise to start out any new credit customer with the understanding that prompt payment is expected and that everything possible will be done to collect any indebtedness incurred. Thus it has been shown that "accounts well opened are half collected," and that it is vitally important at the time the account is opened to impress upon the customer the importance of paying promptly.

Factors Affecting Collection Policy

In its decision as to what type of collection policy to adopt, a firm must recognize that there are many factors which should have an influence on policy determination. While by no means do the following comprise a complete list, at the same time it generally is recognized that capital, competition, type of goods, and class of customers are among the most important and most influential factors.

Capital. One of the most important factors is the amount of capital owned or available to the firm involved. Regardless of how liberal a collection policy a creditor may wish to follow, if he is operating with a limited capital structure, he is forced in most instances to adopt a "strict" collection policy in order to keep himself in a position to meet the demands of his own creditors. Most business firms are not blessed with an overabundance of working capital and depend upon the turnover of their goods to provide the funds needed. But a mere turnover of goods is not enough, if these goods are sold on credit. One step is added to the process and that is completion of the credit transaction by receipt of cash payment. How quickly this last step must be completed is predicated upon how badly the firm is in need of capital. Thus capital availability and need play a vital role in determining just what type of collection policy a firm must adopt, despite the fact that a somewhat different policy might be more feasible in view of some of the other factors involved.

Competition. Another influence in the formation and development of a collection policy is, "What is the competition doing?" Of course size of community plays a role here in that there generally is more room for different policies among large-city competitors than among small-town competitors. Regardless of community size, however, customers in time become cognizant to some degree of widely varying credit and collection policies, and a firm must be aware of what its direct and indirect competitors are offering these mutual customers.

Type of Goods. Another influence in determination of collection policy is the type of goods handled by the retail firm. This factor, however, does not play a dominant role in the policy determination of service concerns, professional men, and financial institutions. It is obvious that the greater the perishability of the good, the greater the need for prompt payment of the account and thus the stricter the collection policy. On the other hand, if the goods involved are of the "hard-goods" category and repossession (although undesired) is made easier through a chattel mortgage or conditional sales arrangement the need for a strict collection policy is lessened. This is not to say, however, that a strict collection policy is never followed by a firm handling hard goods, but it does point up that such a policy is dictated by some factor other than the type of goods involved.

Class of Customers. Collection work would be easier and the results better if there were some magic way in which each account could be immediately and accurately classified as to the reason for nonpayment and as to the collection method which would be most effective with that particular debtor. Sorting devices to perform such miracles unfortunately are not yet available, and until such become economically and mechanically feasible the responsibility for any classification, if made at all, rests with the credit personnel involved.

It should be recognized that certain customers regularly and almost automatically pay in response to the simple suggestion that payment time has arrived and that payment is desired. Those who place themselves in this desirable classification—that of prompt payers—solve one part of the problem of classification and remove themselves as possible collection cases. Worries with them cease.

It has been estimated that out of 100 open-charge and installment customers, 76 will pay with reasonable promptness. On the other hand, 23 will show varying degrees of slowness and will require some mild effort to collect the 30-day charge in less than 90 days and to secure the second payment on the installment transaction. Also it should be recognized that these 23 will not always be the same individuals, but they will fluctuate because of illness, temporary overbuying, and various other circumstances. The remaining 1 out of 100 will turn out to be troublesome and may prove to be absolutely unworthy of having had his credit accepted.

Thus in deciding upon what collection policies and practices to adopt, many firms attempt to decide whether their customers are those persons who pay promptly and who only need slight reminders, if indeed any reminders at all, to make payment. Certainly in these cases if any pres-

sure is ever needed, it will be applied gradually and with exceeding slowness. Included in this classification are those debtors who, although they may be having some difficulty in making payment, respond fully to any inquiry with a complete explanation as to reason for nonpayment and with a careful analysis as to when full payment may be expected.

At the other extreme, if it appears obvious that a mistake was made in accepting credit in the first place, then there is little to be gained from using those gradual and "weak" devices. But experience has shown that such individuals respect only strong efforts, and immediate threat of legal action may produce results not obtainable by less vigorous attempts.

Between these "prompt payers" and these known "dead beats" is the group of debtors with whom judgment and experience will have to play a vital role in determining just how strict to be, just how severe the collection method to be used, just when to apply the pressure and how gradually or rapidly to increase the intensity of this pressure. Thus it is with these debtors that the problem of classification is most acute.

A GENERAL COLLECTION SYSTEM

The ideal collection system would be one which solves the problem of the volume of work by being largely routine in operation and which operates in such a manner that the problem of classification is primarily solved by causing the debtors to classify themselves by their own actions. When properly adapted to the needs of the creditor firm and when correctly fitted to the characteristics of the customers, such a system should get the money and should do so promptly, economically, and without loss of customer good will. The basic question is the design characteristics or principles of such a system. If the principles of design are understood, an actual operating system conforming to these principles can be developed by any competent credit manager.

Promptness and regularity of payment must be built into any system because of the following conditions:

1. A lax collection policy often indicates an incompetent management. This in turn can reflect upon the purchaser's attitude toward the products sold by the firm.
2. Experience has shown that there is a definite correlation between the length of time debts are unpaid and the volume of resulting bad debt losses.
3. Slow collections tend to result in the loss of future sales to these customers because of their reluctance to attempt to buy from creditors whom they have owed for some period of time. Of course, these creditors may show even a stronger reluctance to sell such customers.

4. Failure to enforce the collection activity tends to aid the imprudent purchaser. Thus, the foolhardy buyer may plunge headlong into unwise buying, knowing that the collection system of the selling firm will permit him an excessively long time before drastic legal action is taken, if it is ever taken at all.

A well-designed collection system may be compared to a series of screens over which the accounts are passed for the purpose of classification. The earlier screens are low in cost and handle the customer gently to preserve good will. The later screens are less routine and cost more to apply, may be somewhat sharper in action and thus do not preserve good will with such certainty, and tend to classify the reluctant debtors into much smaller and more exact assortments.

It is possible to divide a general collection system into four stages, giving emphasis in each stage to the kind of effort to use and to the sequence and timing of the collection efforts associated with that stage. These four stages are:

1. The impersonal routine stage.
2. The impersonal appeals stage.
3. The personalized appeals stage.
4. The drastic or legal action stage.

For each of these stages, the collection devices appropriate to that stage and the classes of debtors who may be expected to respond at that stage are indicated in Table 16–2.

In effect then self-classification on the part of the debtors is accomplished in large part at each of the respective stages. The devices suggested for each stage are, of course, much more numerous than would be desirable to incorporate into any one operating system. When developing an actual system to use in a particular situation, the credit manager would select the devices most appropriate to his collection task and would determine the frequency of use and the time to elapse between uses. He naturally would tailor the devices used to his own situation, considering the needs of his firm and the character of his customers. He also would be well advised to conform to the customs of his line of business and territory and to deviate from custom only on the basis of well-informed judgment.

This general system conforms to the principles of effective collection. The system assures that lower cost and routine methods will be used for the mass of the accounts and that those customers with more desire and means to pay will meet their obligations during the early stages of the system. After the bulk of the accounts has been reduced by various low-cost methods which also preserve good will, the higher-cost methods are

Table 16–2

A GENERAL COLLECTION SYSTEM

Stage of System	Collection Devices Available for Use	Debtors Involved
Impersonal routine	Statements—1st, 2nd, 3rd, etc. Statement inserts and stickers Notes on statements Form letters of reminder type (Note: These refer only to devices used after expiration of credit period.)	Those awaiting notice Honestly overlooked Temporarily financially embarrassed Careless or procrastinating debtor
Impersonal appeals	Form letters appealing to· "Anything wrong" tone "Tell us your story" tone Pride in credit responsibilities Sense of fair play Seeking reply from debtor Telephone Telegram Special letters Registered Special delivery Trick reply	Honestly overlooked Careless or procrastinator Temporarily embarrassed Overbought Accident or misfortune Disputed account
Personalized appeals	Personal collector. Telephone Telegram Personal interview Personal letters Debtor Employer Credit bureau	Overbought Eventual insolvents Accident or misfortune Frauds—no intent to pay Disputed account
Drastic or legal action	Extension agreement Composition arrangement Assignment of accounts receivable Collection agency Garnishment or wage assignment Repossession Attorney Suit Other actions	Same as debtors shown in the *Personalized appeals* (all should have assets)

applied selectively to the remaining small number of accounts which need such higher cost appeals. These stronger and more emphatic methods will have lower percentage returns because the potential of the group to which they are applied is lower, but these harsher devices with their reduced emphasis upon retention of good will may be employed since the self-classification process already will have eliminated those accounts whose good will is of primary importance. Thus through these

four stages suggested, there is a gradual increase of pressure which is consistently built up to such a point that the debtor should (but unfortunately not always does) feel that there is no more desirable alternative than that of payment and that there is no escape from this conclusion.

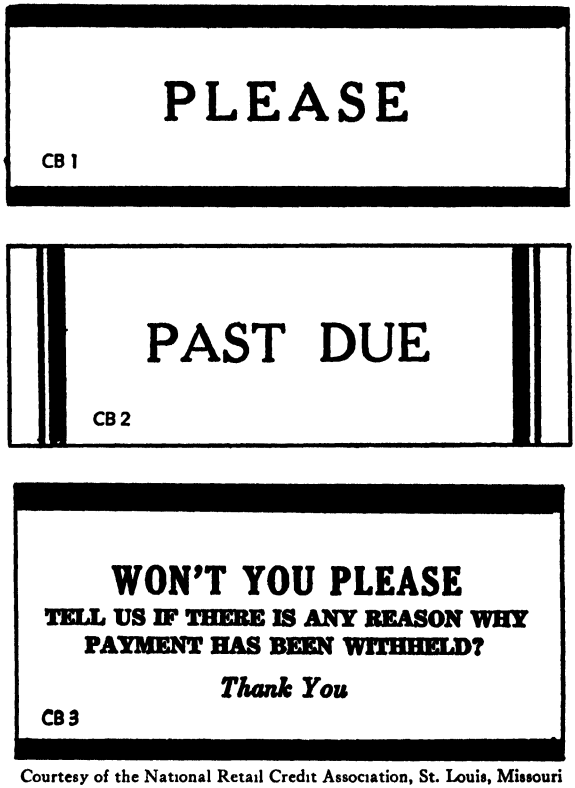
The general system will give a sound, effective, and logical organization to the collection efforts. The skill in the selection of the devices, the quality of the devices individually prepared, and the appropriateness of the timing should assure that the system is properly adapted to the situation of the firm and the nature of its customers. Thus a specific system developed in accordance with these general principles should be effective for the particular firm.

At this point, it is well to examine each of these stages in some detail.

The Impersonal Routine Stage

It is in this stage that the self-classification of debtors begins. Of course, it should be remembered that many debtors will have paid within

FIG. 16–1. Examples of impersonal routine stage (stickers for statements).



Courtesy of the National Retail Credit Association, St. Louis, Missouri

FIG. 16–1—*Continued.* Examples of impersonal routine stage (form letters—reminder type).

Mrs. John C. Patient
000 Main Street
Your City, Your State

Dear Mrs. Patient:

Your cooperation is needed!

You owe us $00.00 for service rendered in July. Reminders have been sent to you.

To write you a long collection letter would hardly seem necessary. Our confidence in you makes us believe that you will send your check today.

Many thanks.

Cordially yours,

(Signed)

Name of Physician or Dentist

Note to office assistant:

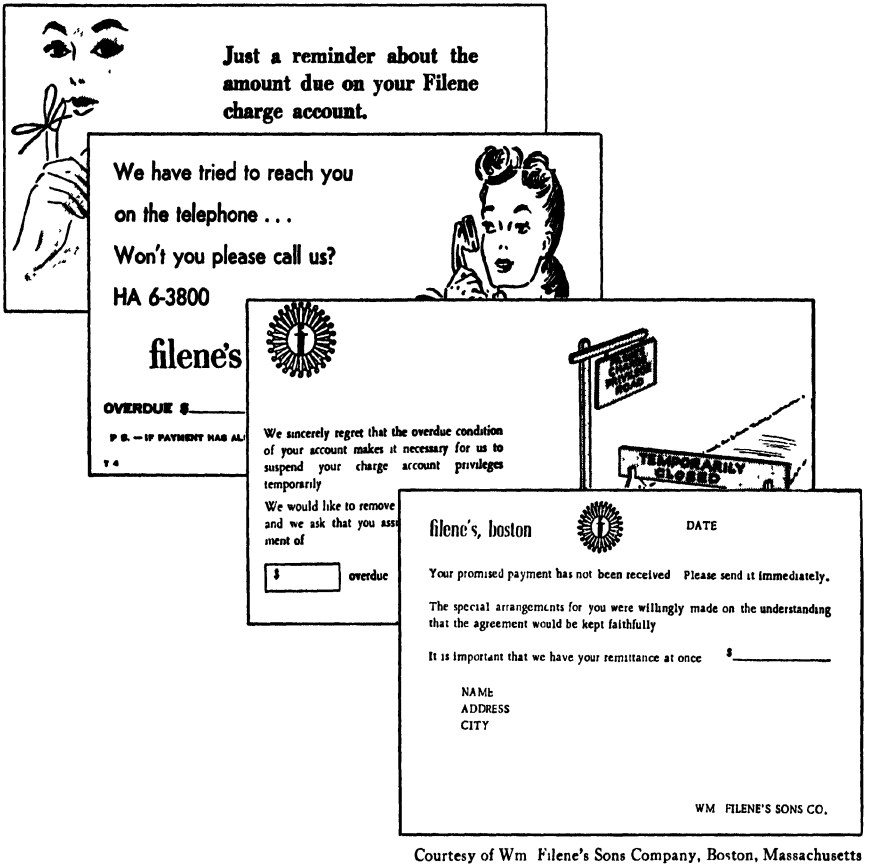
The letter shown above would be appropriate for smaller amounts after the three stickers have been sent.

Courtesy of the National Retail Credit Association, St Louis, Missouri

the credit period established between the customer and the creditor and thus never will appear as persons to be considered in any of the four specified collection stages. Thus this stage does not begin until after expiration of the established credit period.

Some of the more common collection devices available for use in this stage are the various impersonal statements (or bills) sent to customers, statement inserts and stickers, stamped or written notes on the statements, and various form letters of the reminder type (see Figure 16–1). The debtors generally responding to the collection devices of

FIG. 16–1—*Continued.* Examples of impersonal routine stage (form letters—reminder type.



Courtesy of Wm Filene's Sons Company, Boston, Massachusetts

this stage are those who are simply awaiting some notice that the account is overdue, those who have honestly overlooked making payment when due, the careless or procrastinating debtors, and those temporarily financially embarrassed.

It should be remembered that one of the most important means of contacting debtors is by mail. Whether use is being made of statements, inserts, or form letters, it is important for the creditor to bear in mind that his collection device is attempting to sell the debtor on the idea that the account must be paid at once. Frequent change in the wording of notes on statements and of form letters is advisable. In fact, some firms have found it worthwhile to keep a complete record of the pulling power of each form letter used. Some firms also have experimented with

colored paper or colored printing to see whether it materially increases the effectiveness of the collection device used. Instances have been reported, however, where some devices such as form letters "edged in black" have produced considerable unfavorable reaction on the part of customers.

In this impersonal routine stage, a "gentle nudging" is being used without giving the idea that the debtor is seriously concerned over nonpayment. Just how soon this "gentle nudging" starts after expiration of the credit period will vary depending upon company policy as well as upon the type of credit account involved. Thus with weekly or semimonthly payments, a three-day grace period is often common. Since installment accounts generally are paid from current income, a missed payment generally means that the debtor must wait until the next pay period for future payments. Consideration of facts such as these is often overlooked in planning the collection system of a firm.

The Impersonal Appeals Stage

In this stage, consideration should be given to the fact that the collection efforts are still "impersonal" in nature, but have changed from a routine procedure to a nonroutine or an appeals basis. In this stage, the form letters used are no longer of the routine impersonal type but take on more of the character of appealing to "anything wrong?" or "tell-us-your-story" tone, or to the pride of the customer in meeting his credit responsibilities, or to his sense of fair play (see Figure 16–2). If the mild notices in the first stage have failed to produce payment or to gain some response from the debtor, then the time has come for a more forceful means to bring the indebtedness to a speedy conclusion. That is the purpose of this second stage, but the creditor should remember at the same time that the action is yet to be personalized or directed squarely at the debtor involved.

In addition to the form letters suggested, use often is made of the telephone, telegraph, or unusual letters (such as special delivery, registered, or trick reply) in order to secure some indication of receipt of the inquiry on the part of the debtor. After having written to a person who does not respond but who gives every indication of residing at the address used, the debtor has several alternatives which may be more effective but which involve increased costs. These include the use of certified mail, restricted delivery to addressee only, returned postage receipt showing the name of the person who signed for it, and return receipt showing address where delivered.

The debtors involved in this stage generally include those who have

FIG. 16–2. Examples of impersonal appeals stage (appeal to pride).

Mr. John C. Patient
000 Main Street
Your City, Your State

Dear Mr. Patient:

A good credit standing is a priceless asset. It is a wonderful feeling to know that when credit is needed, credit will gladly be given.

Of course, to keep one's credit bright and shining, it is necessary to pay bills exactly as agreed.

And, that includes hospital bills, too!

For one reason or another, your account with this Hospital has not been paid. You know those reasons, but - we don't.

We would be glad to have you tell us. . . and to work out a mutually satisfactory arrangement with you.

Don't allow delay to dull your fine credit record.

Cordially yours,

(Signature)
Name typed
Title

AUTHOR'S NOTE:

Here is another example of letter to a patient whose credit record is generally good but who obviously needs help on the hospital bill.

Courtesy of the National Retail Credit Association, St. Louis, Missouri

honestly overlooked the amount in arrears, those who are in a temporarily embarrassed financial position, those who are careless in making payments or who are procrastinators, those who have suffered a misfortune since incurring the debt and cannot meet their obligation as agreed,

FIG. 16–2—*Continued.* Examples of impersonal appeals stage (appeal to fairness).

Mr. John C. Patient
000 Main Street
Your City, Your State

Dear Mr. Patient:

You expect fairness from us, don't you?

Our entire collection procedure has been based on courtesy and consideration. We have been willing to cooperate with you in every way.

All, alas, to no avail.

Now, our last message to you. . .sent in all fairness.

Your account will be placed with a professional collection agency unless you pay it in full, or make satisfactory arrangements, within the next five days.

Be fair to yourself. . .your immediate action will prevent serious trouble.

Cordially yours,

(Signature)
Name typed
Title

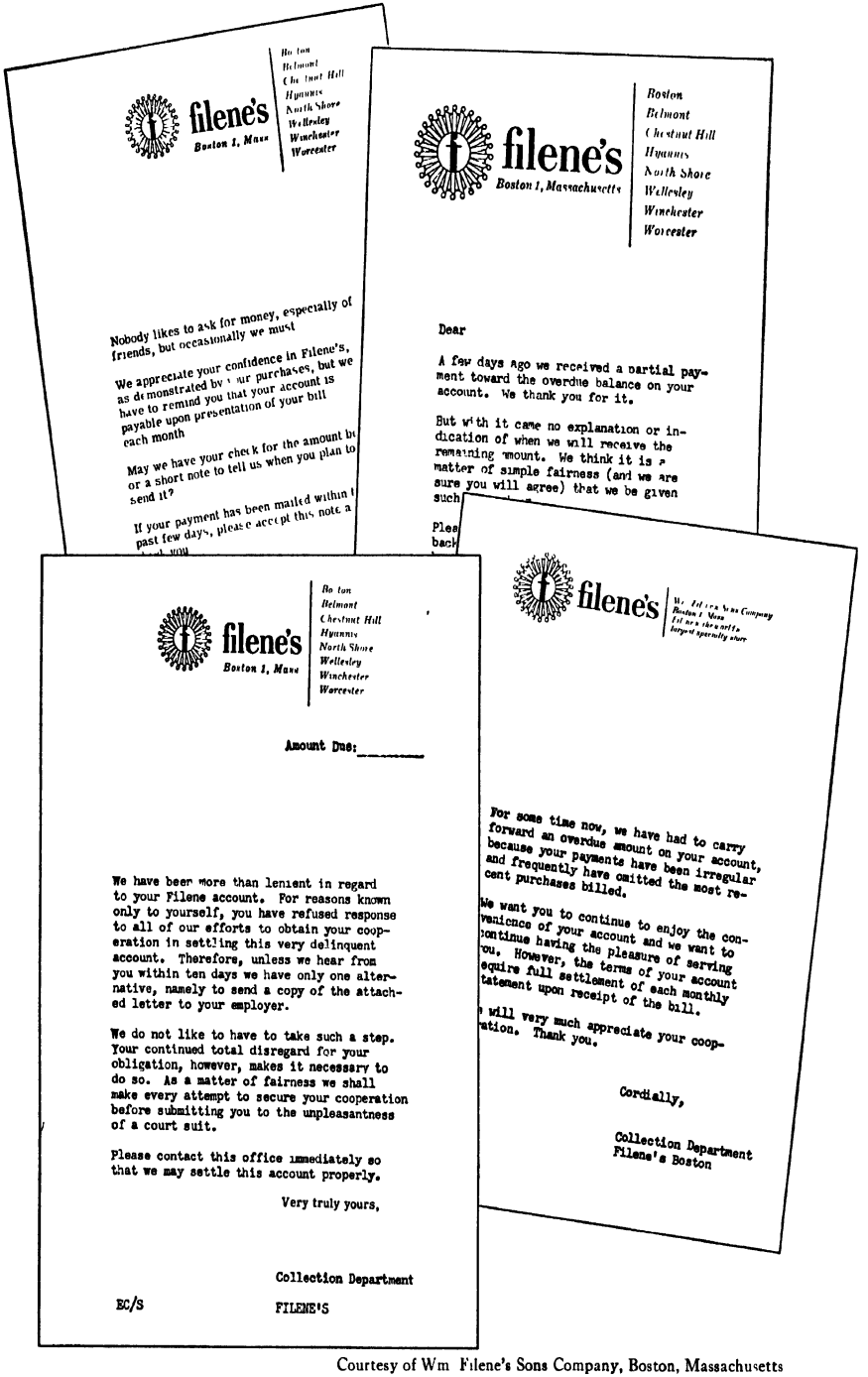
AUTHOR'S NOTE:

This is the "final" letter. Do not send this unless you are determined to give the account to a professional collector if it remains unpaid. Never make threats you do not mean to carry out.

Courtesy of the National Retail Credit Association, St. Louis, Missouri

those who have overbought, and those who believe the amount owed is incorrect or who raise questions involving some phase of the transaction and thus dispute the amount.

FIG. 16–2—*Continued.* Examples of impersonal appeals stage.



filene's
Boston 1, Mass

Boston
Belmont
Chestnut Hill
Hyannis
North Shore
Wellesley
Winchester
Worcester

Nobody likes to ask for money, especially of friends, but occasionally we must

We appreciate your confidence in Filene's, as demonstrated by your purchases, but we have to remind you that your account is payable upon presentation of your bill each month

May we have your check for the amount be or a short note to tell us when you plan to send it?

If your payment has been mailed within t past few days, please accept this note a

filene's
Boston 1, Massachusetts

Boston
Belmont
Chestnut Hill
Hyannis
North Shore
Wellesley
Winchester
Worcester

Dear

A few days ago we received a partial payment toward the overdue balance on your account. We thank you for it.

But with it came no explanation or indication of when we will receive the remaining amount. We think it is a matter of simple fairness (and we are sure you will agree) that we be given such

Ples
back

filene's
Boston 1, Mass

Boston
Belmont
Chestnut Hill
Hyannis
North Shore
Wellesley
Winchester
Worcester

Amount Due:_____

We have been more than lenient in regard to your Filene account. For reasons known only to yourself, you have refused response to all of our efforts to obtain your cooperation in settling this very delinquent account. Therefore, unless we hear from you within ten days we have only one alternative, namely to send a copy of the attached letter to your employer.

We do not like to have to take such a step. Your continued total disregard for your obligation, however, makes it necessary to do so. As a matter of fairness we shall make every attempt to secure your cooperation before submitting you to the unpleasantness of a court suit.

Please contact this office immediately so that we may settle this account properly.

Very truly yours,

Collection Department

EC/S

FILENE'S

filene's

For some time now, we have had to carry forward an overdue amount on your account, because your payments have been irregular and frequently have omitted the most recent purchases billed.

We want you to continue to enjoy the convenience of your account and we want to continue having the pleasure of serving you. However, the terms of your account require full settlement of each monthly statement upon receipt of the bill.

I will very much appreciate your cooperation. Thank you.

Cordially,

Collection Department
Filene's Boston

Courtesy of Wm Filene's Sons Company, Boston, Massachusetts

The Personalized Appeals Stage

This third stage incorporates both the personal aspect and the appeals approach. In other words all efforts are directed toward the debtor himself on a highly personalized basis—efforts which are the last ones before some type of drastic or legal action is taken. Debtors who have forced the creditor to this stage include those who have overbought, those who will eventually become insolvents (and may even resort to bankruptcy), those who have met with some accident or misfortune, those who are habitual frauds with no intent ever to pay, and those who believe the amount owing is incorrect and dispute the bill as it now stands.

The collection devices commonly in use in this stage include personal letters (usually a series, spaced at different time intervals) to the debtor pointing out the long drawn-out procedure that the creditor has been forced to go through up to this stage. Also included in this stage may be personal letters to the debtor's employer, as well as notification to the local credit bureau of the impairment of the debtor's credit standing. Also commonly used during this stage will be personal collectors, as well as personal contacts via the telephone and the telegraph.[3]

It should be recognized that the costs of carrying out the actions in this stage are greater than those involved in the first two stages. Personally dictated letters are one of the main weapons employed, and surveys have shown that it costs from 75 cents to $1.25 to dictate, type, and mail the average piece of correspondence. And this figure could be even higher if cost considerations are given to the time and thought involved in achieving just the right appeal to each debtor. Although personally dictated letters are initially expensive, it must be recognized that they permit more varied and persuasive appeals than stock form letters, that debtor reaction is generally more favorable, and that the end result generally is greater pulling power.

Drastic or Legal Action Stage

In the previous three stages, customer good will has been carefully considered before taking any action, but in this last stage the gloves are off and the honeymoon is over. The debtors involved are much the same type as outlined for the third stage, only consideration usually is given here to the ownership of assets on the part of the debtor before

[3] Many credit managers pay particular attention to the advantage of the telephone or the personal visit which enables them to get an immediate response from the debtor, particularly a promise with regard to the time and amount of a partial or full payment of the obligation.

undertaking some of the legal actions, such as suit. Mention should be made, however, that many stores would not consider most of the techniques to be discussed in this section, because of the possible ill feelings that could be created.

Extension Agreement. Under this agreement an honest and sincere person who is temporarily unable to meet his obligations may be given a longer length of time to pay his debts. The creditor granting this extended length of time may take several simultaneous actions, such as:

1. Addition of a service charge, particularly on 30-day charge accounts on which no finance charge normally is levied.
2. Conversion of a 30-day charge to a revolving credit, with all the accompanying characteristics of such an account.
3. Conversion of an open charge account receivable to a note receivable, with a definite due date and carrying charge.

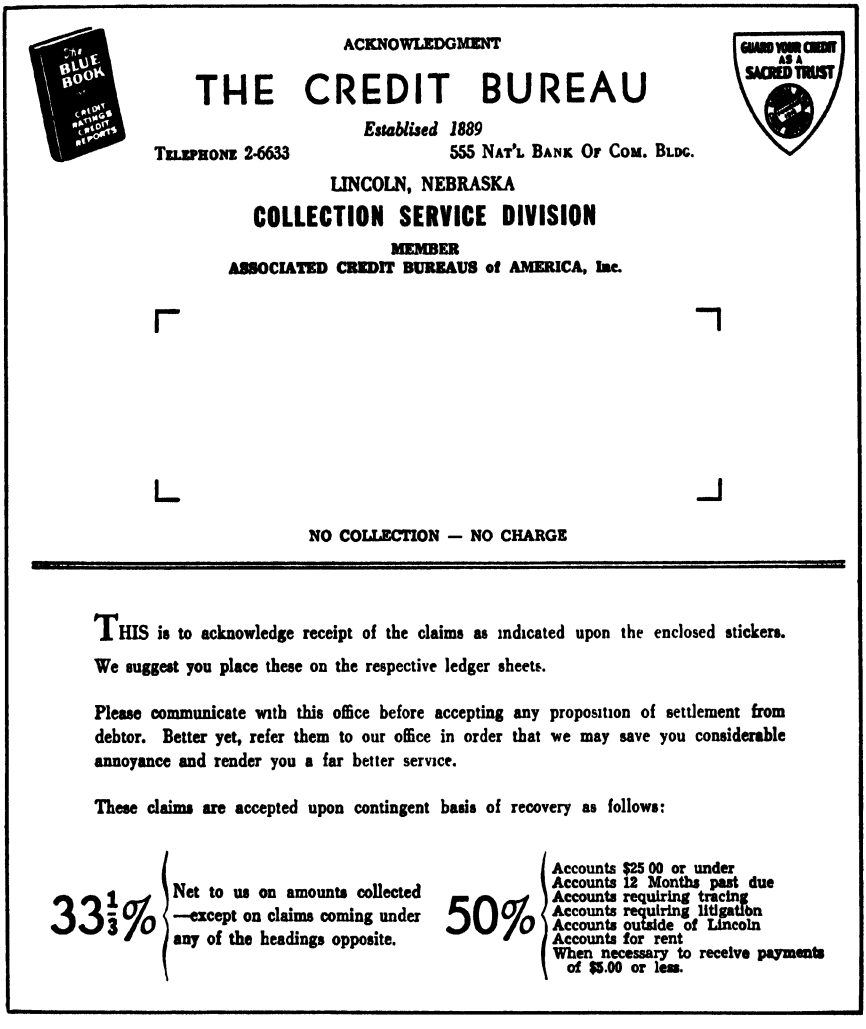
Composition Arrangement. Under this arrangement a group of creditors agree to accept a reduced amount as settlement of their indebtedness in full. This scaling down is done only in those cases in which the debtor is honest and sincere and entirely free from any taint of fraud. Obviously such an arrangement enables the debtor to recover a debt-free position at the retail establishments involved, while the stores may have been fortunate in receiving "x" cents on the dollar of their indebtedness without any more drastic action.

Assignment of Accounts Receivable.[4] Some firms have found it to their advantage to sell their accounts receivable to a financial institution. If this is accomplished and a nonrecourse agreement is made, the firm is relieved of any further responsibilities for collection. Of course, for such a favorable situation the firm must pay the financial institution a fee (or a discount), an action which reduces the profitability of any account receivable. If the sale of the receivable is made on a recourse basis, much of the advantage is lost except for the immediate availability of needed funds.

Collection Agency. Another of the drastic actions that a creditor may take is referral of an account to a collection agency. Although there are thousands of collection agencies over the country, one of the better known groups is the Collection Service Division of the Associated Credit Bureaus of America. These members are located in all parts of the United States and Canada and form what might be termed a network collection service. Each local collection service office may (and does) call upon any one of the other offices for help in locating the debtor of

[4] Charge account banking, as described earlier, embodies many of these features.

FIG. 16–3. Charges of a collection agency.



a local credit granter. The account usually is forwarded to any one of the other offices involved, and personal collection effort is expended on the local level to collect the account. It should be mentioned that these local collection service offices generally have their own predetermined collection system established which may closely resemble the four stages just outlined.

The costs of collecting through such an agency vary considerably, although the average will run between one third and one half of the amount collected. See Figure 16–3 for a schedule of charges made by a collection agency.

Mention should be made of the fact that once an account is turned over to a collection agency, the debtor should insist that all dealings be made through it, that the collection agency should furnish periodic progress reports, and that definite arrangements should be made as to how and when collections should be remitted.

Garnishment or Wage Assignment. These two actions are combined simply to illustrate techniques available to the creditor to collect amounts due by means of securing part of the debtor's income. It should be recognized, however, that the two actions vary considerably in the manner in which they are carried out.

The right of garnishment exists in some form or other in practically every state, although it is called by varying names. It requires a court order, in which a creditor may acquire a right to hold a third party (the garnishee) in whose possession goods, money, or credits of the debtor are found, liable for his debt to the defendant.

Under a wage assignment, the debtor signs an agreement usually at the time the credit sale is made to the effect that in case of nonpayment of the debt the creditor may seek a certain portion of his wages without the necessity of a court order. Such an arrangement is pertinent only to the employer named in the wage assignment. Generally speaking, when a wage assignment is presented to an employer, he is bound to recognize the terms agreed upon by debtor and creditor.

It must be realized, however, that there are exceptions to these provisions. Whether state employees can be bound by garnishment proceedings and by wage assignments will vary by state. On the other hand, generally speaking employees of the federal government and members of the Armed Forces are not subject to these collection devices.

A final word of advice to any firm using these techniques—check with an attorney for the legal provisions of the state involved.

Repossession. Whereas generally the creditor's last desire is to retake the merchandise that is not paid for, this may be the only course of action left to him. The right of repossession is generally found in conditional sales and chattel mortgage contracts under the right of replevin. If the creditor can show a title or a possessory right superior to that of the debtor, then the merchandise can be retaken in case of nonfulfillment of the terms of the contract. However, the varying state laws set forth widely different provisions as to the circumstances under which replevin is applicable.

Attorneys. Another technique is to turn the account over to an attorney who will act like a collection agency in attempting to secure payment. Two different approaches are found under this arrangement:

one, use of the company's own attorney who probably will contact the debtor as a private lawyer and not as an employee of the company; and two, use of a separate and independent attorney who will attempt to collect the indebtedness on a fee or commission basis.

Suit. Collection by suit generally is considered when all the other collection methods have failed and when there are sufficient assets in possession of the debtor against which a judgment may be executed. Suit action, which generally is looked upon with disfavor by most of the creditors of consumer debt because of the possible resulting bad publicity, accomplishes two things: one, the establishment of the legal fact that the debt does exist and that it is of such an amount; and two, the means of providing the creditor with a legal remedy and aid in collecting the proven debt. It should be remembered, however, that the mere obtaining of a judgment does not guarantee payment of the indebtedness. As a result, it is advisable to make sure that the debtor has sufficient assets against which the judgment can be entered before instituting suit.

The effectiveness of collection by suit is reduced by two modifications. First, it must be recognized that a debt cannot be held forever and that in every state there are statutes of limitations which spell out in detail the length of time a debt may be collected and the provisions for renewal of the limitation period. Second, under the provisions of the various state laws it is stipulated what property and what per cent of earnings are not subject to seizure by suit. These exemptions are allowed because of the traditional belief that an injustice is done both to society and to the debtor if he is stripped of all his assets and all of his income.

Other Actions. No attempt is being made to list all of the possible drastic or legal means available to a debtor. However, in addition to those previously mentioned, consideration should be given to the possible collection of small amounts in the various Small Claims Courts or as known in some states "Justice of the Peace" (JP) Courts. Again, wide variations are found in the state laws governing the actions of these courts.

Another technique used is to suggest some form of counseling service to the debtor to the end result of obtaining the debtor's and the creditors' consent to an arrangement by which his debts are "pooled." Under such an arrangement which often is spelled out in state laws, the usual procedure is to have the debtor voluntarily turn over his income to some organization or individual who is paid a fee for the service performed. This income then is allocated to pay off the indebtedness in a stipulated time interval, with a certain predetermined amount being returned to the debtor for his own living expenses.

Another action, this time initiated by the debtor, that has the effect of modifying the indebtedness of an individual is the action that can be taken under Chapter XIII of the National Bankruptcy Act (The Chandler Act) as amended. The increasing number of individual bankruptcies being filed under this provision poses a problem that can no longer be ignored by anyone engaged in the field of accepting consumer credit. True, this is one way of solving the collection problems of a creditor, but unfortunately an undesirable way. Under Chapter XIII, a wage earner who has been defined in the act as an individual who works for wages, salary, or hire may under certain specified conditions petition a federal court, stating his desire to come under this so-called "wage earners" section. The debtor submits to the court a schedule of his assets and his liabilities and a statement of affairs and pays a set fee. Under this plan the wage earner must submit his future income to the supervision and control of the federal court which then has the power to modify the time and amount of payments if a change in the wage earner's circumstances causes such an adjustment to be desirable. It should be noted that by such action the individual removes the possibility of garnishment by his creditors.

IMPACT OF A SOUND COLLECTION POLICY

By this time, it must be obvious that collection work is trying and that patience, persistence, and resourcefulness are needed attributes of a collection manager and his staff. How well he performs his job will determine the impact that the collection activities will have upon his firm. He always is walking a tightrope, trying to decide just how much effort to make and how much expense to incur in attempting to bring an indebtedness to a satisfactory conclusion.

The collection manager, working usually under the direction of the credit manager, will have the following responsibilities:

1. To aid the working capital position of the firm by securing collections of receivables as quickly, cheaply, and completely as possible.
2. To reduce bad-debt losses. This, of course, involves the decision of when an account should be considered a loss. It generally is recommended that any amount that has gone six months past the credit period should be considered as bad and should be charged off. Of course, this does not mean collection efforts should be stopped at this time, and recoveries of accounts charged off as bad-debt losses may take place.
3. To aid the retail sales effort in that an individual who is free from any overdue debt at a store will be much more likely to make purchases there than is the customer who because of a guilty conscience caused by an overdue bill makes future purchases at competing stores.

4. To ease pressure between customer and store, by straightening out any misunderstanding that stands in the way of payment. In fact, here the collection man doubles as a form of public relations man.
5. To help make policy decisions concerning credit and collections. For example, what policy should be established concerning paid-up slow accounts seeking new credit?

To repeat the opening sentence of this chapter, it should be apparent that collections are an inherent part of any credit business.

REVIEW AND DISCUSSION QUESTIONS

1. Explain the statement, "collections are an inherent part of any credit business."
2. Discuss the differences in the definitions of the word "collections."
3. What is consumer credit insurance?
4. What are the two categories into which consumer credit insurance are divided? Explain each.
5. Trace the origin and development of consumer credit insurance.
6. Why does it appear necessary to have state regulation of this type of insurance?
7. Explain the four general policies that can be followed in collections.
8. What factors affect a collection policy? Discuss each factor in some detail.
9. A general collection system is usually divided into four stages. What are these stages? Study Table 16–2 carefully in preparing your answers.
10. What types of debtors are usually involved in the impersonal routine stage? In the impersonal appeals stage? In the personalized appeals stage? In the drastic or legal action stage?
11. When is an extension agreement used? A composition settlement?
12. Distinguish between assignment of accounts receivable and charge account banking.
13. Visit a collection agency in your town and compare the charges of this agency with those shown in Figure 16–3.
14. What are the principal differences between garnishment and wage assignment?
15. What is a Small Claims Court? What is its place in collection methods of a retail store?
16. What is the primary purpose of bankruptcy? How does consumer bankruptcy procedure vary from that of a business firm?

CHAPTER 17

Testing the Success of Credit Operations

TOO OFTEN in the rush of getting the day's work done the credit manager may tend to lose himself in the mass of the details of his work and never stop to ask himself if he knows exactly what the objectives of his position are or if he still is on the right road to accomplish these objectives. These questions may well be raised, for without clearly defined objectives and the means of measuring his progress the credit man may waste much precious time, effort, and money in exploring side roads and bypaths which do not lead toward the end desired. In fact there is the possibility he may entirely lose sight of the destination and never arrive.

The credit man should be prepared to answer the following questions:

1. What are the proper policies of the credit department of my firm in view of the current and anticipated conditions?
2. What measures can I use to determine whether these policies are reached?

Thus, enlightened credit management should have constantly before it clearly defined goals or aims. The probability of success in reaching these goals is increased when management is aided by devices and measures which show the progress that is being made toward the final objective—that of making profits for the business firm.

Although the credit man constantly is engaged in testing the work of others, it is interesting to note that credit management has paid much less attention to the development of techniques to test its own work. It is not clear whether this situation has resulted because of the difficulty in measuring attainment, or because of indifference on the part of manage-

ment, or because of a failure to recognize the importance of evaluating credit operations, or for some other reason. Whatever the reason, the credit man has yet paid but relatively little attention to applying tests that measure his own performance.

RESPONSIBILITY OF THE CREDIT DEPARTMENT

In setting the proper objectives of his credit department, the credit man has an implied responsibility to three interests:

1. To the firm which employs him.
2. To the debtor whose credit he accepts.
3. To the business and social community whose well-being may be—and undoubtedly will be—affected by his actions.

The responsibility to his own firm is the most direct and readily apparent of the three mentioned. As previously pointed out, the main objective of business management is to make profits. The intermediate objective of the credit function has long been recognized as being the achievement of a maximum of sales and a minimum of losses. This is its contribution toward the profit objective. At times the emphasis is on the sales portion of the task; and at other times, on the loss-avoidance portion. Most frequently, however, the twofold objective has been properly kept in mind. It should be recognized, however, to accept this statement of the ideal the phrase "minimum of losses" must be interpreted in the widest possible sense. This must mean more than merely bad-debt losses. By a policy of careful and persistent collections, low bad-debt losses can be attained but maximum profits may not result because of the high collection costs and expenses involved and the high costs of carrying receivables. The final result may even be considerably less profit and in times of stress may seriously handicap the business operations because of the freezing of capital in slow-moving receivables. Nor can the time element be ignored. Over what period of time shall the minimum of losses and maximum of sales be calculated? Exposure to loss due to the taking of today's substandard business may mean the securing of some customers who will cause losses, but it also involves the securing of some customers who will be the volume buyers of tomorrow. Perhaps a better statement of the ideal might well be to seek a minimum of costs and a maximum of gains, in both the present and the future.

As was pointed out, the second interest served by the credit manager is that of the debtor. It is generally recognized that the credit manager has a responsibility to the debtor which is just as definite and exacting as

that which he assumes to his own firm. As enlightened sales departments have discovered that "satisfaction" is one of the most vital stages in a sale, so have credit departments recognized the need of customer "satisfaction" in every credit transaction. When customers find that their obligations are too heavy for them and that the strain of paying on these heavy obligations is severely handicapping them, then this final stage of "satisfaction" is not attained and the credit department has not performed correctly its function to the debtor whose credit has been accepted. This situation applies not only to the type of individual who has monthly payments on installment and revolving charge purchases totaling more than his monthly income but also to the individual who has too good credit and whose strain of payment severely reduces the satisfaction derived from credit purchases.

The third interest involved is the interest of society at large. The economic community in general is not a party to the transaction which is arranged between debtor and creditor. It occupies the role of the innocent bystander and as such, society at large is frequently hit and injured by the actions of the immediate participants, unless care is exercised by the debtor in seeking additional credit and by the creditor in making sure that the acceptance of this additional amount is to the benefit of all concerned.

To some extent, credit management should be concerned with the social consequences of policy decisions or operating results. Certainly overextension of credit is not good for debtor, creditor, or business community. Excessive charges for the credit service not only impose excessive burdens on the debtor and interfere with the expansion of the creditor's market; they also are socially undesirable. Excessive credit losses or long-delayed collections are costly to all parties to a credit transaction and are damaging to the entire business community. They do not contribute to a healthy economic climate.

TESTS OF CREDIT DEPARTMENT OPERATIONS

To serve these three interests—particularly the first one—many elaborate and effective devices for gathering testing material by fact-seeking investigations have been perfected and many highly efficient organizations developed to aid in the accumulation of reliable factual information. Credit men have been diligent in seeking, and alert in applying, quality tests to the credit which they are asked to accept from day to day. They have discovered that these investigations must be sufficiently complete to uncover all unfavorable information, and to permit

proper analysis, must be reasonable from a cost point of view, and must be done with sufficient speed to enable a decision to be reached without causing customer dissatisfaction. These are exacting requirements, but credit personnel have discovered the means to meet them well.

The responsibility of credit management to these various interests having been recognized and the objectives of credit department operations having been clearly stated and visualized, the next step should be to measure the attainment of these objectives—the testing of the manner in which the credit department is meeting its responsibility. Some of these measuring devices are fairly well known to most credit personnel; some of them may be familiar only to credit management personnel who have made a study of this phase of credit work. It also should be recognized that many credit departments operate without any checks on their operations, other than perhaps that of the bad-debt loss index. Suffice it to say, these tools or indexes described in the subsequent sections are designed to provide credit management some means to test the efficiency or successfulness of performance of its credit operations. It is with these tools that the credit manager is assisted in determining whether or not his department is succeeding in bringing about maximum sales and minimum losses.

Certain tests of credit department operations have become more or less conventional. To the extent that conventional tests permit comparisons between the subject firm and other similar firms, they are more useful because they have more meaning. Additional tests may be developed to meet the requirements of special situations or to explore further those situations which seem to be significantly important. Some analysis of credit department operating results may be used to test closeness of fit between policies and actual operations or to see whether policy or operation is faulty. On occasions an analysis of operations should be undertaken as a guide to the formation of new policies.

These tests are valuable in many important ways:

First, the periodic calculation of ratios, percentages, and other figures is necessary to measure credit and collection results. Unless this is done, you have no way of knowing just what has been accomplished and what changes have occurred in each of the various aspects of your firm's credit business.

Second, keeping these statistical records makes it possible to set up standards or goals to shoot at in each phase of your credit and collection activity. Without standards, you have no basis for judging accomplishments. Also, an important stimulus to efficiency will be lacking.

Third, the accumulation of records kept on the same basis from year to year enables you to compare current credit and collection performance with that of previous periods, and to determine the progress made. Credit-sales volume for

the current month, for instance, may be compared with the figure for the same month last year, or the preceding month this year, to see whether there has been an increase or decrease.

Fourth, if your firm's credit business is large enough to require the time of more than one person, comparisons often may be made between different individuals. You can calculate separate collection percentages for each person having responsibility for a given section of the accounts. Separate rejection percentages may be computed wherever two or more persons are engaged in granting credit.

Fifth, you may compare results shown by your figures with those reported by other firms. Data for such comparisons are published by the National Retail Credit Association, the Credit Management of the National Retail Merchants Association, and many national trade associations in many specific lines of business, as well as by the Board of Governors of the Federal Reserve System.

Sixth, the records you maintain may be used in forecasting future trends in credit sales volume, collections, and other aspects of your credit business. These forecasts can be very helpful in revisions of your general budget, and they often suggest changes in your credit and collection policies.[1]

Bad-Debt Loss

In the past, a credit department's efficiency often has been judged by rule of thumb. Successful operation was assumed to be evidenced by the manager's skill and ability to reduce bad-debt losses to a minimum or to keep them at a minimum. Even now, one sometimes still hears a credit manager boasting of the fact that his concern has lost practically nothing during the year or that losses amounted to a very insignificant fraction of credit sales or of total sales. Such rule-of-thumb judgments are indeed misleading, although unfortunately they often appeal to certain segments of top management. An exceedingly small loss record alone constitutes no indisputable evidence of efficiency in credit administration. In fact, it may be an inferior basis on which to judge performance efficiency, for such a feat may be accomplished with comparative ease by practicing conservatism and accepting only the best risks. Such a policy often results in a diversion of trade to competitors and a loss of possible business profits.

The bad-debt loss index was among the first of the tests to be developed and still is one of the most generally used by credit men. The relationship is generally shown by dividing bad debts incurred during the period under consideration by total credit sales of the period, as follows:

$$\frac{\text{Bad-debt loss}}{\text{Total credit sales}} = \text{Bad-debt loss index.}$$

[1] Clyde William Phelps, *Credit and Collections Controls for Small Marketers* (Washington, D.C.: Small Business Administration, Small Marketers Aids No. 33, May, 1958), p. 1.

It should be recognized, however, that there is little uniformity in the calculation of this proportion. By some firms it is calculated as a percentage of bad debts to total sales, by other firms as a percentage of bad debts to credit sales. Also there is no uniform practice as to the time when an account shall be classified as bad and thus another variable is introduced into the calculation. Some firms leave it to the discretion of some official to decide when an account shall be called bad; others so classify accounts after the passage of some definite time without payment; others after the occurrence of some definite act, such as the return of an unsatisfied judgment or similar event. A big margin of error also exists because of the fact that some accounts may be written off as bad debts within a brief period after they have become overdue, while other accounts may be carried for many months before they are eventually written off to profit and loss. Consequently, a substantial portion of the bad debts recorded for a given year may have resulted from credit decisions or collection procedures of the preceding year. Yet they are compared with credit sales of the year just past, and conclusions drawn from the ratio are applied to the credit and collections policies of this recent year. Furthermore, because of this lag in bad-debt recording, a substantial change in sales volume between two years may introduce a misleading variation into the bad-debt ratio. Thus when sales for credit are increasing while cash sales are remaining fairly stationary, the base on which the index is computed will increase and cause a more favorable apparent showing than is justified.

Percentages of bad-debt losses naturally vary with different lines of business, with competitive conditions, with the month or season of the year, and with general business conditions. Proper interpretation of the figures for bad-debt losses would require comparison between the current year's business, business for previous periods, and results secured by other firms operating under similar conditions. Data for comparison with other firms are becoming increasingly available as a result of the statistical work of the various credit and trade associations and of the federal government. A word of caution should be given, however, on using the bad-debt ratios of other sellers to determine a "sound" ratio for one's own company. The bad-debt ratio of any other concern for a single year would be of little value as a guide because of the "lag" factor just discussed. Furthermore, if the other concern operates on a higher or lower profit margin, its "sound" bad-debt ratio should be smaller or larger than one's own; if the difference in profit margins is known, an adjustment should be made for it. Also trend analysis of a company's bad-debt ratios over a short series of years will not, by itself, indicate whether its

credit or collection policies are becoming more strict or more lax. General business fluctuations, and particular regional and trade developments, are likely to influence the bad-debt ratio more profoundly than changes in the credit and collection policy of a firm.

Too implicit reliance on the test of the bad-debt losses by the credit department is dangerous since it tends to overemphasize caution in accepting credit. In the proper interpretation of this test, it is recommended that a policy be developed which seeks to hold the proportion within normal limits. These normal limits should be determined, for each firm, on the basis of the profit margin on which it works. An illustration of the fixing of the margin could be drawn from the insurance field. Here the attempt is not to avoid all losses, but to hold the underwriting to the normal loss point in such fashion as to make certain that the profit margin is greater than the probability of loss.

Mention also should be made that if a firm has adopted a credit plan which includes several types of credit—such as, open charge, installment, and revolving credit—it generally is desirable to keep separate data, if consistent with the accounting system used, of the bad-debt losses and credit sales in each type of credit accepted. Such a procedure will enable the firm to pinpoint any troublesome areas as to the particular type of credit involved. In such instances, the additional indexes computed would include:

$$(1)\ \frac{\text{Bad-debt losses from open charge sales}}{\text{Open-charge sales}}$$

$$(2)\ \frac{\text{Bad-debt losses from installment sales}}{\text{Installment sales}}$$

$$(3)\ \frac{\text{Bad-debt losses from revolving credit sales}}{\text{Revolving credit sales}}.$$

Credit Sales

In all business enterprises, it is important to know what percentage of the total sales is represented by credit transactions. This percentage or index is secured by dividing credit sales by total net sales:

$$\frac{\text{Credit sales}}{\text{Total net sales}} = \text{Credit sales index.}$$

Generally it also is advisable to determine the percentage of business done on each type of credit, as for example, installment credit, charge account business, revolving charge account volume, C.O.D.'s, and so on. When comparisons are made from month to month or over a period of years, this measure affords a valuable picture of the firm's credit business

and of some of the effects of its conduct regarding its credit policy. Comparisons with similar figures for other firms operating under substantially similar conditions indicate something of the relative success achieved in obtaining credit business.

While an increase in the credit sales proportion is indicative of greater credit activity, this really may be a measure of the public willingness to use credit rather than a measure of the activity of any one credit department. Caution in the application of this test must be exercised and all local and territorial differences influencing the use of credit must be considered together with peculiarities of the firm's clientele.

Collection Percentage, Days to Collect, and Turnover of Receivables

These are included under one heading because they simply are different ways of stating a similar fundamental relationship. The collection percentage, which is one of the most commonly used of the credit control indexes, is determined by dividing the total amounts collected during a period (such as a month) by the total receivables outstanding at the beginning of that period as shown in the following formula:

$$\frac{\text{Collections made during period}}{\text{Receivables outstanding at beginning of period}} = \text{Collection index.}$$

A derivation of this index is an estimation of the average length of time that receivables[2] are outstanding. If, for example, the net credit period in a particular line of business is 30 days and the collection index is 50 per cent, indicating that only one half of the outstanding receivables were collected during the month, receivables would "on the average" be outstanding 60 days. This estimate is made by using the following formula:

$$\frac{\text{Net credit period}}{\text{Collection index}} = \text{Average collection period;} \quad \frac{30}{50\%} = 60.$$

Another criterion of credit management efficiency is the use which is made of the capital invested in accounts receivable. The rate of receivables turnover is found by dividing the total credit sales by the average receivables outstanding, as follows:

$$\frac{\text{Total credit sales}}{\text{Average receivables outstanding}} = \text{Receivables turnover rate.}$$

The seasonality of the business is, of course, important in determining how to compute the average of the receivables outstanding. It also is

[2] As stated in the discussion of the previous indexes, the breakdown of this kind of information is more valuable if done by each type of credit being accepted.

pertinent to point out that the activity of the investment in receivables may be expressed as a rate or in terms of the number of days required for one turn of the accounts. The latter may be computed by dividing 360 days by the receivables turnover rate, as shown below:

$$\frac{360 \text{ days}}{\text{Receivables turnover rate}} = \text{Number of days to collect credit accounts.}$$

These measures of credit management have an advantage over the bad-debt loss calculation in that they can be figured earlier in many instances and can help to forecast difficulties in collection sufficiently in advance to permit the application of some corrective measures. Collection percentages, when decreasing, show the accumulation of poor accounts on the books or slackening of collection efforts before the bad conditions have had the opportunity to become inevitable. These measures of credit activity should make it possible to detect the effects of the adoption of unsound policies early. For example, the adoption of unduly lenient terms, the solicitation of unsound classes of customers, the yielding to competitive temptations to outdo the other fellow in credit—all of these will reveal their fruits in a falling collection percentage. In addition, unduly stringent collection activity, overly conservative acceptance of credit, undue hesitation in the taking of risks will tend to be detected earlier by study of the trend of collection percentages.

As with the other indexes previously described, these computed figures should be compared for the subject firm with those of the previous months and with the same month of as many preceding years as possible. Such an accumulation of figures over a period of years will permit recognition tc be given to possible seasonal trends which should be taken into consideration in any analysis correctly made. Likewise, additional comparisons with other similar firms will give some indication of the subject firm's activity as contrasted with firms carrying on comparable operations.

Mention should be made at this point that these indexes reflect only "averages" and that it still is necessary to realize that certain accounts may be falling behind in payments at the same time that the over-all collection tests are reflecting a favorable picture. It is vital that this situation be recognized by credit management personnel and that care be taken to allow for it in any analysis which is based on "averages" alone.

Further consideration should be given to the fact that an improvement in the collection percentage of a firm may tend to reflect improved economic conditions even before a future increase in credit and cash sales. This situation arises because of the general tendency of consumers

to repay previously incurred debts before assuming new obligations. Conversely, a decline in economic conditions is more likely to be reflected first in a decline of credit sales rather in a decline of collection percentages. This results from the debtor's reluctance to make additional credit purchases until the way to pay for them is clearly evident. Proper analysis of these pending changes should enable credit management to carry out advantageously its obligation to the subject firm, the firm's customers, and society in general.

Number of New Accounts Opened

Certainly the activity of the credit department will be reflected by the number of new accounts—open charge, installment, revolving credit, and so on—which it opens during the period in question. This will indicate the extent to which emphasis is being placed upon credit service and whether or not the business concern is alive to its opportunity for attracting new trade. The number of new accounts opened may serve also as a means of measuring the effectiveness of store publicity. The figure, together with the acceptance percentage, will measure the leniency or strictness of the concern's credit policy.

Acceptance Index

The attitude toward applications as well as the quality of the applicants and the credit policy currently being followed are shown by the number of acceptances. A measure of growing importance is the acceptance index or percentage showing the proportion of applications for credit which are accepted. This is computed as follows:

$$\frac{\text{Applications accepted}}{\text{Applications submitted}} = \text{Acceptance index.}$$

Of course, this index will vary considerably, depending upon the line of business in which the store is primarily engaged, the leniency or conservativeness of its credit-granting policies, and the stage of the business cycle.

Past-Due Index

This measure of credit management involves a determination of the proportion of all accounts, in amount or in number, that are past due. It is computed by dividing the total past due by the total outstandings, as follows:

$$\frac{\text{Total past due}}{\text{Total outstandings}} = \text{Past-due index.}$$

When this index is computed for several successive periods, it serves as a barometer indicating whether the general trend of poor pay is upward or downward. If this percentage increases faster than it should at any given time, proper steps can usually be taken to curb the trend or perhaps to bring it back to the normal position, which can be ascertained after such a record has been maintained over a period of years.

Aging of Accounts

This is a detailed analysis of accounts—such as not due, 30 days past due, 60 days past due, over one year past due, and so on. This suggestion of aging accounts stems from the fact that there is a direct and important relationship between the length of time that an account has been outstanding and the rate of collection and the probable net loss from bad debts.

This device may be supplemented with a detailed itemized list of overdue accounts, showing both the name and the present status of the account. Such a list is valuable in authorizing additional requests for credit. The introduction of extensive machine operations in the credit department has permitted this type of analysis to be performed easily and quickly.

In this connection, it is interesting to note the relation that exists between the age of past-due accounts and the amount of business that may be expected from them. In a retail grocery store where such an analysis was recently made, 17 per cent of the customers whose accounts were 30 days overdue failed to buy during the current month under survey, 28 per cent of those 60 days overdue acted likewise, and 70 per cent of those whose accounts had not been paid in 90 days or more bought nothing from the store during the month in question.

Slow accounts also call for extra collection effort and expense, additional bookkeeping, extra interest costs in money tied up, and a higher cost of doing business. Knowledge of the exact situation on this score is likely to lead to improved collections and to efforts to remedy it in time.

Aging of accounts is easier to accomplish if the store is using only one billing date rather than a cycle billing system. Nevertheless, even under a cycle billing arrangement, aging of accounts has been found to be highly desirable and helpful to better credit operations.

Cost Analysis

Any final summation of the results of credit department activities should include cost figures. Credit management is on much sounder

ground in deciding on a policy of instituting a service charge on overdue accounts and on other important credit and collection policies, if accurate knowledge is available concerning the cost of operating on a credit basis and of carrying receivables on the books. To be sure, bad debts afford one such measure, but losses from bad debts are only one item in the operation of a credit department. In addition to bad debts, there are other expenditures the total of which normally exceeds all bad-debt losses. Wages and salaries of persons employed in credit and collection activities are the most important single category of credit expense. This expense in addition to interest on outstandings, fees and dues for credit information, and charges for outside assistance in making collections constitute the bulk of the costs incurred. Costing of credit operations may seem needlessly complex, involving a detailed accumulation of data. At the same time, effective credit management cannot be expected to work blindly. Nor can policies be intelligently decided other than upon the basis of known facts.

PRESENTING THE MEASURED RESULTS

The justification of credit operations as an important service division of the business is rendered easier and more certain when it can show definitely and positively the facts relative to its own operations. See Figure 17–1 for an illustration of a credit department report to top management. Consideration might be given to the use of charts in presenting these various measures of the successfulness—or failures—of credit operations. While figures on some things—and people—are very interesting, perhaps use of various types of charts would prove valuable in presenting these credit facts to top management. For example, by the use of bar charts for showing the aging of receivables and the use of line charts for illustrating the seasonal influence on collection ratios, the credit manager can give "the boss" much of the story at a glance and be better prepared to present his story justifying the operation and the budget of his department.

It should be recognized that the foregoing discussion of techniques to test the success of credit operations should not be considered as final and complete. This is a field of credit which calls for further refinement of concepts and greater skill in the use of the tests employed. As credit management becomes more and more conscious of the need to measure its own operations, better credit decisions will be made. Such an improvement will benefit the firm, the debtor, and society in general.

FIG. 17–1. Credit report to top management—statistical report of accounts receivable and credit.

	Sales				Accounts Receivable Balances		
	This Yr.	Last Yr.	Incr. or Decr.	%	This Yr.	Last Month	Last Yr.
Layaway							
Contract							
CBA							
RCA							
Regular							
Total							
Cum Total							

	Collections						New Accounts	
	This Yr.	%	Last Month	%	Last Yr	%	This Year	Last Year
Layaway								
Contract								
CBA								
RCA								
Regular								
Total								

	P & L Collections				Statements Mailed		Transactions	
	This Yr.	%	Last Yr.	%	This Yr.	Last Yr.	This Yr	Last Yr.
Balance FOM					City		Chg.	
Coll. this mo					County		Cr.	
Balance EOM					State		Csh	
					Total		Tot.	
					No bal.			
					Total			

	RCA		CBA		Regular		Total	
	This Yr.	Last Yr.	This Yr.	Last Yr.	This Yr.	Last Yr.	This Yr	Last Yr.
Coll %								
Svc Chg. %								
Charge trans.								
Credits								
Cash								
Accts billed								
Media per sta.								
Average sale								

	Delinquency Ratios									
	3 Payments		4–6 Payments		7–8 Payments		9–12 Payments		Total	
	TY	LY	TY	LY	TY	LY	TY	LY	TY	LY
RCA										
Acct billed										
Ratio										
CMD Ratio										
CBA										
Acct. billed										
Ratio										
CMD Ratio										

Courtesy of the Gold Department Store, Lincoln, Nebraska

REVIEW AND DISCUSSION QUESTIONS

1. Why is it necessary to test the success of credit operations?
2. What two questions should the credit man be prepared to answer?
3. What is meant by the term "enlightened management"?
4. The credit manager has an implied responsibility to three interests. What are these interests?
5. Which interest is the most direct and readily apparent? Why?
6. Why is it necessary to interpret the phrase "minimum of losses" in the widest possible sense?
7. What is "satisfaction" in a credit transaction?
8. Professor Phelps says that tests of credit department operations are valuable in five important ways. What are these ways?
9. Why can the bad-debt loss index be very misleading?
10. What is the credit sales index? How is it computed? What does it show?
11. What is the collection index? How is it computed? What does it show?
12. What is the receivables turnover index? How is it computed? What does it show?
13. What is the acceptance index? How is it computed? What does it show?
14. What is the past-due index? How is it computed? What does it show?
15. Why is it recommended to age the accounts receivable of a concern?
16. What methods can be used to present to top management the measured results of credit department operations?

PART IV

BUSINESS CREDIT, GOVERNMENT CREDIT, AND FOREIGN CREDIT

CHAPTER 18

Business and Governmental Use of Credit

AS WAS SHOWN in Chapter 1, credit may be classified according to the form of the debtor's responsibility, as private or public credit. Private credit was shown to comprise two major types of credit, each of which denoted the use of the funds or wealth exchanged, as *consumer* credit and *business* credit. Consumer credit is sometimes referred to as "consumptive credit," whereas business credit is frequently referred to as "productive credit." Private credit, then, identifies any credit employed by individual consumers and businesses, and public credit is the employment of the credit mechanism by political bodies such as federal, state, and municipal governments.[1]

At this point the discussion turns from our comprehensive treatment of consumer credit to a general consideration of the several types of business credit and government credit. Part V is a comprehensive treatment of commercial credit.

BUSINESS USE OF CREDIT

If business is to function properly in the economy its financial requirements must be accommodated. Not only must the monetary system provide financial assistance to meet the long-term needs of businesses, it must also supply the means whereby intermediate-term and short-term needs are met. Furthermore, business must be accommodated by a variety of credit types to satisfy its complexity of operations. The day-to-day,

[1] See classification of credit, Chapter 1, p. 15.

seasonal, irregular, and even cyclical changes affecting the production and marketing aspects of business demand a good deal of flexibility be provided by the nation's financial and credit institutions. Much of businesses' diversity of credit needs is provided by our modern banking system, whereas some of it is provided by other financial institutions, individuals, and some by business enterprises themselves.

The Nature of the Demand for Business Credit

Business credit is used to further the production and marketing of goods and services. To a businessman credit is a means to an end. It permits him to engage in the production and/or marketing of goods and services which yield him profits. The expectation of profitable business activity creates the demand for business credit, and conversely the expectation of unprofitable activity depresses this demand. The flow of all forms of business credit into productive activity, then, is a reflection of business opportunity.

This concept of business credit tells us little, however, of the variety of credit needs demanded by business. The variety of credit needs stems principally from the character of the business activity to be financed. Few, if any, businesses are entirely financed by the owner's capital. Be it a proprietorship, partnership, or corporation, it would indeed be rare if a demand for various kinds of business credit did not exist. Even though all businesses have an ownership interest in one form or another, it is seldom large enough to forego substantial financing of the assets by creditors. With most businesses the ownership interest is an outlay of cash used to purchase only a portion of the current assets and fixed assets; or, simply the placing of physical assets such as machinery, real estate, or equipment with the firm for its operation. Business credit is used by management to acquire all remaining assets not covered by the owners' investment. Hence, the need for business credit arises. Since the total assets of any business comprise current assets and fixed assets, different types of business credit are available to meet its short-term and long-term requirements. Essentially, short-term financing, as evidenced by the current liabilities section of the balance sheet, is used to acquire current assets for the business. Long-term financing, on the other hand, is undertaken to acquire both current and fixed assets. Clearly, then, business credit is a device for acquiring business assets in the form of both current and fixed assets.

The particular types and magnitudes of credit needed by any business are dictated by its scope of operations, business objectives, and the type of assets to be acquired. Most businesses throughout their lives have

almost a continuous need for cash as well as merchandise and services. To fulfill both of these needs, business credit comprises two broad types, namely, commercial credit and cash (financial) credit.

Commercial Credit

This type of credit aids businesses in the acquisition of current assets. It is created as one business accepts the credit of another business in exchange for goods and services. This is singularly the most frequently used type of business credit by all buyers of goods and services in the various stages of production and marketing. Commercial credit transactions take place from the time goods are sold as raw materials until they reach the industrial consumer or reseller as finished goods. In other words, commercial credit transactions take place between manufacturers, producers, wholesale distributors, and retailers. It does not include, however, credit which retailers accept from consumers, thus distinguishing commercial credit from consumer credit.

In addition to the above mentioned characteristics, it is generally an unsecured short-term type of credit. With the exception of retail firms, most commercial enterprises are both debtor and creditor as the result of commercial credit transactions. A wholesaler, for example, is a creditor as evidenced by his accounts receivable for merchandise sold to his business customers; and a debtor, as evidenced by his accounts payable for inventory and services purchased from manufacturers and middlemen. Commercial credit has as its principal purpose the facilitation of the movement of goods through the successive stages of production and channels of distribution.

Cash (Financial) Credit

The sole use of commercial credit would leave most business enterprises short of other working-capital requirements. Hence, to acquire both current assets and fixed assets most businesses use their credit power to borrow cash. The principal sources of business loans are commercial banks, investment companies, insurance companies, factors, commercial finance companies, and individuals. The use of one source of funds rather than another, or a particular combination of sources, is mostly determined by the specific financing requirement and the acceptability of the business as a credit risk.

Commercial banks and commercial finance companies are the principal sources for short-term loans. In general, short-term loans from these sources are available to businesses for periods of less than one year and frequently for a maximum of two or three months. Businesses use

short-term loans for the purposes of acquiring inventory, the payment of current obligations, and the payment of employees wages and salaries. Whereas commercial credit facilitates the acquisition of most inventory needs, the credit terms may be unrealistic from the standpoint of some businesses. This type of financing permits the business to meet its obligations until such time as it receives income from merchandise sold. The firm which has a long period of time involved in its manufacturing process or sells products on extended terms of sale will usually require considerable short-term financing. Business enterprises which can finance current operations with owners' investment or by receipt of income from operations have less need for short-term loans.

Commercial finance companies such as General Motors Acceptance Corporation, Commercial Credit Company, C.I.T. Finance Corporation, General Electric Credit Corporation and a large number of similar companies, specialize in the wholesale financing of dealers' stocks.[2] Accounts receivable financing and factoring is a specialized activity of some of these firms or their subsidiary corporations.[3] Businesses which cannot obtain sufficient working funds from commercial banks may take advantage of this source. These institutions frequently deal with businesses which cannot qualify for commercial bank loans. A case in point is the financing of automobile dealers' stocks which frequently are out of balance relative to other balance sheet items. Because of the more lenient credit standards and profit potential commercial finance companies may accept a lower grade of business credit risk than the risk accepted by commercial banks.

Long-term financing is usually one of the first forms of financing used by businesses to acquire fixed assets. When a business resorts to borrowing funds for this purpose, the credit involved is known as "investment credit." Evidence of this type of borrowing appears in the fixed liabilities section of the balance sheet. Whereas the fixed liabilities and the owners' interests constitute the total long-term financing, owners' interests are not to be regarded as credit. The ownership of shares of corporation stock does not give the owner a creditor's right, and the purchase of such shares is not a credit transaction nor is the stock representative of a credit instrument. The investment of funds into corporation stock represents ownership equity and not creditor interests.

The typical fixed assets purchased by means of long-term borrowing include land, buildings, machinery, equipment, and other "permanent" items necessary to the operation of the business. In addition to acquiring

[2] This phase of commercial finance companies operations was covered in Chapter 6. See pp. 132–34 for a detailed discussion of this type of financing operation.

[3] See Chapter 20, pp. 401–8 for a detailed treatment of these methods of financing.

fixed assets in this manner, a portion of the current assets may be provided by the use of investment credit. Other than many of the technicalities of this type of borrowing, the principal distinction between long-term financing and short-term financing is the time element involved. Whereas short-terms loans are expected to be repaid from the conversion of current assets into cash, long-term loans are usually repaid from profits which have resulted from the employment of the additional capital in the business.

The principal source of long-term loans is the savings of the individual investor. Some individuals may invest their savings directly into an investment opportunity, whereas most people channel their savings into institutions which perform the investment function for them. Most people are quite willing to turn their savings over to investment institutions for the following reasons: (1) the small amount an individual has to invest would not attract investment opportunity, (2) the investment structure is complex and not generally understood, and (3) most savers do not have the ability nor inclination to cope with the details of managing their investment. Insurance companies, investment companies, savings banks, commercial banks, and trust companies are the principal channels through which individual savings flow for investment purposes. These institutions are not only more capable of dealing with businesses' long-term financing problems, they also attract the better investment opportunities.

Intermediate-term loans, which mature from say one to five years, are needed by a large number of business enterprises. The need for intermediate-term loans arises because short-term and long-term loans leave uncovered some important areas of business finance. Plant additions, replacements of machinery and equipment, the replenishment of depleted working capital, and the financing of temporarily depressed business situations are examples of a few situations calling for intermediate-term loans. For the most part the commercial banks provide this type of capital, although their interest in this type of business credit is of recent origin. Until two or three decades ago, banks held to the theory that their function was to supply to businesses short-term loans of the self-liquidating type.

A more complete treatment of the role of commercial banks and investment credit in the business area is reserved for Chapter 20.

GOVERNMENT USE OF CREDIT

Public credit which includes that credit used by all governmental bodies and units completes the structure of credit in the United States

economy. Federal, state, and municipal governments find it increasingly necessary to use their credit to meet their expenditures in the many areas of government interest. In recent decades, the increased reliance of governments on credit to finance their operations stems from (1) greatly increased costs, and (2) the expansion of public programs in the areas of education, highways, military readiness, and health and welfare. Governments borrow money for essentially the same basic reason as businesses borrow money; it is simply that their financing needs exceed their incomes. When governments borrow money it is usually done by the issuance of a credit instrument. State and municipal governments often issue bonds in order to finance their needs. Federal government, on the other hand, may issue bonds, or the shorter-term treasury notes, treasury bills, and treasury certificates. Each of these instruments represents government's promise to pay at some future date in exchange for the credit used to acquire money, goods, or services for government. The issuance of such instruments typically results in the creation of checking accounts in the banking system against which government draws to meet its needs.

The credit capacity of any government is based on the sustained confidence it enjoys and its ability to levy and collect taxes from the public. Insofar as the federal government is concerned, there is no question about its credit worthiness—and its credit involves little or no risk on the part of lenders. Some other political bodies enjoy this same high rating among lenders, but there are a number of local governments which experience difficulty in fulfilling their credit needs. In recent years it has become increasingly difficult to increase the revenue from existing tax sources and even more difficult to find additional tax sources. As this problem is either lessened or becomes more aggravated in the future, it will have a direct effect upon the services of local governmental units. Because taxation is the local government's principal source of income which in turn is partly used to meet its credit obligations, it is obvious that a close relationship must exist between the two. Except for federal government (because it can actually create money), then, the credit worthiness of political subdivisions perhaps rests more on their tax revenue potential rather than on some degree of confidence they may enjoy. In this respect local government may be likened to a business enterprise which must assure creditors of its income possibilities relative to its actual and planned expenditures.

While governmental use of credit is not of major interest in this volume, it takes on significance when considered relative to business and consumer credit.

THE INTERRELATIONSHIP BETWEEN GOVERNMENTAL, BUSINESS, AND CONSUMER CREDIT

If credit executives are to appreciate fully their part in the credit economy, it behooves them to familiarize themselves with the close relationship between governmental credit, business credit, and consumer credit. The expansion and contraction of any form of credit influences each of the other major types of credit, and hence the conditions under which credit management must operate and formulate policies. Monetary and credit conditions help to explain the general level of prices and the overall price-making processes which influence the credit worthiness of credit risks. If a credit manager is to serve his company with the greatest effectiveness, he must be aware and knowledgeable of monetary matters and how his employer's activity as well as his customers' activities are affected.

While it is not within the scope of this book to consider the detailed workings of our monetary system, a brief summary of its more important aspects will serve to establish the close relationship between governmental, business, and consumer credit.

Credit Expansion and Contraction[4]

The monetary system of the United States is a complex mechanism founded on credit transactions. The key to expansion and contraction of bank credit is found in the fact that each member bank is required to maintain a fractional cash reserve which is sufficient to support the bank's deposit liabilities. This reserve must be kept at a specified percentage of its demand and time deposits. The percentage is set by law and regulation. Whenever the bank's reserves are in excess of the minimum requirements, it is in a position to loan or invest the amount of the excess.

The process by which credit expansion and contraction takes place arises from the lending activities of individual banks, but results from the operation of the entire system of banks. An individual bank can lend only such money in excess of its reserve requirements that it acquires from its stockholders, depositors, or the federal reserve. As the money leaves the hands of the first bank, it continues to do business as it passes into the banking system from bank to bank (in the form of deposits) or from person to person. Each loan or investment results in a

[4] For a more detailed and interesting description of these processes, see Rollin G. Thomas, *Our Modern Banking and Monetary System* (3rd ed., Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1957), chap. 20.

series of events within the banking system which permit a multiple expansion of credit. First, the lending bank increases its earning assets by making the loan, and second, it loses cash to other banks as the money is spent on goods and services, but other banks receive a corresponding increase in deposits. As the series of loans and deposits go on throughout the banking system, multiple credit expansion occurs. On the assumption of a 20 per cent reserve requirement, a $100,000 primary deposit can become required reserves for $500,000 of deposits, of which $400,000 can be loaned.

Further expansion of credit in the banking system comes about as the U.S. Treasury buys gold. The Treasury upon receipt of gold usually issues an equivalent amount in gold certificates. This gold and the corresponding gold certificates are, in fact, the foundation for our entire monetary and credit structure. The gold certificates are issued to the federal reserve and permit the federal reserve to have four times the value of the gold certificates in commercial bank reserves on deposit with it. With the ability to expand credit five-to-one, commercial banks may have twenty dollars on deposit for each gold certificate dollar. Thus, the purchase of gold provides a basis for credit expansion.

The contraction of credit in the commercial banking system can result as the above described processes work in reverse. Hence, credit contraction can take place either with actions of the Treasury or by businesses. When gold flows out of the country the contraction results from the loss of commercial bank reserves which were the original basis for expansion. Similarly, as the need for credit from the banking system by businesses diminishes the repayment of loans occurs faster than the making of new loans and the contraction of deposit credit takes place. Credit contraction is cumulative as is credit expansion.

Despite the theoretical aspects of the expansion and contraction processes, they are accurate in the way the phenomena occur. In practice, however, the processes frequently take place in different ways. The importance of the impact of these forces gains significance in that checking account money (credit) is used to settle the great bulk of all business transactions.

Instruments of Federal Reserve Policy

It has been shown that commercial bank reserves are the basis for the volume of credit in the economy. In regulating the reserves of the commercial banking system, the Federal Reserve System relies on three interrelated instruments, all or any of which influence the expansion and contraction of commercial bank credit. *Open market operations, discount*

operations, and changes in the *reserve requirements* are the methods which may be used to affect changes in the capacity of banks to expand or contract the credit supply.[5]

Briefly, open market operations generally consist of federal reserve purchases or sales of United States government securities. These securities are evidence of government borrowing and expenditures. Federal reserve purchases of government securities add to the reserve balances of member banks and thus result in a greater capacity of member banks to make loans and to acquire investments.

Discount operations permit member banks to obtain additional reserves by borrowing from the federal reserve. The proceeds from such loans are credited to the member bank's reserve balance on deposit at the reserve bank. While commercial paper and other business paper of prime quality are eligible for discounting, borrowing against government securities is easier and instantly appraisable. The interest rate charged for this service is known as the "discount rate." The federal reserve can either encourage or discourage borrowing by member banks by lowering or raising the discount rate. When the federal reserve believes that further credit expansion would be economically harmful, it may raise the discount rate; and conversely when it believes credit expansion may be helpful to the economy. In actual practice member banks are very reluctant to resort to this method of gaining additional reserves which provide the basis for expansion of their loans and investments. The discount rate, however, is typically viewed as the direction of federal reserve policy. Furthermore, and more importantly, there is a close interrelationship between the discount rate and other interest rates because the rate reflects the federal reserve judgment on the credit and money supply relative to general economic conditions.

Finally, changes in member bank reserve requirements influence the capacity of commercial banks to expand credit. Changes in the reserve requirements affect the amount of reserves that member banks must hold as deposits with the federal reserve. In other words, a given amount of member bank reserves can be made to support more or less credit and monetary work. If reserve percentages are raised, banks with no excess reserves must sell liquid assets in the market, borrow from other banks or the reserve banks in order to obtain loan and investment funds. If reserve percentages are lowered, on the other hand, banks find themselves with excess reserves which are available for loans and in-

[5] For a complete and detailed discussion of these operations, see *The Federal Reserve System, Its Purposes and Functions* (Washington, D.C.: Board of Governors of the Federal Reserve System, 1947), chap. 3.

vestments or debt repayment. If the required reserve is 20 per cent, $1 of reserves will support $5 of deposits, whereas a 15 per cent reserve requirement means that $1 will support $6.67 of deposits.

Inasmuch as the banking system has the ability to affect a greater or smaller amount of credit the effects on businesses, consumers, and governmental units must be recognized. While the close interrelationship between credit in our banking system and all other forms of credit is clearly apparent, it is appropriate to examine briefly the widespread effects of monetary actions.

Impact of Credit Expansion and Contraction[6]

It has been shown that the actions taken by monetary authorities are transmitted to the United States economy through the commercial banking system. This same system is the foundation of our monetary and credit structure and hence the reactions to its changes bear importantly on the credit activities of governmental units, businesses, and consumers. In general, the immediate effect of monetary actions is to influence the cost of credit and the amount available at commercial banks. After a time, the easing or tightening of credit will influence the decisions of businesses and consumers to participate in credit transactions.

If banks begin to restrict credit expansion, many business borrowers can be expected to curtail their spending plans. Insofar as bank financing is relied upon to acquire inventory, expand plant, replace equipment, and perform other financing requirements—a restriction of credit normally will reduce the accomplishment of these business factors. A credit restriction policy also affects long-term financing arrangements because the willingness of banks to lend for this purpose is also lessened. Financial institutions engaged in taking mortgages on business and consumer durable goods find the likelihood of refinancing through commercial banks lessened. In this way the ability of other lenders is influenced, and in particular mortgage lenders and sales and consumer finance companies will of necessity restrict their operations by becoming more selective (raising their credit standards).

The cost of credit (interest rates) also functions as a brake or release on business and consumer spending. Rates of interest usually move up or down with the availability of credit. A reduced supply of credit will be reinforced with higher rates of interest. Higher borrowing rates alone are frequently enough to discourage and divert some demands for credit.

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[6] For an interesting and expanded discussion of this topic, see Ralph A. Young, "Tools and Processes of Monetary Policy," *United States Monetary Policy,* The American Assembly, Columbia University, December, 1958, pp. 37–42.

Businesses regard the use of their credit as a device for their involvement in a profitable business opportunity, but higher money rates may easily wipe out the attractiveness of their venture. As consumers are confronted with higher real estate mortgage interest or an increase in the cost of financing automobiles, it might be expected that large numbers of households will be discouraged from making the credit-financed expenditure.

When the credit contraction and higher interest rate policies of the federal reserve are sufficiently intense so as to create an atmosphere of business pessimism secondary effects are likely to set in. Notably, cash expenditures by businesses and consumers are likely to be reduced. This result coupled with the lessened credit availability will add to the overall effectiveness of creating depressed economic conditions.

Expansion in consumer and business spending, then, will generally be slowed as the commercial banking system limits the pace at which credit is created and as it adopts policies that make it more costly to transact credit-financed purchases. The actual impact on borrowing and spending will differ in timing and degree from one consumer or business to another. The reason for this is that various credit users have different degrees of reliance on credit financing and some are more sensitive to the increased costs of borrowing than others.

At times federal reserve policy attempts to encourage credit expansion and spending. The effects of this policy are the reverse of those briefly described above. With the improved reserve positions of commercial banks they will undertake the buying of government securities and the making of loans, which in turn expand checking account money (credit). These conditions tend to reduce interest rates and banks must compete for credit customers. This increased supply of credit and the lower cost of credit-financed purchases will encourage such purchases. As this policy creates a climate of economic optimism cash expenditures by consumers and businesses will increase.

While this brief description of the impact of credit expansion and contraction is perhaps oversimplified, it suffices to point out the importance of economic forces which are set in motion by a tightening or easing of credit conditions. It should also be noted that federal reserve policy is only one factor which influences monetary and credit conditions. The effectiveness of its policies, of course, depends upon the timing and strength given to a particular action and upon its isolation from offsetting influences.

Credit expansion and contraction by the banking system are closely related to the fiscal policies of federal government. During an infla-

tionary period, and if government desires to stem an inflationary tide, one might expect actions designed to reduce government expenditures, increase taxes, and reduce the volume of bank credit. Conversely, in periods of depressed economic activity, the expectation is usually that government will increase expenditures, ease tax burdens; and, the banking authorities will take such actions necessary to increase the supply of credit. There is perhaps little doubt that the application of these measures is sound, and that they tend to activate businesses and consumers in one direction or another.

In actual practice, however, it is not always possible for the inflationary or deflationary measure(s) to effect the result(s) desired, because of the complexity of economic forces at work and the undesirable aspects of monetary, fiscal, and debt management policies exhibiting too high a degree of flexibility. Furthermore, the authoritative powers may be in disagreement as to the soundness of their decisions and the over-all impact on the economy. At best, one can "expect" given monetary and fiscal policies to produce certain economic influences, but one should be aware that offsetting economic forces, poor timing, and the lack of co-ordinated policy decisions may destroy the possibility of attaining the desired economic results.

PRODUCTIVE NATURE OF BUSINESS AND GOVERNMENTAL CREDIT VERSUS CONSUMER CREDIT

Despite the close relationship between business credit, government credit, and consumer credit and their apparent foundation in our modern banking system, there is not unanimity of opinion as to the economic significance of each type of credit. These differences in opinion are partly the result of regarding business credit and government credit as essentially *productive* in use and consumer credit as essentially a *consumptive* type of credit. The commonly held views are: business credit is productive in the sense that this type of credit facilitates the *production* of goods and services at a profit which in turn liquidates the indebtedness; government credit which is not self-liquidating does, however, give rise to the production of goods and services and frequently sets the wheels in motion which produce the conditions for debt liquidation; and, consumer credit is consumptive in that it is used to acquire things for consumptive purposes. This view of consumer credit has led some to regard the use of credit by consumers with reservation and at times entirely ill advised.

Attempts to compartmentalize the types of credit by the use of the

terms *productive* and *consumptive,* and to regard "productive credit" as beneficial to the economic welfare of the nation, leads one into fallacious reasoning. This very approach to monetary and credit matters is practiced in many circles including our most outstanding colleges and universities.

At this point in this book, the student should become aware of the fact that *all* credit is productive and to view it otherwise is an economic fallacy. Consumer credit which has been an instrument in raising the standard of living, affording a host of consumer satisfactions, and resulting in the creation of utility cannot be regarded as anything but productive. There is no question that consumer credit has served a need of the American consumers, the same as other types of credit serve the need for governments and businesses. All too frequently this basis of consumer credit becomes distorted by those who wish to set themselves up as authorities as to who ought to pay cash and who need not. Furthermore, they would like to decide for consumers what should and what should not be credit financed.

It is, therefore, desirable and sound reasoning to regard all types of credit as productive. Good economic theory and analysis will not dispute the interrelationships and interdependence of the various types of credit. Our earlier sections concerned with consumer credit, and this chapter which has introduced the other major types of credit should serve as an appropriate basis for a broader and more comprehensive concept of credit in our economy. One must recognize that services as well as merchandise have value, and that our credit system facilitates their acquisition by functioning as a medium of exchange. And, after all, most credit transactions, whether business, government, or consumer involve economic activity which has as its aim—consumption.

REVIEW AND DISCUSSION QUESTIONS

1. What is the nature of the demand for business credit?
2. What is the role of commercial credit in the financial scheme of most businesses?
3. Distinguish between the long-term and short-term cash credit needs of a typical business enterprise.
4. Define the term "investment credit."
5. What is an intermediate-term loan? How does the need for this type of financing usually arise?
6. What is meant by the statement "the monetary system of the United States is founded on credit transactions"?

7. Explain how policies of the Federal Reserve System influence credit policy.
8. Are the artificial measures used by fiscal authorities to temper inflationary and deflationary pressures effective?
9. What considerations lead some to regard consumer credit as *consumptive* in character whereas business credit is more often regarded as *productive?*
10. Is consumer credit clearly a productive type of credit? Justify your answer.

CHAPTER 19

Commercial Credit and Terms of Sale

COMMERCIAL CREDIT, sometimes referred to as "mercantile credit" or "trade credit," is the power of a debtor to obtain merchandise and services in exchange for his promise of future payment. It is used only in connection with conducting a business enterprise or for the purchase or sale of goods for resale. The fact that the value received includes merchandise and services distinguishes it from cash (financial credit), and because it is accepted by business concerns from other business concerns it does not include consumer credit. Any number of different institutions in the economy use their commercial credit such as manufacturers, wholesalers, retailers, governments, co-operative enterprises, and the like. The services included in commercial credit transactions may be in connection with the goods acquired or may be rendered solely as a service necessary in the conduct of the enterprise. This type of credit is the most important short-term credit used and accepted by businesses by virtue of the multiplicity of transactions, the policies associated with accepting it, and the accounting procedures necessary to manage it accurately. It is commercial credit which gives *raison d'etre* to the credit departments of all marketing institutions, except retailers.

FUNCTION OF COMMERCIAL CREDIT

In the preceding chapter it was mentioned that commercial credit facilitated the movement of goods through the successive stages of production and distribution. While this important function is frequently

supplemented by other forms of credit, the reliance and use of businesses upon commercial credit far outweighs alternative sources of credit.

Financing the Movement of Goods

A simple example will be sufficient to illustrate the use of commercial credit in the successive stages of production and distribution. As the producer of raw materials sells to processors and manufacturers there are several ways in which the goods may be financed. If the original producer of raw materials is financially capable, he may accept the credit of his customers and hence commercial credit is created. More likely than not, the raw materials supplier may be financially weak, and the burden of financing the goods as they move from hand to hand falls on the purchaser. The purchaser of the raw materials may finance the goods with his own capital, or even by borrowing from a bank or other lending institution.

As the raw materials are processed or converted into semiprocessed goods, they again are sold to manufacturers of finished goods. As these goods are sold the manufacturer will offer his credit in exchange for the goods. This is known as commercial credit because he is acquiring goods for further fabrication or to conduct his business enterprise. Other forms of credit will pay, in whole or in part, the manufacturer's workers, meet overhead, and cover other manufacturing costs. As the goods are manufactured into finished goods they are sold to wholesalers or industrial supply houses. The transfer of the goods is again accomplished by commercial credit—the wholesaler offers his credit to the manufacturer in exchange for the goods. A similar commercial credit transaction takes place each time the goods change ownership until such time as the goods reach the retailer, who also gives his commercial credit for the inventory of finished goods he has for resale. As the retailer makes a sale to a consumer, chances are the consumer uses his credit to acquire the merchandise.

Commercial credit, then, is used by all kinds of business enterprises to finance the acquisition of goods or services. The transaction is very informal, involving nothing more than an order for goods or services by one business and the delivery of goods or performance of services by another business. Evidence of the transaction is an account receivable or note receivable claim in the accounting records of the seller. The buyer's evidence of the transaction is an account payable or note payable obligation in his account records. Perhaps only a few businesses in the nation are free from the frequent credits and debits to these asset and liability accounts. Furthermore, although there are no precise data to sup-

port the point, the vast majority of all goods and services flowing through the productive and marketing processes are financed in this particular way.

It is worthwhile to note the United States is far advanced in its use of commercial credit as contrasted with other countries throughout the world. Much more credit is offered and accepted by business firms here than in any other nation. Not only is our system simple and informal, it is much more extensive. This is principally due to the informal and well-developed network of interchange of credit information which is unique among countries of the world. Even the highly developed economies of Germany, Sweden, England, France, Italy, and Switzerland have nothing which approaches our commercial credit system.

Essential to a Mass-Distribution Economy

Some method of relieving the financial problem in the various steps of production and distribution, such as commercial credit, is essential to the effectiveness of a mass distribution economy. Other than short-term bank loans and the ownership interests of businesses there are few other ways to accomplish the financing task done by commercial credit. Even if businesses of all types were exclusively dependent upon bank loans and their own capital, it is doubtful that enough financial capacity could be marshaled to cover the value of the goods and services handled by means of commercial credit.

The widespread use of commercial credit and much of its importance as a form of business finance stems from the nation's economic developments. As the nation grew the distances between manufacturers and their customers lengthened. With the development of transportation systems and adequate means of communication, population and businesses became scattered over vast geographical areas. Paralleling these developments the mass-production and mass-distribution methods assumed their place in the economy. Retailers also increased in number and large-scale retailing became necessary throughout the nation to meet the wants of a growing population. All these changes resulted in trade being carried on in a more impersonal basis and over great distances. Speed of commercial transactions became essential as competitive forces became more intense. If the systems of production and distribution, as we know them today, were to be effective in a changed economy some method of financing goods as they moved through the production and marketing phases was essential. If businesses were required to settle for their purchases with cash, only the imagination could conceive the resulting inefficiencies and delays. Commercial credit, then, has devel-

oped alongside economic developments as a means for businesses to finance an important part of their assets. Without this type of credit, a gap in the financing needs of businesses and the economy alike would exist.

Changing Attitudes toward Commercial Credit

From the above it should not be assumed that commercial credit—the giving of goods and services in exchange for a promise of future payment—is of recent origin. The fact is that credit transactions between merchants date back to times of antiquity. In American colonial times, commercial credit was the backbone of much trade with England and other European countries. The attitudes associated with credit and the credit instruments used as evidence of the transaction were, however, greatly different.

The prevailing attitude toward credit of only a few centuries ago as compared with the attitude today has undergone marked change. The laws and attitudes concerning a delinquent debtor were rigid and harsh. Punishments ranged from imprisonment or enslavement to death in some instances. Quite obviously, this state of affairs placed the risk squarely upon the debtor and not upon the creditor. Furthermore, involvement in a credit transaction by a prospective debtor brought about serious consideration of the consequences of nonpayment and this thwarted the role credit could play in an expanding economy. Of comparative recent origin is the abolition of rigorous laws and hence more lenient attitudes regarding the delinquent debtor. Today, only the debtor who perpetrates fraud by means of credit transactions faces the threat of imprisonment. The creditor today who deals with businesses regards himself more as a business partner than one who can ruthlessly enforce his claim. Credit between business enterprises is recognized as mutually profitable, i.e., each seeking to profit from the action of the other. Risk, rather than being placed solely upon the debtor, is now assumed also by the creditor. In a sense then, both have risk capital in the business enterprise and an attitude of partnership is easily fostered.

Contributing to the changed attitude toward credit has been the different environment in which commercial credit transactions take place. Prior to the Civil War retailers had to estimate their inventory requirements for six months or longer. They took annual or semiannual trips to the market where they purchased relatively large quantities of merchandise. Because of the large amount of credit needed and the lack of adequate communications systems, the credit was secured with a trade acceptance, promissory note, or draft. As transportation and communi-

cations improved the need to estimate accurately inventory requirements diminished. Supplier's salesmen could now travel to distant points, retailers could visit the market more often, and competition for their business became intense. The open-book account, as evidence of the commercial credit transaction, supplanted in most cases the trade acceptance, promissory note, and draft. Retailers no longer had the risk of estimating requirements over an unrealistic period of time; they did not have to obligate themselves so heavily; and, the tendency to shorten credit terms prevailed. Shorter terms and less relative commercial indebtedness meant that retailers could liquidate the obligations faster and thereby increase the turnover rate of suppliers' receivables. The adaptability of commercial credit to modern-day business practice has resulted in it becoming commonplace and even a customary means of financing a phase of business operations.

TERMS OF SALE

With each commercial credit transaction an understanding must exist between the buyer and seller regarding the conditions for payment for the goods and services. The establishment of such conditions is generally known as the *terms of sale, credit terms,* or *payment terms.* It is sound business practice which dictates that terms of sale be quoted on all invoices covering the shipment and on all instruments associated with the contract of sale. If specific terms of sale are not quoted the buyer may legally presume that any terms established by custom for that line of trade may apply. The buyer's obligation to meet the terms of sale arises as the seller delivers the goods or services or meets other specified conditions of the contract of sale. The terms of sale applicable in commercial credit transactions are a characteristic peculiar to this type of credit. Table 19–1 which shows the typical terms of sale for 50 lines of trade is a helpful reference for much of the discussion to follow.

ESTABLISHING TERMS OF SALE

The credit terms offered to customers should be determined by the major executives charged with the responsibility of making policy decisions. The policy relative to this element of the sale deserves just as careful consideration as any other element of the sales program. While the credit policy and the terms of sale may be varied to meet the particular situation at hand, the circumstances surrounding most companies are such that certain general principles are common to most situations.

Table 19–1
TERMS OF SALE IN 50 LINES OF BUSINESS

Industry	*Terms of Sale*
Manufacturers	
Airplane parts and accessories	Net 30 days, occasionally ½% or 1% 10 days, net 30 days
Automobile parts and accessories	2% 10th prox.
Bedsprings and mattresses	2% 10th prox., net 60 days
Breweries	Controlled by various states
Chemicals, industrial	Net 30, some 1% 10 days, net 30 days
Men's and boys' coats and suits	Net 30, net 60 and datings
Women's coats and suits	8%, 10 days E O.M.
Cotton cloth	Net 10 days for gray goods. 2% 10 days 60 days extra on finished goods
Cotton goods (converters of)	Net 70 days or 2% 10 days, 60 days extra
Rayon, silk and acetate dresses	8% 10 days E O.M.
Drugs	2% 10 days net 30, also 2% 10th prox.
Electrical parts and supplies	2% 15 days prox. net 60 days. Also 2% 10 days net 30 days
Foundries	Net 30 days and ½% and 1% 10 days net 30 days
Furniture	2% 30 days net 60 days, and 2% 10 days net 30 days
Hardware and tools	2% 10 days net 30 days
Hosiery	Net 30 days
Machine shops	Net cash and net 30 days
Machinery, industrial	Net 30 days or time payment
Meats and provisions, packers of	Sight draft bill of lading in carload lots—otherwise net 7 days
Metal stampings	Net 30 days
Outerwear, knitted	Net 10 days E.O.M.
Overalls and work clothing	Net 30 days
Paints, varnishes and lacquers	2% 10 days net 30 days
Paper	1% 10 days, net 30 days on coarse paper—2% 10 days net 21 days on fine paper
Petroleum (integrated operators)	1% 10 days net 30 days to wholesalers—load to load to retailers
Printers, job	Net 30 days
Shirts, underwear and pajamas, men's	2% 10 days net 30 days
Shoes	Net 30 days
Steel structural fabricators	Net 10th prox. on contract terms and net 30 days
Stoves, ranges and ovens	2% 10 days net 30 days
Wholesalers.	
Automobile parts and accessories	2% 10th prox net 20th prox.
Cigars, cigarettes and tobacco	Net 7 days
Confectionery	2% 30 days or net 30 days
Drugs and drug sundries	1% 10 days E O M
Dry goods	2% 10 days net 60 days
Electrical parts and supplies	2% 10 days net 30 days
Fruits and fresh produce	Net 7 days
Furnishings, men's	1% up to 3%, 10 days E.O M.
Gasoline, fuel and lubr. oil.	Load to load—some net 30 days on gasoline—and 1% 10 days net 30 days on lubricating oil—fuel oil C.O.D.
Groceries	Net 7 days and C.O.D.
Hardware	2% 10 days net 30 days and 2% 10th prox.
Hosiery and underwear	Net 30 days
Household appliances, electrical	Net 10 days and net 30 days on major appl. 2% 10 days net 30 days on traffic appl.
Lumber and bldg. materials	2% 10 days after arrival, 2% 5 days after arrival, net 30 days

Table 19–1—*Continued*

Industry	*Terms of Sale*
Meat and poultry ..	Net 7 days, biweekly and net 30 days
Paints, varnishes and lacquers	2% 10 days net 60 days
Paper	1% and 2% 10 days net 30 days
Plumbing and heating supplies	2% 10 days net 30 days
Shoes	Net 30 days
Women's wear, coats, suits, dresses	8% 10 days E O M.

Reprinted with permission from "Terms of Sale and Average Collection Period for 50 Manufacturing and Wholesaling Lines" (New York Dun & Bradstreet, Inc , June, 1958).

The factors which influence the policy to be adopted will be briefly considered and commented upon.

Two major variables are involved in the establishment of all terms of sale. The first is the *credit period,* also referred to as the net credit period, which is the length of time allowed the buyer before payment is considered past due. The second is the *cash discount* which may be allowed for early payment. Not all firms make a practice of allowing cash discounts, but they are so common in most trades that they should be considered whenever terms are discussed. The cash discount element of terms of sale should not, however, be confused with the trade discount, which is a pricing device and bears no relationship to the time of payment.

In addition to the importance of quoting terms of sale a clear understanding should exist between seller and buyer as to the credit instrument employed. The most frequent evidence of a commercial credit transaction is, of course, the seller's accounts receivable ledger. In some few instances this is not the credit instrument and the seller may use the promissory note, trade acceptance, or time draft, all of which require the buyer's signature. If one of these instruments is utilized, its use should be specified. Terms of sale, the credit instrument, delivery dates, and all other details of the credit transaction must be understood by the buyer if sellers are to avoid disputes and eventual loss of customers.

Factors Influencing Terms of Sale[1]

Even though there is a great variety of terms of sale used by American industries, there is a tendency in many trades towards standardized selling terms. Frequently the standardized terms are referred to as *customary* or *regular* terms of sale. This trend suggests that the factors in-

[1] For an interesting discussion of the history, development, and trends in terms of sale see Roy A. Foulke, *Current Trends in Terms of Sale* (Dun & Bradstreet, Inc., 1959), part i, pp. 5–43.

fluencing the establishment and adjustment of selling terms similarly affect most sellers and buyers. When conditioning factors influence the members of a trade to adopt similar selling policies over time, such policies become customary or standardized for a trade.

Despite the above trend, most companies have several terms of sale which serve as credit department guideposts. Once a company establishes its selling terms, they are likely to correspond to the rest of the trade. Established terms, however, are often subject to adjustment to meet the conditions affecting a particular customer, or a circumstance prevailing in the trade. The following factors represent those which most importantly influence the adoption of particular selling terms, and on occasion affect an adjustment in terms to individual customers.

Rate of Stock Turnover. It is rather common practice for the seller to finance the buyer through at least a portion of his turnover period. Accordingly, there is a correspondence between the period it takes to convert merchandise into cash and the time allowed for payment of the indebtedness. Those lines of trade having a rapid turnover of merchandise generally have a short credit period, and those lines of trade having relatively slow rates of stock turnover generally have a longer credit period. For example, the short credit period for most food products as shown in Table 19–1 and the relatively longer credit period for dry goods and clothing items are illustrative of this factor.

Location of Customer and Transportation Facilities. Sellers in reaching distant markets are often at a disadvantage as compared to local producers because their terms of sale do not make adequate allowance for the time it takes mail and freight to travel. If the time for payment starts from the date of the invoice, a distant customer does not have as much time after he receives the shipment as he would receive were he to purchase from a nearby source. To overcome this handicap and bring about more equality, the seller may attempt to equalize the distance and transportation factors by allowing a longer credit period, or by allowing terms starting with receipt of goods or receipt of invoice. In this way, the time lost in transportation and the expense of carrying a larger stock by a distant customer is not entirely the loss of the buyer, but it is in part assumed by the seller.

Regional Differences. When selling in certain sections of the country it may be necessary to adjust terms to local conditions. While this factor is not as important today as it was in the past, there are a number of areas today in which this influence is still real. Crop farming, for example, is more seasonal than is dairy farming or areas where agriculture is more diversified. Commercial credit selling terms should, to

as reasonable an extent as possible, be adjusted to this condition. It may also be necessary to make similar adjustment where the nature of a major industry is such that the income of customers is very irregular.

Character of the Goods. The adoption of terms and their adjustment may be on the basis of the character of the goods. Many concerns sell a wide variety of products, but a sole selling term may not apply equally well. Some products on the same invoice may carry no cash discount, while on others a cash discount may be applicable. Likewise the credit period may vary from one line of goods to another, even though such goods are sold by the same supplier. Variations in terms of sale thus may be the result of such things as the margin of profit, the perishability of goods, the novelty of the product, and even the seasonal characteristics. Perishable goods and those affording a narrow margin of profit for example, have a short credit period and little or no cash discount. Conversely, a longer credit period and perhaps a larger cash discount is granted when goods are seasonal, new and novel, and yield a wide margin of profit.

Nature of Credit Risk. The generally announced terms to a particular trade need not be made uniform to all customers. There should be some variation of terms to correspond to the nature of the credit risk. Thus certain buyers who represent poor credit risks may be sold on a cash basis, C.O.D., or C.B.D. terms, whereas the better credit risks are given the advantage of more liberal terms of sale. Peculiarly, when most buyers in a particular trade are weak credit risks it may become standard practice to use the above terms and they may continue even after this reason has ceased to exist.

Class of Customer. Variations in selling terms may also exist because of customer differences. Customers may be classified in numerous ways, as by size of order, type of buyer (wholesaler or retailer), and even by type of wholesaler or type of retailer. Customers making small purchases are frequently allowed shorter terms than the standard terms for the trade. On the other hand large buyers that represent an important portion of the supplier's total volume may be given terms that are more lenient than customary. Associated with the size of order and the type of customer is the ability of some customers to perform important marketing functions for the suppliers. Large buyers, for example, are frequently in a position to assume the storage function provided the selling terms are adjusted to their requirements and other discounts are made available to them. Usually as a matter of industry trade practices, wholesalers are given different terms than retailers, and large department stores and chain customers are given different terms than small retailers.

Competition. The competitive influence on selling terms is perhaps the strongest factor to be considered. Since terms of sale cannot be determined without awareness of the action of competitors the influence of competition frequently causes modification to be made in the customary terms of sale. Because of this we find extra datings or season datings being granted various customers. We may also find certain customers who, because of the competitive pressures which they are able to exert, are granted terms of M.O.M. (middle of month), or E.O.M. (end of month). Too frequently the effect of the competitive influence is a departure from the sound policy which may have been originally decided upon. Originally some of these modifications of customary terms are made to favored customers and are considered exceptions. Competitors, however, come to adopt the same terms so generally that the more lenient terms become standard trade practice. When this happens, the effectiveness of terms of sale in stimulating sales is lost and the entire trade finds itself following unsound practices without any one firm deriving any special benefit.

Financial Resources of the Seller. In determining policy relative to the terms of sale, the ability of the seller to carry accounts receivable may force some modification of terms. Obviously, a new business venture which is short of working capital, will of necessity sell on shorter terms than might be offered by a well-established business with adequate resources to carry large accounts receivable. If many firms in a particular industry are financially weak, this may cause the policy to be generally adopted. It is said, for example, that the shortage of working capital of the early manufacturers of automobiles led to the adoption of cash terms by the industry. This same policy has persisted long after the shortage of working capital was no longer present as a reason.

Economic Conditions. Business activity is influenced by economic conditions and hence some business practices are modified in accordance with the business cycle. There is a strong tendency for selling terms to be adjusted in periods of prosperity or depression. Probably the ideal adjustment to cyclical changes would be to tighten terms during prosperity and to liberalize terms during depression. In actual practice, customers demand longer terms during depression or recession and sellers may offer this accommodation. During prosperity, however, there is seldom a tightening of terms as ideally proposed. By tightening terms during the prosperity phase of the cycle the overstimulation of business activity would be somewhat reduced; and, by liberalizing terms during the depression phase a stimulus to business would be in operation when it is most needed. This policy has to commend it, the argument that credit

would thus be used to aid or abate business stimulation rather than make it less stable, and also, that it works with the coming trend rather than against it. Unfortunately, not all business policies are made because of logical reasons, nor can all competitors be expected to be as rational as they might be. Accordingly, and all too frequently, selling terms are not adjusted to changing economic conditions.

Attitude of Credit Manager. The credit manager's attitude can influence selling terms. The degree of influence he may register is, however, dependent upon his position within the company relative to other policy-making positions and the relationship he may have established with other selling departments. If the credit manager views his sole responsibility to be the elimination of bad-debt losses, and he is successful in imposing this attitude throughout the company, the seller may unduly shorten the credit terms. This and even the opposite extreme of attitude will abort the function of the credit department to the detriment of the seller and customers. Such narrow and one-sided concepts on the part of credit managers are in conflict with the role of credit management in our economy as emphasized elsewhere in this book.

TERMS OF SALE CLASSIFIED

Terms of sale in use today can be classified into the following groups:

1. Prepayment terms.
2. Cash terms.
3. Ordinary terms.
4. Single-payment or lumped-order terms.
5. Special-datings terms.
6. Consignment terms.

Prepayment Terms

Technically prepayment terms are not characteristic of a commercial credit transaction. In all instances where prepayment terms are used, the element of risk which is inherent of credit transactions is absent or at least slight. It is necessary, though, to discuss briefly these terms so as to establish a point of reference; and, because it is necessary for credit management to be knowledgable of their use. This class of terms includes C.B.D. (cash before delivery), C.O.D. (cash on delivery), C.W.O. (cash with order), C.I.A. (cash in advance), and S.D.-B.L. (sight draft with bill of lading attached).

Aside from a few instances where they are customary in certain lines of trade, the above terms indicate the seller's unwillingness to accept

the credit risk. It may be that the credit risk was never satisfactory or that having once been acceptable, the risk has deteriorated to a point of unacceptability. Not only is the seller unwilling to accept the buyer's credit, he often requires the buyer to submit payment by certified check or cashier's draft, thereby not even assuming the risk of check clearance. It is not advisable to use these terms to ship new orders to customers unless arrangements for prepayment have been made. Furthermore, if the customer has a past-due balance it is wise to reach an agreement on a specific payment schedule for the past-due account.

C.O.D. terms and S.D.-B.L. terms are not entirely free of risk as are the other prepayment terms. The risk involved in the use of these terms centers on the possibility that the buyer may reject the shipment after it has arrived at destination. In such instances the seller has the alternatives of accepting the round-trip transportation costs, entering into a questionable credit arrangement with the original buyer, or as a last resort, seek out another possible customer in the immediate vicinity of the merchandise. It is desirable that the seller insist on cash or a certified or cashier's check in payment of C.O.D. shipments.

S.D.-B.L. terms, which are a modification of C.O.D. terms, involve an order bill of lading, properly endorsed, attached to a sight draft. These instruments are sent to a bank in or near the buyer's city. When the buyer is notified of the arrival of the merchandise, he may inspect the condition of the shipment and then pay the sight draft at the bank. In return for his payment of the sight draft he receives the bill of lading which grants him title and possession of the shipment. Once a shipment is made on S.D.-B.L. terms the seller should be cautious of the buyer who pleads lack of funds at the time the goods arrive. Coupled with this claim the buyer is likely to encourage the seller to permit the bank to release the shipping papers, promising payment in ten days. The temptation for the seller to accept this arrangement is strong, for otherwise he is confronted with unattractive alternatives. To accept the arrangement, means accepting credit from a customer whose credit was unsatisfactory a few days earlier.

In those lines of trade where these strict terms are customary the credit manager should not associate the terms with the quality of credit.

Cash Terms

Cash terms do not indicate the immediate payment of cash, but the acceptance of credit for a period of approximately ten days from the date of invoice. Clearly, cash terms are a step removed from prepayment terms as the credit period is very short. The time interval allows the

buyer time to inspect and accept the shipment, and the seller's risk is lessened in comparison to more common (longer) terms. These terms do not usually allow the buyer a discount privilege. Since the seller has no special recourse in the event the buyer fails to pay, he is involved with the usual degree of credit risk.

Ordinary Terms

In many lines of trade the terms of sale include only two component parts—the net credit period and the cash discount. Terms involving no other features are referred to as "ordinary terms." Typical of the frequently used ordinary terms is "2/10, net 30" (2 per cent, 10 days, net 30 days). If a customer receives an invoice for $300, dated March 15, terms 2/10, net 30, he has the choice of paying $294 on or before March 25, or $300 by April 14. By electing to pay the $300 the buyer pays the equivalent of $6 for the use of $294 for 20 days. Buyers are usually well advised to take advantage of the cash discount. In this case the discount is equivalent to 36.7 per cent a year.

Single-Payment or Lumped-Order Terms

In a number of industries sellers permit their customers to accumulate their obligations over a short period of time. These arrangements are used where there is a high frequency of purchase and repurchase by individual buyers. Rather than bill the customer for each individual order, the multiple number of orders are accumulated, usually for a month, and the customer billed as of one date.

Single payment terms are in reality a special form of dating. The terms used may be based on E.O.M. (end of month), M.O.M. (middle of month), and proximo (a specified date in the following month). If E.O.M. terms are used all sales made during a given month are dated as of the first day of the following month. The cash discount period and net credit period which are usually identical commence with this date. Under terms of 8/10 E.O.M., common in the apparel trades, all deliveries in the month of October would be included in the statement rendered as of the last business day of October, and payment with 8 per cent deducted would be due November 10.

M.O.M. terms are a variation of E.O.M. terms which allow for a shorter total credit period. Under M.O.M. terms all purchases made between the 1st and the 15th of any month are consolidated and a statement rendered as of the 15th. Purchases made between the 16th and end of the month are similarly consolidated as of the last day of the month (or, as of the first of the next month). The credit period and

discount period, as with E.O.M. terms, are identical and usually ten days. Hence, all purchases invoiced the first half of a month, are to be paid less discount as of the 25th, and purchases accumulated the last half of the month are due the 10th of the following month.

Proximo terms specify payment to be made in the month following shipment as do E.O.M. terms. In many instances of use (where the discount period and credit period are identical) there is no distinction between proximo terms and E.O.M. terms, but the use of one or the other terms has become customary in the particular trade. Proximo terms do, however, often provide for a shorter discount period than the net credit period. Hence, terms of 2/10 prox. net 30 set the discount date as of the 10th of the month following the shipments and a due date the last day of that month. Seldom do E.O.M. terms set different discount and credit periods as is the case with proximo terms.

Special-Datings Terms

To adjust terms to conditions peculiar to a trade or its customers, special datings are used. The use of special datings function to extend the credit period. "Season" dating and "extra" dating are two of the common credit terms denoting special dating.

Season dating is used where the demand for a product is seasonal, and hence, an inducement is needed to have buyers purchase and accept delivery well ahead of the buyer's selling season. The seller benefits from these arrangements by being able to plan his production more in accord with his sales curve and also by shifting some of the storage burden to the buyer. The buyer, of course, has the goods on hand without an immediate investment of his own funds.

Season dating is nothing more than an extension of ordinary terms. This type of dating compensates the buyer for the storage burden and also brings the payment date closer to the buyer's selling season. Summer wearing apparel, for example, may be purchased in October, delivered in January on terms of 2/10, net 60, but the invoice may be dated May 1. These terms permit the discount on or before May 10, and establish the net due date as no later than July 1. This same arrangement may be accomplished by extending the regular selling terms an additional 30, 60, or 90 days during the preselling season months.

Extra dating is another method of extending long discount and credit periods to customers. Extra dating terms treat the discount period and credit periods as identical, but rather than state the terms as 2/70/70 they are customarily stated as 2/10–60 ex. Under these terms the purchaser is expected to pay the stated amount of the invoice, less 2 per cent, 70 days after date of invoice. If the purchaser desires to pay earlier he

may deduct ½ per cent per month (6 per cent per annum) anticipation discount. The usual method of allowing this additional discount is to quote the terms as 3/10, 2/10–60 ex. thus indicating that the extra 1 per cent can be deducted provided payment is made before the expiration of 10 days from date of invoice.

R.O.G. (receipt of goods) and A.O.G. (arrival of goods) terms and a few other similar arrangements are used to compensate for disadvantages imposed on distant buyers. The effect of these terms is to adjust the beginning date of the discount period, but not the net credit period. Since terms usually start with the date of the invoice, R.O.G. and A.O.G. terms adjust the entire discount period so that the first day of the discount period is in correspondence with receipt of goods or arrival of goods whichever may be applicable. Terms of this type are often competitively necessary for those sellers dealing with distant customers.

Consignment Terms

Consignment terms are most often used for other than credit reasons. Sales of agricultural products are customarily made on consignment terms with commission agents; new products, and for that matter *any* merchandise, for which a distributing organization refuses to accept the purchase risk, may be handled on consignment terms; and, some goods of very high unit value move through marketing channels under these terms. They may also be used when the credit worthiness of the buyer does not justify ordinary terms of sale, and when the buyer lacks the resources to satisfy prepayment arrangements such as C.O.D. or S.D.-B.L. Title to consigned goods remains with the shipper, while the recipient acts as an agent for the seller. Credit managers must use caution when transactions involve the use of these terms because of the legal implications. The goods must be physically segregated from other goods; proceeds from the sale of such goods must be separately accounted for; insurance on the merchandise, and in the name of the consignor, must be carried by the shipper; and periodic sales and inventory reports and remittances by the consignee must be provided for. Credit managers are well advised to seek the services of the legal profession to draw up the consignment contracts and prepare the necessary directions to the consignee.

CASH DISCOUNTS OR TRADE DISCOUNTS?

The cash discount as treated in this chapter should be considered as a *reward* to prompt-paying customers for (1) saving the seller additional costs associated with a slower turnover of his receivables, and (2) avoid-

ing the collection difficulties involved in handling slow-paying accounts. It may also be considered a *penalty* assessed against slow-paying customers to compensate for the higher costs and inconveniences of handling their business. In the former case the quoted price may be considered the list price and the cash discount allowed would then be roughly equivalent to the expenses saved by doing business with prompt-pay customers. In the latter case, clearly, the net price is the true realized price and the penalty collected from the slow-paying customers is approximately the amount necessary to cover the expense of doing business with them.

It would be very difficult to collect this penalty if it were so labeled, and efforts to enforce payment of "fines" for delinquency would be strongly resisted and cause much ill will. Psychologically, it is better to collect it as a benefit withdrawn. Loss of the discount then appears to the buyer as the withdrawal of a gain which, through his own fault, he did not obtain and, hence, his resistance to it is less. Even though stating terms so that the cash discount is made to appear as a reward rather than as a penalty is strategic, we should not allow this strategy to mislead us as to the true nature of the transaction. Considering the cash discount as a penalty assessed against slow-paying customers requires that this penalty, if it is to be equitable, be no larger than is necessary to recover the additional costs involved in handling this class of customer. If discount terms are to be logical these costs should supply the base which determines the amount of the discount.

The costs to be recovered by the penalty are: (1) for the use of the seller's capital during the extra time allowed for payment; (2) for the assumed risk of potential bad-debt losses; and (3) for the increased billing and collection costs. We previously showed that 1 per cent, 2 per cent, or even 3 per cent is the amount of cash discount usually allowed in many trades. It is generally thought that this amount of discount generally corresponds to the cost savings incurred when doing business with prompt-pay customers. Many discounts under the guise of a cash discount are, however, as high as 6 per cent, 7 per cent, 8 per cent, and higher. In many instances these larger discounts are not denied even though payment is late. The correct interpretation of large discounts established with a high degree of liberality is that they are *trade discounts* and *not* cash discounts. It is also proper and sound logic to place a similar interpretation on special-dating terms, when the discount is not disallowed because of late payment. Similarly, when the discount period and the net credit period are synonymous the "cash discount" is regarded by some credit managers to be in reality a trade discount.

When discounts offered are so large that all customers take advantage of them, whether paying on time or not, they cease to function as a cash discount. Cash discounts established on some logical basis and allowed or disallowed as specified can function to automatically classify credit customers. When, however, the credit service is taken advantage of by a sizable group of customers because the discount is too liberal it is not a credit function, but clearly a trade discount.

Discounts and the Equivalent Rates of Interest

The attractiveness of buyers taking advantage of cash discounts is indicated by Table 19–2. It is obvious that the equivalent interest rates

Table 19–2

EQUIVALENT RATES OF INTEREST TO SELECTED CASH DISCOUNTS*

½% 10 days, net 30 days	= 9% per annum
1% 10 days, net 30 days	= 18% per annum
2% 10 days, net 60 days	= 14.4% per annum
2% 30 days, net 60 days	= 24% per annum
2% 10 days, net 30 days	= 36% per annum
3% 10 days, net 30 days	= 54% per annum
3% 30 days, net 60 days	= 36% per annum
4% 10 days, net 60 days	= 28.8% per annum

* To compute these and other equivalents, first find the number of days difference between the cash discount period and the net credit period This represents the number of days the seller gains in the use of his funds when the buyer remits within the discount period The potential number of times this is apt to occur in 360 days × the rate of discount = the equivalent rate of interest per annum For example, for terms 2/10, net 30, 360 ÷ 20 = 18 × 2% = 36%.

are substantially above money rates of interest and hence businesses would do well to borrow money in order to take advantage of discounts rather than forego this attractive return. In some businesses, particularly retail enterprises, the discounts taken can make the difference between a profit or a loss. Several offices of the NACM have complete tables, similar to this, for distribution to their members, thus informing them of the advantage of taking all cash discounts.

Cash Discounts and Federal Legislation

Terms of sale can be used by sellers to practice price discrimination. When discounts are varied from one buyer of the same class to another "price discrimination" is said to exist. Credit terms came under the scrutiny of the federal government during the 1930's when the Robinson-Patman Act was enacted as a law. Insofar as credit terms are con-

cerned, the purpose of the Robinson-Patman Act is to prohibit price discrimination which results from discriminatory credit terms. If discounts are allowed uniformly to all customers of the same class, (i.e., all the manufacturer customers, all the wholesaler accounts, and all the retailer customers) the seller is not practicing price (or terms) discrimination and this is a permissible policy. The giving of larger cash discounts to one buyer than to another of the same class; the acceptance of terms insisted on by "terms chiselers," and the allowance of late discounts when not applicable uniformly to all customers of the same class are illegal practices.

The Robinson-Patman Act may be regarded as lending a legal tendency to greater uniformity of credit terms. During the past few decades this tendency appears to be in evidence.

REVIEW AND DISCUSSION QUESTIONS

1. Explain how commercial credit facilitates the movement of goods through the successive stages of production and distribution?
2. Why is the United States so far advanced over other countries in the use of commercial credit?
3. What factors contributed to the changed business attitude toward commercial credit?
4. What are the major variables involved in terms of sale?
5. How do the buyers' rates of stock turnover influence terms of sale? How do other factors exert an influence?
6. Define and distinguish:
   a) Prepayment terms.
   b) Cash terms.
   c) Ordinary terms.
   d) Single-payment or lumped-order terms.
   e) Special-datings terms.
   f) Consignment terms.
7. Under what conditions is it advisable to use prepayment terms? Cash terms?
8. When are special-datings terms used?
9. Is there a logical basis to believe that some cash discounts are in reality trade discounts?
10. What is the basis for reasoning that cash discounts can be a form of price discrimination?

CHAPTER 20

Business Use of Cash (Financial) Credit

WHEREAS COMMERCIAL credit is used to finance a portion of the current assets of a business by acquiring merchandise and services, most businesses require additional financial assistance. It was shown in Chapter 18 that a substantial portion of other business financial needs may be met by cash borrowing. Borrowing of funds may take the form of short-term, intermediate-term, or long-term borrowing. Short-term borrowing is most often undertaken to acquire current assets not covered by commercial credit or the owners' investment. Intermediate- and long-term borrowing, on the other hand, may be undertaken to finance both current and fixed assets.

Commercial banks, factors, and commercial finance companies are the principal sources for short-term and intermediate-term loans. Long-term loans are available from insurance companies, investment houses, trust companies, and to some extent from wealthy individuals and commercial banks. Before turning to our discussion of certain features of commercial bank loans, the financing of accounts receivables, and a brief survey of long-term financing, it is desirable to emphasize the significance of cash credit activities relative to commercial credit management.

COMMERCIAL CREDIT MANAGEMENT VERSUS CASH CREDIT MANAGEMENT

Commercial credit management is concerned with a highly specialized type of business credit—that of facilitating the sale of merchandise and services in exchange for credit. Likewise, commercial banks, factors,

finance companies, and the institutions which supply long-term credit are as equally specialized in their financing the capital needs of business. With a high degree of specialization existing, then, there is a tendency for the individual managements of the specialized operations to regard their activities apart from the entire credit structure. This preoccupation with one's own activities is frequently a natural tendency and it has many advantages. Certainly it is of first-order importance that a credit manager conceive, thoroughly understand, and effectively administer the activities of his own company's credit department. He would, however, be seriously deficient in his effectiveness as a credit manager if he failed to gain at least a general knowledge of the more common forms of business credit. Only by having an intimate understanding of his own credit function and a clear concept of the needs and uses of other forms of credit can he best serve his company and its customers. Hence, it is not enough that he recognize the economic impact and interrelationships of all types of credit; nor is it enough that he clearly understand that the very foundation of all credit lies in our commercial banking system. If he is to play the important role of guiding, suggesting, and recommending in regard to the financial aspects of his company and its customers he must be knowledgeable of the several classes of business credit.

Whether a credit executive is in a position to be directly concerned with the financial needs of his own company is frequently dependent upon his position in the organizational structure. Organizational structures vary according to the number and type of functions to be performed. A small or medium-size enterprise may well employ a single executive who is charged with both commercial credit administration and the company's working capital requirements. This person may be designated the "treasurer," with a subtitle "credit manager." It is quite obvious that if this executive is to work both sides of the fence—i.e., customers' credit and his company's credit—he must be intellectually equipped to cope with the several types of business credit. Large business enterprises, on the other hand, divide financial responsibilities among several executives. Commercial credit management may be established in a separate department headed by a "credit manager." The short-term, intermediate-term, and long-term capital requirements of the company may be under the administration of an executive designated "treasurer," or the treasurer and a select group of company officers. Whatever the complex of the company dictates, it is clearly apparent that these executives need specialized knowledge to perform effectively their tasks. The

close interrelationship between credit management and debt management of any company establishes the need for knowledge of all phases of business credit.

Irrespective of titles, organizational structure, and company size any executive charged with the responsibility of commercial credit management will be called upon to advise his credit customers on their financial problems. Likewise cash loan managers are frequently required to assess their customers' credit and financial problems. The increased tendency for credit managers to counsel their business customers is fostered by the present-day partnership concept of creditor and debtor. A number of commercial credit managers report that they consider the customer-counseling aspect of their credit departments to be one of the most valuable services rendered. Their clear understanding of other sources of working capital and ability to recommend their use have often given new life to a marginal or deteriorating customer. Similarly, cash loan managers must recognize the financial role played by commercial credit in financing a portion of their customers' current assets. Hence, both commercial credit managements and cash loan managements need more than a casual grasp of all types of business credit to better serve their own employer and their debtor customers.

The parts of this book devoted to business credit and in particular commercial credit can be a valuable source of information for cash-lending executives, despite the fact that cash loans to businesses are not a major portion of its content. This stems from the fact that selling merchandise and services on credit and making business loans have a marked degree of similarity. The credit information utilized, the credit decision-making process, and the collection policies of these two fields of credit extension are very similar. The significant differences between commercial credit extension and the making of business loans stem from the dependence placed on various sources of credit information, differences in credit standards, and the methods of controlling customers' accounts.

COMMERCIAL BANK LOANS

As a source for short- and intermediate-term loans no other institution is as dominant as the commercial bank. The tremendous financial resources of our commercial banking system make it the largest provider and most frequently used source for borrowed capital. This is in accord with the basic functions of the American banking system.

The Need for Commercial Bank Loans

As we saw earlier, in Chapter 18, most business enterprises need cash credit to finance a portion of their assets, and the business not requiring such financial assistance is indeed rare. Inasmuch as no one type of business credit normally meets the financial requirements of a business, commercial bank loans are needed partially to fulfill business financial needs. Cash loans might be said to equalize the financial requirements of a business with its productive and marketing operations. Cash needs of businesses, though, are seldom constant or regular. At certain times large amounts of working capital are needed and at other times only small sums are required.

A retailer, for example, may borrow from his bank shortly after a heavy buying season in order to take cash discounts on merchandise credit obligations. Wholesalers may borrow to acquire inventory and take advantage of suppliers' special offerings. Manufacturers may discount wholesalers' trade acceptances in order to acquire working capital for current manufacturing operations. These examples serve to illustrate how commercial bank loans are often used to supplement commercial credit. This is only one possible use of bank loans. Realistically, when a business borrows from a commercial bank, it may use the deposit money which is created to fulfill any number of business needs. Whatever the specific use made of the borrowed funds, it remains that the need for commercial bank loans stems from the very nature of business itself. That is, the disbursements of the firm do not coincide with the receipt of income insofar as time is concerned.

Kinds of Loans

Traditionally, loans to businesses were made to finance their short-term needs and the maturities corresponded to the normal terms of sale of 30, 60, or 90 days. During the depression years of the 1930's commercial banks began to change their policies with respect to loan maturities and lending was adjusted more to the needs of borrowers. The lending of short-term capital left many business firms with inadequate funds for continuous working capital and the sorely needed capital to refinance their bond issues.[1] Since that time banks have been making intermediate-term loans, with maturities from one to five years, and long-term loans with maturities in excess of five years. Hence, when commercial bank loans are classified by maturity they may be referred

[1] Rollin G Thomas, *Our Modern Banking and Monetary System* (3rd ed.; Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1957), p. 161.

to as *short-term loans* (maturity less than one year), *intermediate-term loans* (maturity from one to five years), and *long-term loans* (maturity over five years). The trend throughout the last three decades has been toward greater and greater use of the longer-term loans.

Bank loans may also be classified according to security. Loans made may be either *secured* or *unsecured.* A secured loan is one which relies not only on the borrower's promise to pay, but also on the pledge of some specified property. The bank can exercise its lien upon the collateral in the event of nonpayment by the borrower. Banks prefer security which is readily convertible into cash. Government bonds, for example, which are easily converted into cash represent the highest quality of collateral. Businesses may, and often do, pledge inventories, stocks, bonds, mortgages, equipment, real estate, accounts receivable, and other property of value.

The unsecured loan is quite obviously one that does not involve the pledge of collateral, but its quality is based solely on the credit worthiness of the business borrower. Evidence of this type of loan is usually the borrower's promissory note. Bankers refer to credit instruments which evidence loan transactions as "commercial paper" or merely as "paper." An unsecured loan made on the basis of single business' or person's signature is known as "single-name" paper.

Another type of unsecured loan takes the form of commercial paper which is discounted at the commercial bank by the borrower. This paper consists of trade acceptances and promissory notes used between buyers and sellers in some lines of business. The seller who holds this paper may indorse it and discount it at his bank. This process gives rise to the term "two-name," "double-name," or "indorsed," commercial paper. The borrower (seller) by indorsing the instrument assumes a contingent liability, and hence the bank has the specific promise of the buyer of the goods to pay the indebtedness as well as the contingent promise of the seller (borrower). Most American businesses use the open-book account method of selling their merchandise and therefore this type of paper is relatively scarce.[2]

Double-name commercial paper must be distinguished from that

[2] Under certain circumstances drafts or bills of exchange are drawn against the buyer's bank and upon acceptance the instrument becomes a *banker's acceptance.* Sellers who hold such bankers' acceptances may hold them until maturity or discount them at their bank. In effect, when a bank places its signature on the draft or bill of exchange it is guaranteeing the credit of the buyer. If the bank accepting the instrument is a well-known bank, the instrument is regarded as "prime" paper and as such is sought after by other banks for use as a secondary reserve. Acceptances of this type can obviously be converted into cash at a low rate of interest. In banking circles, this and the discounting of notes and trade acceptances are sometimes referred to as "open-market loans."

which arises from an *accommodation indorsement.* Some businesses and persons are required, because of a weak credit condition or other circumstance, to bolster the quality of their credit by supplying a co-maker or indorser to their promissory note. When this is done the co-maker is lending his credit worthiness as an accommodation, and this paper is then referred to as "double-name" paper or "accommodation" paper. In this latter instance the loan is classified as a *secured* loan whereas the loan which results from the indorsed trade acceptance or note is classed as an *unsecured* loan. The indorser of a promissory note as an accommodation guarantees payment and is legally liable for payment in the event of default on the part of the maker.

Bank Interest Rates—Discount Rates

Interest rates on bank loans and discount rates on discounted paper are determined by a number of factors. In contrast to consumer cash credit an established rate of interest does not apply to all customers. Rather, the rate charged a business customer is determined by the amount and term of the loan, the credit standing of the borrower, the relative tightness or abundance of bank funds, the compensating balance maintained on deposit with the lending bank, the geographical location of the bank, and the demand for loans. In general, small businesses pay higher rates than large enterprises; rates vary inversely with the size of loan; long-term loans (over 5 years maturity) command a lower rate of interest than do shorter-term loans; and rates are somewhat higher in the large cities of the South and West as contrasted with the rates in New York City and Chicago.[3]

Commercial banks employ two methods of collecting interest charges. In the case of short-term loans of 30, 60, or 120 days and advances made on customers' discounted paper the interest charge is deducted at the time the loan (the advance) is made. Technically, this charge is referred to as the "discount," "bank discount," or "discount rate." The rate of discount paid by a customer is not the same as the rate of interest paid on other loans. If, for example, a $10,000 note which is to mature in six months is discounted at 6 per cent, the discount would be .03 of $10,000 which is $300. The business borrower receives $9,700 as the proceeds of the loan, and upon maturity of the note a payment of $10,000 is due the bank. The user has use of $9,700 and not $10,000 and hence the discount rate is higher than the interest rate. In-

[3] "Member Bank Lending to Small Business, 1955–1957," *Federal Reserve Bulletin,* April, 1958, pp 393–409. Also see current issue of *Federal Reserve Bulletin,* Financial and Business Statistics Section for bank rates on short-term loans.

terest on other loans is usually calculated on the daily balance of the loan and charged to the borrower monthly.

Commercial Banks Credit Policy

A business firm can enjoy a long and continuous financial relationship with its commercial bank. Other than acting as a depository for business funds it stands ready to serve its customers by providing an important segment of their financial needs. A commercial bank will, however, require borrowers to meet higher credit standards than does the business which sells merchandise on credit. What this means is that the commercial bank will require a greater degree of certainty of payment than the commercial credit house. Business houses failing to meet the standards must acquire cash by borrowing from other, and frequently less attractive, sources.

Chief among the reasons for the high credit requirements of banks is the fact that they are entrusted with the public's money. A bank acting in this capacity must guard this trust above all else if its confidence and reputation are to be maintained. A federal reserve member bank cannot ask for extensions of its obligations without impairing its position in the system. It is said that "the liquidity of banks depends largely upon the liquidity of their customers."[4] The requirement that banks always be in a position to meet their obligations places a necessary limitation on extensions granted its customers. Banks do grant extensions to borrowers who find it inconvenient to meet their loan maturity, but the number of these cannot exceed a safe limit, beyond which the liquidity of the bank would be impaired.

Another reason which contributes to banks' conservative attitude is that their "stock-in-trade" is money and not merchandise. Merchandise creditors generally have a wider margin of profit from the sale of merchandise than banks do from the lending of money. Because of this, merchandise creditors may be more willing to accept marginal risks and grant extensions not otherwise considered prudent by a bank. Furthermore, the amount of credit involved in a commercial credit transaction may represent only a small portion of the debtor's total obligations whereas bank loans frequently represent a major portion of the business' total debt. These facts clearly indicate that an extension granted by a merchandise creditor has very different implications than the extension granted by a bank.[5]

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[4] Albert F Chapin, *Credit and Collections Principles and Practice* (5th ed.; New York: McGraw-Hill Book Co., Inc., 1947), p. 70.

[5] *Ibid.*, p. 71.

Finally, banks are subject to the supervision of state and federal banking authorities. They are restricted on the size of loan made to any one borrower; they are not permitted to loan on the security of their own stock; and they may not lend in excess of $2,500 to an officer of the bank. There are exceptions in one form or another to the above restrictions, but more importantly bank loans are periodically examined. Bank examiners and their supervisors have the responsibility of enforcing the numerous administrative regulations affecting bank loan activities. Commercial bank loans are classified by examiners into four classes: (1) loans with repayment assured, (2) substandard loans, (3) doubtful loans, and, (4) uncollectible loans.[6] Obviously, if a bank is to be regarded highly in the Federal Reserve System and by its examining bodies, it must not have a record of lending money to a high proportion of weak credit risks. Thus, legal regulations are another factor affecting the standards imposed on business borrowers.

The great majority of bankers operate in accordance with the various state and federal restrictions. Despite the occasional lending abuses, which, when publicized, shake the public's confidence in the offending bank—most businessmen will experience an atmosphere of conservatism and solidarity when dealing with his banker.

The Line of Credit and Compensating Balances

Once a business has established a relationship with its bank which engenders a high degree of credit worthiness, a line of credit may be set. A line of credit is the maximum amount the bank is willing to lend. Lines of credit are established after the bank has made a thorough analysis of the customer's needs, credit standing, and frequency of cash needs. Once the line is established it will be much more convenient for the bank and for the customer to borrow needed amounts within the line without the formalities of a new credit investigation, analysis, and credit decision. A line of credit in no way obligates the bank to lend that amount, nor does it obligate the business customer to utilize the entire amount. The bank, however, will normally maintain the line of credit for the customer who preserves his credit standing.

When establishing a line of credit the bank will usually make two requirements. One is that the customer will be expected to maintain a *compensating balance* on deposit at all times. This balance is a fraction of the line of credit which the borrower is expected not to withdraw. Generally, compensating balance requirements range from 10 to 20 per

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[6] *Federal Reserve Bulletin,* July, 1949, pp. 776–77.

cent, with 20 per cent the common figure in large metropolitan money centers. This rule is not uniformly applied, but it is considered a customary requirement among many banks. Some banks have instituted variations of the principle by requiring borrowers to maintain a fraction of the total loans made on deposit. The other requirement is that the borrower is expected to clean up his loans at least once a year. This gives the bank the assurance that the loan is fulfilling its proper purpose and is not utilized for investment purposes. The seasonal needs of business are regarded as the basis for the line of credit, and if it is being used for this purpose it should be self-liquidating. Business firms not able to meet this requirement from their own funds, must borrow from other banks to clean up their loans, and at the same time submit their financial affairs to the scrutiny of the other banks.

FINANCING AND FACTORING ACCOUNTS RECEIVABLE

So much misunderstanding exists with regard to the *financing* of accounts receivable and the *factoring* of accounts receivable that it is desirable to treat separately each of these basic types of receivable financing. The financing of accounts receivable is fundamently different than factoring in the following major respects:

1. Commercial banks and commercial finance companies are the principal sources which finance accounts receivable, whereas specialized companies generally know.. as "factors" are the source for factoring.
2. The reasons that a business may enter into the financing of its accounts receivable are fundamentally different than the reasons for factoring.
3. The methods of operation, procedures, costs, and service charges are basically different in each type of financial arrangement.
4. Finally, there is a marked difference in the relationship between the parties involved in accounts receivable financing as contrasted with factoring.

To note clearly the differences and similarities of these methods of financing the definitions of each from the *Credit Management Handbook* are used.[7]

Ordinary accounts receivable financing involves an agreement under which a financing institution (*a*) purchases its customer's open accounts receivable, or advances him loans secured by the pledge of such receivables, (*b*) with recourse to him for any losses, and (*c*) without notice to his trade debtors.

Factoring involves a continuing agreement under which a financing institution (*a*) assumes the credit and collection function for its client, and (*b*) pur-

[7] *Credit Management Handbook,* A Publication of the National Association of Credit Men (Homewood, Ill.· Richard D Irwin, Inc., 1958), pp. 616–17.

chases his open accounts receivable as they arise (*c*) without recourse to him for credit losses, and (*d*) with notice to his trade debtors.

It is important to emphasize that the above definitions imply the reasons a business may enter into one or the other type of financing arrangement. Businesses use accounts receivable financing for one major reason which is—to acquire needed capital. Specific reasons for the use of this kind of financing are numerous and varied, but all such reasons can usually be met by short-term or intermediate-term borrowing. Factoring, on the other hand is entered into for two reasons: first, to acquire operating capital by selling the receivables outright, and second, to shift the entire credit and collection burden to the financing institution.

Financing Accounts Receivable

As noted earlier commercial banks and commercial finance companies are the sources which normally finance accounts receivable. Commercial banks generally follow the procedure of making a *loan* on the basis of the accounts receivable as security. Finance companies follow the procedure of *purchasing* the receivables in exchange for some stated amount of cash, or it may accept assigned receivables as security for a loan much as a bank does.

Both lenders will normally make their advances with *recourse* to the borrowing firm, but without notice to the borrower's trade debtors.[8] Recourse gives the lending institution protection against slow-paying accounts and losses which occur due to uncollectible accounts. The recourse provision of the transaction results in the assumption of little or no risk on the part of the lender, for in essence, the assignor guarantees payment of all assigned accounts. The lending institution, whether bank or finance company, will examine the quality of the accounts receivable offered. To be acceptable the major proportion (about 75–80 per cent) of the assigned receivables must have the high or the second-high rating granted by Dun & Bradstreet or some other commercial credit reporting agency. The contract between the parties under the nonnotification plan will: (1) set forth the lender's advances and charges; (2) provide that the assignor act as the assignee's agent in collecting accounts; (3) establish the method and time by which the assignor will transmit collec-

[8] Assignment of accounts receivable may be done either by the *notification* plan or the more common *nonnotification* plan. Under the former plan trade debtors are notified of the assignment or purchase of their receivables and informed that they are to make payment, when due, to the financing institution. Frequently such notification is made on the face of the debtor's invoice. Under the latter plan no notice to trade creditors is given, and the assigned or purchased accounts are borrowed upon without knowledge to debtors. The borrower (assignor) then acts as an agent, accepts collections of the accounts, and in turn pays the assignee.

tions to the lending firm; (4) provide for the assignor to guarantee all assigned accounts; and (5) provide that the assignee may inspect the accounting records of the assignor at any time. These and other provisions of the contract as well as other technicalities of the transaction dictate for the borrower a precise accounting for all funds received which are to be credited to the assigned accounts receivable.

Loan Advances and Charges

The American Bankers Association recommends that loans based on accounts receivables should be no more than 80 per cent of the face value of the receivables, less trade and other discounts allowed to customers and consideration for merchandise returns. Commercial finance companies may advance 70 to 95 per cent of the face value of the receivables. Each of the above quoted percentages is of course dependent upon the quality of the receivables and the standards of acceptability of the lender. The difference between the above percentage and the net value of the receivables is a margin of safety against deductions, shrinkages, and bad-debt losses.

Bank rates on this type of lending vary widely. As shown earlier bank interest rates are determined by a group of complex factors. With regard to this particular type of secured loan the rate may be set on the basis of the risk involved, the credit standing of the trade debtors' accounts which are assigned, the terms of sale of the assignor, the borrower's credit and collection practices, and other factors previously discussed. One authoritative source quotes 6 per cent plus a service charge for each transaction to be the prevailing goal of bankers.[9]

There is also wide variance in the rates charged by the commercial finance companies. The larger companies generally have the lower rates which range from 10 to 15 per cent true rate per annum. While the method of computing this rate is quite different than the bank method, it can be said that the two institutions are competitive in regard to the rate charged. Small commercial finance companies that finance firms with a small volume of receivables and with proportionally more costly operations have rates as high as 18 to 20 per cent per annum. Clearly, the small finance company cannot achieve the economies of large-scale operation.[10]

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[9] Raymond Rodgers, "Factors, Bank Financing of Accounts Receivable, Commercial Paper," in Herbert V. Prochnow (ed.), *American Financial Institutions* (New York: Prentice-Hall, Inc., 1951), p 216.

[10] Clyde William Phelps, *Accounts Receivable Financing as a Method of Business Finance* (Baltimore: Educational Division, Commercial Credit Company, Studies in Commercial Financing, No. 2, 1957), p. 41.

Use of Accounts Receivable Financing by Businesses

The use of accounts receivable financing by businesses has not always been held a desirable practice, and even today many businessmen and lenders object to this method of acquiring capital. The principal objection seems to be that the assignment of receivables deprives trade creditors from protection against losses. This objection is not as strongly apparent as it was prior to the 1930's. Since that time many creditors have come to recognize the need for this type of financial arrangement and also that the pledging of accounts receivable may be a desired alternative method of acquiring capital. Some evidence of the acceptability of this type of borrowing is indicated by the large number of banks presently making these loans. Furthermore, the American Bankers Association in a recent publication recognized: (1) that accounts receivable financing is becoming increasingly important, (2) that the security is often the most liquid a borrower has to offer, (3) that the necessity to borrow arises not from failure, but from growth problems in the business, and (4) that as a business grows its large volume of receivables places financial stress on the business and that it is only logical that this asset be resorted to for necessary relief.[11]

Borrowing on the basis of accounts receivable should also be considered as an alternative to other financing possibilities. The business that does not have a short-term financial problem is the exception and not the rule. Relief may be had in a number of ways. Rather than gain the necessary relief by increasing its long-term debt the business is likely to seek an increase in its line of credit at the bank. If this is not possible it may secure an additional loan from the bank by pledging its accounts receivable. Some businesses may not qualify for an additional bank loan, or because of preferences, it seeks financial aid from a commercial finance company. Whatever the source of the funds, it has secured expeditiously a self-liquidating loan. The self-liquidating feature alone is more attractive than the alternative of a long-term debt burden. With the newly acquired funds the business may benefit by taking advantage of profitable opportunities one of which may simply be the discounting of its current obligations.

In addition to financing accounts receivable commercial finance companies offer a number of supplementary loan services. Loans on inventory, installment financing of machinery, equipment, and other durables, loans on fixed assets and other collateral as well as note loans to busi-

[11] American Bankers Association Credit Policy Commission, *Accounts Receivable Financing* (New York: American Bankers Association, 1957), p. 2.

nesses round out their operations. Many businesses find this source more flexible in their dealings and perhaps more closely meeting their business needs. The wide variety of financial services is in part the reason they enjoy a close working relationship with their customers. Because these companies operate on a branch-office basis, and because they are not hampered by the legal restrictions imposed on banks, they are able to acquire a more diversified group of risks and hence accept greater risks.

Factoring Accounts Receivable[12]

In contrast to the financing of accounts receivable by banks and commercial finance companies—the financing aspect of factoring is often secondary to the desire and need to shift the entire credit and collection management phase to the factor.

Factoring involves the purchase of accounts receivable from the client without recourse for credit losses and the assumption of all credit risks involved. It is the only known institution which completely assumes the entire credit and collection function for its clients. Trade debtors, accordingly, are notified that payments are to be made directly to the factoring company. In addition to these services the factor will advance cash for receivables whenever the client so desires. In other words, he will advance cash immediately for receivables purchased or hold cash in the account of the client until such time as needed by him. This service permits the client to reduce interest charges paid to the factor, because the client pays interest only for cash actually advanced. Factors, in addition to their primary activity, make loans to businesses on their inventory, fixed assets, open accounts, and other security. Most factors maintain an advisory service for their clients which counsels customers on the broad aspects of production, marketing, and financial matters.

Method of Operation. There may be considerable variation in the factor's method of operation in the dealings with individual clients. The specific relationship and the responsibilities of the parties will be set forth in the factoring contract. The following steps indicate the factoring procedure after the assignment of existing accounts on the books is made:

1. Before the client ships any merchandise to a customer as a result of his sales he will submit the list of customers, amounts of the orders, terms of sale, and any other essential information to the factor for approval.

[12] For an authoritative and excellent account of factoring operations from which this section was developed, see Clyde William Phelps, *The Role of Factoring in Modern Business Finance* (Baltimore: Educational Division, Commercial Credit Company, Studies in Commercial Financing, No. 1, 1956). This and other studies done by Dr. Phelps are available in quantity from the Commercial Credit Company, Baltimore 2, Maryland.

2. The factoring institution will investigate each account and make the credit decision to accept or reject the order. The order copies with the proper notations "accepted" or "rejected" are returned to the client. If, at this point, the client desires to ship to the rejected accounts he may do so at his own risk.
3. After shipments are made on the approved orders the client sells the accounts to the factor by signing and transmitting to the factor an assignment schedule supported by a copy of each invoice and shipping order. The assignment schedule provides space for a complete description of the sale and shipment such as customer name, address, terms of sale, due dates, and amounts of invoices. The invoices in turn are stamped before mailing, giving notification to the account that payment is to be made directly to the factor. Sufficient copies of each instrument are made so that the factor and client have complete records.
4. The factor credits the client's account for all accounts receivable purchased. The proceeds are remitted as mutually agreed upon by the factor and the client. If the client does not wish to withdraw the funds immediately, he may do so at regular intervals. The method of payment to the client is normally geared to his working capital needs. The factor pays the client 6 per cent interest per annum on all money which accrues on matured accounts and not withdrawn.
5. An "account current" is rendered monthly to the client. This instrument reveals to the client the exact financial standing he has with the factor. It is a record of the accounts receivable purchased, the charges for returns and allowances, factor's commission and interest charges, and other items that may affect the account.

Extent of Factoring. It is estimated that factors supply in excess of $4 billion to American business each year. Despite heavy concentration and tradition in the textile industry, factoring operations are spreading into many other lines of business. Clearly, as this method of financing is adopted by other lines, it will result in a continuous growth of the dollar volume supplied businesses. The factoring operations of this country are concentrated among eighteen firms which specialize in this activity.

Factors Terms and Charges. Factoring charges are made up by (1) a commission or service charge, and (2) an interest charge. The commission charge ranges from less than 1 per cent to 2 per cent or more. The exact amount of commission is determined by taking into consideration the kind of industry the client represents, its annual sales volume, the credit standing of the client's customers, and the like. The commission is based on the face value of the accounts receivable, less cash discounts, merchandise returns, and other normal allowances.

The interest charge is 6 per cent per annum computed on the average daily net debit balance. In other words, the 6 per cent rate of interest is

the true rate of simple interest per annum. In explaining this charge Dr. Phelps elaborates as follows:[13]

> This is a rate of interest per annum, not a discount or flat charge. That is to say, the factor does not make a flat charge of $6 per $100 advanced regardless of the fact that the invoice concerned has, for example, only one month to run to maturity. Such a charge would represent a simple interest rate of 72 percent per annum. Instead, in this case, the factor would charge 50 cents for the advance of $100 for one month, i.e., at a true simple interest rate of 6 percent per annum.
>
> Not only is interest charged at a true rate of simple interest per annum. It is charged only on the amount of cash the client firm wants and only for the time elapsing between the date of the advance and the average due date of the receivables involved. It is to be noted that a factoring agreement does not require a firm to cash its receivables, i.e, to take cash from the factor for its receivables before their maturity date and, therefore, pay interest.

In comparing factoring costs with the costs of borrowing funds from other sources, the services rendered by the factor, especially the assumption of the complete credit and collection management operations, should not be ignored.

Use of Factoring Operations by Businesses. Contrary to common opinion the factoring of accounts receivable does not imply a financially weak business concern. It is true, that the factoring service *may* be used by a business whose credit may not be acceptable elsewhere, but by and large financially strong companies use factoring to good advantage. As implied earlier other considerations may subordinate the ease of acquiring working capital by financing accounts receivable. The cost of maintaining a commercial credit department is quite obviously determinable and often quite high. Such costs include overhead, investigation costs, accounting costs, collection expenses, and the always present expense of bad debts. The firm that factors all of its accounts receivables, as many textile companies do, can eliminate this important, but oftentimes costly business function. Another advantage which is gained is the freedom of business management from the credit and collection problems. This permits them to concentrate their efforts more intensely on production and other marketing problems. It should be recognized that in a sense factoring provides a form of complete credit insurance while at the same time it frees the business from its investment in accounts receivable. Finally, factoring increases the client's net working capital provided, of course, the cash received is put to work to pay current obligations.

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[13] *Ibid.*, p. 56.

Perhaps the principal objection to factoring accounts receivable is that the service is too costly. It must be emphasized that only the interest rate of 6 per cent per annum should be considered when comparing this method of financing with other possible alternatives. The factoring commission is not entirely a charge for advancing funds, but more accurately for the assumption of the credit and collection management function.

LONG-TERM LOANS

Up to this point, our discussion has been concerned principally with the short-term and intermediate-term financing needs of businesses. Long-term borrowing is often one of the first forms of financing used by a business enterprise. When a business resorts to acquiring funds by entering into long-term borrowing arrangements, it is said to be using its *investment credit.* This is not a major topic of concern in this book and hence a brief survey of the subject is sufficient.

The Need for Long-Term Financing

Almost as rare as the firm that does not require short-term financing is the firm that does not need long-term financing. The undertaking of long-term financing may occur for a number of reasons. Frequently the original need for such financing is to provide the costly productive or marketing facilities for an enterprise. In providing such facilities any number of items carried as a fixed asset may be acquired on a long-term basis. Land, buildings, equipment, and machinery are a few of the common fixed assets so acquired. If the owners furnish the capital (equity capital) then there may be no need for the use of their investment credit.

Many businesses, after their origin, grow and prosper over the years. This often creates the need for expanded facilities, and at the same time, the replacement of some facilities. Hence, long-term financing may be necessary to permit the replacement or expansion of facilities. Corresponding to fixed asset expansion is the need for an increase in current assets. Oftentimes a portion of the needed current asset expansion is financed by long-term methods rather than the previously discussed short-term methods. During periods of rapid expansion it is often more desirable to rely on long-term financing rather than short-term financing in order to keep a reasonable balance between current assets and current liabilities. Additionally, such financing may be used to renew existing business indebtedness, to retire some business debts, and to ef-

fect the acquisition of assets of another company under merger arrangements.[14]

Forms and Sources of Long-Term Borrowing

As a business has a need for long-term financing and it in turn uses its investment credit to acquire the capital, it may take any one or combination of the following three forms: (1) long-term loans, (2) real estate mortgage loans, and (3) the issuance of secured or unsecured bonds. The latter method is used only by large and medium-size enterprises. In each instance, the business uses its investment credit as a power to obtain the funds to be used for production or trade in exchange for its promise to pay an equivalent value at some date in the relatively distant future.

Long-term loans are those with maturities in excess of five years. This definition is in accord with the classification of loans by maturity of the Federal Reserve System. Although not a major lending function of commercial banks this type of loan is available from that source. Maturities are generally for ten years or less. Evidence of the transaction is the promissory note either secured or unsecured as discussed in an earlier section. When loans are made over long periods they are often renewed again and again thus resulting in a more or less "permanent" obligation on the part of the business borrower. Usually these loans are repaid at specified intervals mutually agreed upon by the lender and borrower. The borrower then gives the lender a series of notes maturing, say, at six-month intervals over the years until the entire loan is repaid. Some borrowers are able to work out arrangements with lenders whereby the payments gradually increase with each succeeding interval. This feature is very attractive to many borrowers because when they use their investment credit, immediate profits are seldom realized.

The principal source for real estate mortgage loans is life insurance companies. Secondary sources are savings banks, trust companies, mortgage companies, and other lenders. A variety of instruments is associated with this type of loan. The lender will require all papers and legal documents pertinent to the property in proper form. A certificate of appraisal, an abstract of title or title insurance policy, and a comprehensive insurance policy protecting the lender's security will normally be required. The mortgage loan may be a single-payment type, also known as the straight-payment loan, whereby the borrower makes no

[14] Carl A. Dauten and Merle T. Welshans, *Principles of Finance* (Cincinnati: South-Western Publishing Company, 1958), pp. 140–41.

payment on the principal until such time as the entire amount is due. Usually interest on such loans is to be paid at stated intervals and prepayment privileges are provided for in the event the borrower wishes to make part payment or full payment on the mortgage prior to maturity. The direct-reduction mortgage loan, also known as the amortized loan is the other common type of mortgage contract. This instrument specifies monthly, quarterly, semiannual, or annual repayments of principal plus interest. A maturity of 15, 20, 25, and even 30 years is common for real estate mortgages. Life insurance companies today have taken the lead in erecting stores, shopping centers, and office buildings. They will either finance the building(s) from the construction stage onward, or purchase the property outright and lease it back to the interested parties on favorable terms. Leases under this arrangement are known to run for an extended period of time, as ninety-nine years.

The corporation that issues bonds as a means of acquiring investment capital guarantees to pay a specified sum at some future date, with interest at a fixed rate. Maturity dates are usually in excess of ten years, such as 15, 20, 25, or 30 years. Longer-term issues are not common today. When borrowing by this method the business sells the entire issue to investment bankers which in turn sell the bonds to the general public, or the issue may be sold to a single holder as a life insurance company or some other investor.

REVIEW AND DISCUSSION QUESTIONS

1. Why is it necessary that commercial credit managers be well informed on businesses' needs, uses, and sources of cash credit?
2. In what ways may bank loans be classified? Distinguish each type.
3. Distinguish: (*a*) commercial paper, (*b*) double-name paper, and (*c*) accommodation paper.
4. Distinguish between bank interest rates and bank discount rates.
5. What are the principal reasons commercial banks have high credit standards and requirements?
6. What are the principal differences between *financing* accounts receivable and *factoring* accounts receivable?
7. Is accounts receivable financing a desirable or undesirable business practice? Explain.
8. Under what circumstances can a business use factoring to a good advantage?
9. What is investment credit?
10. What are the common forms and sources for long-term funds?

CHAPTER 21

Export Trade Credit[1]

SINCE THE United States has become the dominant world power our trade with customers located in foreign countries has become increasingly important. Although export trade has been an important market segment for many years, it was not until the recent postwar years that a great surge of such trade got underway. During this era most of the nations of the free world sought the products of American industries to bolster their economies and standards of living. From 1946 to the end of 1957 the value of export trade (exclusive of military shipments) rose from $11.7 billion to more than $19.5 billion. During the next year, however, commercial exports decreased by more than $3 billion to an estimated $16.3 billion by the end of 1958, but moved up to approximately $17.7 billion by the end of 1959.

Despite the fact that at this writing export trade has declined from its peak in 1957, most United States industry will continue to press for a strong position in overseas markets.[2] To substantiate this contention one need only recognize that the expanded productive capacities of

[1] This chapter is not a complete nor an exhaustive coverage of export trade credit. It is intended to only introduce the subject to the student by surveying some of the major considerations of this important and growing area of credit. For a detailed and complete treatment see J Rodriguez Sánchez, *Foreign Credits and Collections* (New York: Prentice-Hall, Inc., 1947). Also see chapter 29, *Credit Management Handbook,* A Publication of the National Association of Credit Men, Credit Research Foundation (Homewood, Ill.: Richard D. Irwin, Inc, 1958).

[2] Three principal reasons seem to account for the declining market opportunities of United States industry. First, most western European industries have regained their productive capacities lost during World War II. Second, foreign manufacturers are in a better position to undercut the prices of goods made in the United States. Our costs are simply higher than those abroad. And finally, many United States companies, that found particularly lush foreign markets for their goods, established foreign subsidiaries which compete with their own exports. See *Business Week,* January 2, 1960 for several interesting and revealing articles on the same subject.

United States manufacturers during the postwar years rapidly became *excess* capacity as domestic demand was satisfied. To offset this, many manufacturers looked overseas for new and expanded markets for their goods. Additionally, the opening of the St. Lawrence Seaway in 1959 brought foreign markets to the doorstep of Midwestern manufacturers. The seaway alone has stimulated much thinking about foreign markets. The expanded market opportunities of the past afforded by selling overseas and the present-day stimulation of the subject have focused attention on export credit problems.

CREDIT PROBLEMS OF EXPORT TRADE

The fact that a customer trading on his credit is located in a foreign country does not alter the basic principles and procedures of sound credit management set forth in Part V of this book. The foreign customers must still be investigated, the risk carefully analyzed, logical credit limits imposed, and collections made. There are, however, some basic differences in practice and some problems encountered not otherwise common to domestic credits and collections.

The principal problem area for most credit managers stems from their need to accurately judge the credit risk. A foreign credit customer usually represents greater risk and is more difficult to evaluate. The increased degree of risk and difficulty in evaluation should by no means be construed to mean that credit losses on foreign customers are higher than on domestic customers. On the contrary the Foreign Credit Interchange Bureau of the National Association of Credit Management reports that "credit losses in foreign trade are consistently and considerably below those experienced in domestic operations, even when the foreign and domestic credits are handled by the same credit executive."[3] Risk and evaluation problems are magnified though, because of currency and exchange, foreign business practices, the distance factor, the status of export credit insurance, and collections.

Currency and Exchange

One of the inherent risks of export trade stems from (1) the instability of some foreign currencies and (2) the ability of foreign customers to convert their currencies into United States dollars. This risk must be assumed by one of the parties to the transaction. If the exporter bills his foreign customer in the native currency (i.e., pounds, pesos, francs,

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[3] *Credit Management Handbook, op. cit.*, p. 709.

rupees, etc.) he runs the risk that when the bill is paid by the importer that the exchange into dollars may yield a smaller amount than anticipated. If the foreign currency should drop in value the seller will receive fewer dollars as he converts his foreign currency. If on the other hand, the exporter bills his foreign customer in dollars (this is more common) the risk of devaluation is placed on the importer. If, for example, the value of the dollar rises, the importer will need more of his native currency to make up the difference.

Not only does risk surround the relative value of currencies but each foreign country rigidly enforces exchange regulations. In general, foreign monies can only be obtained from designated exchange authorities which are usually within the control of the central banking system. Exchange regulations fluctuate with the political and economic conditions of the country. In the past importers in some countries have been prevented from remitting dollars to the United States, or due to an unfavorable exchange situation the foreign buyer may delay settlement of the account until more favorable exchange rates prevail.

A credit manager whose firm sells to foreign customers must be a student of international financial developments. While exchange stability has been somewhat strengthened by the International Monetary fund, the threat of foreign nations' monetary restrictions still exists. On occasion, even during recent years, unfavorable trade balances have used up the dollar and gold reserves of some countries. When this situation exists importers obviously cannot convert their currencies into dollars, and payment of the invoice will be delayed until dollar reserves are again available. Hence, before shipments are made to foreign countries, the credit manager would do well to determine the sufficiency of that country's dollar reserves. The sufficiency of dollar reserves, the likelihood of foreign currency devaluation, and monetary restrictions are all factors which must be considered in evaluating the foreign credit risk.

Business Practices

Management techniques and the tools of efficient business management are not as advanced in foreign countries as in the United States. This deficiency takes on significance particularly in the area of accounting and the rendition of financial statements. Foreign merchants, except for those in the largest trade centers, do not have trained accountants available to them. Furthermore, many foreign merchants still hold to the archaic view that their "names" and integrity are sufficient evidence upon which to base credit appraisal. Many of them also are reluctant to supply financial statements even though they have them because they

fear they reveal their business secrets. While these arguments have diminished in recent years as more advanced business practices have been adopted, it remains that adequate financial information on foreign buyers is woefully short. At best the foreign credit manager must for the most part rely on estimated financial details and sketchy comments about the operating techniques and resources of the importer.

The lack of or poor quality of financial data is further complicated by language difficulties. Despite the great emphasis of the foreign language requirement for those concerned with foreign trade, it is seldom that either party is well versed in technical terms, commercial definitions, and trade names. Hence there is a greater possibility that misunderstandings, disputes, and rejection of the shipment may occur.

Business practices also are influenced by the diversity of commercial laws of foreign countries. Commonly such things as import restrictions and licenses, laws of contract and title, bankruptcy, commercial arbitration, and patents are highly technical and complex. Because of the wide variety of such foreign regulations, most creditors are well advised to consult with an attorney familiar with international law before getting involved with importers of a particular country for the first time.

The Distance Factor

The distance between the exporter and importer compounds the problem of risk evaluation. If financial information is inadequate on domestic customers, the credit manager or one of his representatives often has an opportunity to visit his prospective customer's place of business and thereby judge the risk as best he can on nonfinancial factors. Obviously, the opportunity for personal contact with foreign customers is almost out of the question. This is particularly true where small accounts are involved. Consequently, the credit decision must be based almost entirely on data supplied by credit investigation agencies and other sources.

Furthermore, the distance factor influences the terms of sale. Usually there is a relatively long lapse of time between the purchase or shipment of goods and their receipt by the importer. Because of this, terms of sale are often longer than domestic terms of sale and hence, the accounts receivable remain unpaid for extended periods. Additionally, credit managers report that in recent years as competition for foreign customers increased, their demands for longer credit terms also increased. Inasmuch as the credit manager is not close to the foreign customer it is extremely difficult for him to know whether such demands are the actual "playing of one creditor against another" or whether the

customer is taking advantage of a "plausible" situation. Whatever the particular circumstances the exporter will require greater financial capacity than the amounts needed to carry domestic accounts. The long lapse of time and longer terms granted to compete with other sellers further aggravate the exchange risks and the risks created by the possibility of new import regulations.

Export Credit Insurance

Most of the major exporting nations have adopted either export credit insurance plans or guarantees which protect creditors against defaulting foreign customers. Great Britain, for example, has had such plans since 1920. Credit export insurance in the United States is presently not available on the majority of credit financed shipments.

Export credit insurance was first written in the United States in 1921 by a private insurance company. This company was liquidated in 1932 after a critical export credit situation arose when Great Britain abandoned the gold standard. Another private company succeeded this one, but it operated on a restricted basis until World War II when the volume of export trade declined and the character of the available risks deteriorated. The Export-Import Bank of Washington which extends medium- and long-term credits to foreigners does not extend any short-term credit. It does, however, provide for exchange risk guarantees on investments and certain special shipments to specified countries. For the most part the Export-Import Bank facilities are neither useful nor available to most commercial creditors.

Since World War II every session of Congress has been confronted with legislation which would establish a government-operated export credit insurance system. At this writing, as United States exporters and government are concerned over stiffening competition in the export field from the European countries, new interest in a government sponsored plan has revived. Two somewhat different approaches to the problem are usually cited. One is an insurance plan whereby the government would underwrite a given portion of an exporter's total overseas credit volume. The other plan is a government guarantee of payment on exports to specified countries. The percentage of any default which the government might guarantee is usually subject to debate, but 85 per cent of the defaulted amount is frequently quoted as desirable. The need for some concerted effort in this direction stems from the fact that some vast and profitable markets exist in the undeveloped countries of the world, but the risk of default for business or political reasons is too great to assume. No great problem exists with the established export markets

where exporters and banks have had considerable experience. They are reluctant, though, to finance export sales to customers located in countries where they have not previously operated and gained the valuable experience on payments and the exchange situation.

Collections

Another problem area of concern to the credit manager is that of collections. As with domestic customers, the collection of accounts is an inherent risk of the adoption of a credit policy. The cost of collecting overdue export accounts, the variance in commercial laws from one foreign country to another, and the factors already discussed compound the problem. Because of the greater collection problem, standards of acceptability for foreign accounts are generally higher than for domestic accounts. Even despite the higher standards, creditors should expect to experience some difficulty with collections and some bad debt losses.

The variety of reasons or conditions which cause export customers to become delinquent, and the collection procedures and devices necessary to effectuate settlement are similar to those discussed in Chapter 31 and 32. Due to the nature of the conditions which influence the collection of foreign accounts it is particularly important that the credit manager establish internal controls which detect overdue accounts at an early date. Prompt follow-up of the account by mail, telephone, or cable will usually bring forth the reason for the delay of payment. Once the specific reason for payment delay is known, future courses of collection action may be plotted more intelligently and the effectiveness of such action can then be expected to be greater.

The credit manager is confronted with a particularly knotty collection problem when his collection devices fail to bring results and the export account is eventually classified as "placed for collection" or "legal action." It is at this stage in the life of the account that the credit manager must decide whether it is worthwhile to proceed further. Litigation abroad is not only costly, it is time consuming, and the effort may well be out of proportion to potential results. Obviously only sizable accounts and large unpaid balances should be considered for legal action. If legal action is necessary the creditor should consult with his bank, his own legal counsel, or an export agency for advice on competent legal counsel in the foreign country. In some countries only nationals are permitted to practice law. American exporters' experiences with foreign counsel have been such that it is often felt that the claimant's rights are not wholeheartedly enforced.

If a foreign account is to be placed for collection as distinguished from

collection by legal action, then a number of well-known agencies may be of valuable assistance. Dun & Bradstreet, Foreign Credit Underwriters Corporation of New York, and the services of the Foreign Credit Interchange Bureau of the National Association of Credit Management are a few such agencies. Each of these services uses "moral suasion" letters which emphasize the importance of maintaining a good credit standing.

SOURCES OF FOREIGN CREDIT INFORMATION

The evaluation of the foreign credit customer is much the same as that for a domestic customer. The exception to this, of course, is the close evaluation of those factors peculiar to export trade which were just discussed. Likewise the sources of credit information, the content of credit reports, and their format are much the same as those frequently consulted in domestic credit analysis.[4] A brief survey of a number of the more common sources of foreign credit information will reveal the parallelism which exists between these sources and domestic sources.

Commercial Credit Reporting Agencies

Dun & Bradstreet and American Foreign Credit Underwriters Corporation of New York are two well-known sources of foreign credit information. Both agencies write credit reports on manufacturers, wholesalers, sale agents, and other commercial enterprises located in most of the free nations of the world. In general, their credit reports include the history of the business concern, its method of operation, a financial section, and payment record data. Financial statements, when available, are included with the reports. In the case of American Foreign Credit Underwriters' reports, a definite opinion is given in regard to the acceptability of the credit.

Each of the agencies publishes rating books for Latin America and a few other overseas markets. Dun & Bradstreet's *Latin American Sales Index*, one of the books published annually, rates more than 160,000 concerns in 29 Latin American markets. Subscribers may purchase any section (for example, Section I covers Cuba, Puerto Rico, and other West Indian islands) of the book individually. For each business concern listed the address, line of business, and the capital and pay codes are shown. Much of the information shown in the credit reports and rating books is gathered by personal investigations performed by credit reporters operating out of overseas offices.

[4] See Chapters 24, 25, and 26.

Foreign Credit Interchange Bureau

Since 1919 the National Association of Credit Management has operated the member-owned Foreign Credit Interchange Bureau. Similar to its domestic counterpart, the Credit Interchange Bureau, it functions as a clearinghouse for exporters' payment experiences with overseas customers. This information rather than being historical and financial in character is the actual ledger and credit experience of American export creditors. The body of the credit report is essentially the same as that illustrated in Figure 26–3, p. 514. In addition to the data shown in the domestic report, each member who reports on a particular account also rates the customer as "High," "Good," "Satisfactory," "Unsatisfactory," or "Undesirable" by using the respective code letters "Q," "R," "S," "T," "U." Other services of the bureau include weekly bulletins, round-table conferences, various consultant services, and the "moral suasion" collection letters referred to earlier. This service is available to members of the National Association of Credit Management at a cost which is sufficient to cover the bureau's operating expenses.

Commercial Banks

Oftentimes the exporter's bank, through which he conducts his international business, has extensive credit information on foreign customers. This is in direct contrast to the role of banks as a source of credit information on domestic customers. The reason they have accumulated much foreign information is that they are often directly involved in export credit sales. Drafts and letters of credit are frequently used in export credit transactions and hence banks have a great interest in the same types of credit information as export credit managers.

The information contained in their extensive files is usually free to clients who request it for credit purposes. In requesting such information the creditor should completely reveal the details of the export credit transaction. Complete information on the transaction will be of much assistance to the bank in making an accurate and most usable reply. Banks will also write or cable for information not in their files. This is possible because of their foreign offices and correspondent banks that have firsthand experience with importers in the payment of their foreign trade obligations.

Bank information on foreign customers is regarded highly by export credit men. The information available includes the history and antecedents of the importer firm, its financial strength and capacity when available, and its record of the payment performance experienced by the

bank's overseas branches and correspondents. In general, this source of information has the advantages of completeness, high quality, and speed —any one of which may not be characteristic of the other mentioned sources.

Department of Commerce

The Bureau of Foreign and Domestic Commerce, United States Department of Commerce compiles reports on foreign markets and importers. The reports are made up by our embassies and consulates, forwarded to Washington, and then compiled into various country and industry bulletins.

The World Trade Directory Reports contain information on individual buyers abroad. These are available from the Department of Commerce at a cost of one dollar each. Even though the reports are not intended to be credit reports, they often contain the type of information sought by the export credit manager for more objective evaluation of the buyer. Usually the reports include a brief summary of the concern's history, antecedents, capital, and supplemental data on its operating characteristics.

Other Sources

There are a number of other sources, any one of which may supply valuable information. Foreign trade publications, exporter's associations, and the importer's bank may provide supplemental information of value. The export credit man who is closely associated with foreign trade groups will have little difficulty in picking up essential information on particular markets and the exchange problems encountered by other members. Not to be overlooked are the exporter's salesmen, their foreign representatives, and, of course, the customer himself.

EXPORT TERMS OF SALE

In recent years competition for foreign customers has become particularly intense in a number of the international markets. When this condition exists considerable bargaining for lenient credit terms becomes a normal course of buying action by importers. So prevalent are these practices today, that credit managers believe the particular credit terms granted may be a deciding factor in making a sale. The export credit manager must, however, be careful to avoid those risks who take advantage of a competitive situation, but are still marginal or deteriorating in regard to financial condition. Even though the present-day

competitive scene magnifies the exporter's credit problems, the future outlook is somewhat brighter. As competition improves some international markets will have overcome their perplexing political and economic situations, and hence, the risk of exchange and monetary restrictions are likely to decrease substantially.

Terms of sale used in export trade, to some extent at least, denote the quality of the risk just as terms of sale in domestic trade classify commercial accounts by risk or unique circumstances. Most writers classify export terms of sale in order of decreasing risk as follows:

1. Consignment terms.
2. Open account with terms of sale similar to domestic terms.
3. Drafts, usually time drafts and sight drafts.
4. Export letters of credit.
5. Cash before delivery (C.B.D.) terms.

Consignment Terms

Consignment sales are not widely used in export trade and are never used when exchange and monetary restrictions are not favorable to converting foreign monies into dollars. Foreign laws on passing title to goods differ in some countries and this alone may preclude the use of this device. If, however, an exporter is shipping to a customer of long standing in which he has the utmost of confidence, or to foreign subsidiaries and sales agents consignment terms may be desirable. Customers of these types must obviously be located in established foreign markets where the trade and banking facilities are capable of coping with the technicalities of the consigned shipment.

Open Account

The use of the open account with terms to compensate for the distance factor and other normal delays are in the minority in export credit transactions. Again, the utmost confidence in the customer must exist and the exchange provisions must be favorable to the use of these terms. In some countries priority is given to applications for exchange to settle dollar draft obligations as contrasted with applications to settle open-account obligations. The use of such terms is more common in dealings with western European customers and a few of the Latin American markets.

Drafts

Time and sight drafts are widely used credit instruments in export credit sales. Drafts may be either *dollar drafts* or *foreign currency*

drafts depending on the arrangements previously made between the exporter and the buyer.

Usually the drafts (whether time or sight) are *documentary drafts* as contrasted with *clean drafts.* The documentary draft is accompanied by all the title documents and paper essential to the shipment such as bills of lading, insurance certificates, shipping documents, and the like. The clean draft is free of these attachments. In this case the importer may have already received the shipment and the clean draft is forwarded through banking channels for the purpose of collecting the amount of money due.

A documentary time draft (time draft, documents upon acceptance, T/D, D/A) is forwarded to the importer's bank and the title documents are released to the importer as soon as he accepts the draft. The customer then has a stipulated number of days after date of time draft to settle his debt with his bank. The advantage to this draft over the open account is the follow-up of the bank as the due date approaches and as the customer fails to satisfy the draft conditions.

Sight drafts (sight draft, documents upon payment, S/D, D/P) are equivalent to the domestic terms C.O.D. The draft and title documents are sent by the exporter's bank to its foreign branch or correspondent bank. The sight draft, as with its domestic use, is payable upon its presentation to the importer.

In using a draft to collect the credit accepted, the exporter is well advised to consult the Credit Manual of Commercial Laws published annually by the National Association of Credit Management. This volume contains much helpful information on terms of sale, trade definitions, and on the various documentary requirements. Furthermore, the instructions to the bank in regard to collection of the draft, remittance of the funds by the foreign bank, the handling of collection charges and taxes, and other charges must be clearly set forth so as to avoid misunderstandings, delays, and more complicated collection procedures.

Letter of Credit

The exporter who desires to have the greatest certainty of payment, other than cash before delivery, should request the importer to arrange for an export letter of credit.

An export letter of credit is evidence that the importer has arranged through his bank (usually a branch or correspondent to the American bank) to guarantee collection of drafts drawn in compliance with the terms of credit. The American bank *accepting* the letter of credit from the importer's bank takes very little risk because it is backed by the for-

eign bank, which is oftentimes a correspondent or branch bank. In turn, the foreign bank has issued the letter of credit on the basis of its credit investigation of the foreign buyer, and hence all the risk is assumed by the overseas bank.

A letter of credit issued by a foreign bank and accepted by an American bank is known as an "irrevocable export letter of credit." An irrevocable letter of credit also may be issued by an American bank. Two variations of the irrevocable letter of credit should be noted. First is the irrevocable letter of credit issued by a foreign bank but *unconfirmed* by an American bank. Drafts drawn under this type of letter of credit will be paid by the foreign bank, and not by the American bank. Second is the *revocable* letter of export credit issued by an American bank. Because this instrument may be revoked or amended at any time the exporter has only day-to-day assurance that sight drafts and time drafts drawn against it will be accepted by the issuing bank.[5] The two former instruments are much preferred by exporters and are in widespread use, whereas the latter instruments are not widely used.

The preference of export creditors for the irrevocable export letter of credit stems from their ability to convert accepted drafts into cash almost immediately. All the exporter must do is draw a draft, support it with the necessary shipping documents, and present it to the "accepting" bank. After verification of the exporter's claim the bank "accepts" the draft. Once the bank has accepted the draft on the irrevocable letter of credit, the exporter can in turn discount it on the open market and receive full payment for the shipment less the discount charge. For all practical purposes, then, the irrevocable letter of credit parallels a cash sale. If, however, the exporter desires to save the discount charge he can hold the draft until maturity.

Cash before Delivery Terms

The circumstances under which an exporter may demand C.B.D. terms are much the same as those in domestic sales. When an importer cannot qualify to meet the demand for a letter of credit, or when his credit standing is clearly unsatisfactory it is desirable to ask for cash before delivery. Not all circumstances which call for this arrangement are the responsibility of the importer. Exporters may request these terms when the foreign country's exchange conditions are such that long delays are likely to be encountered if more lenient terms were used. A few products have customarily been sold for C.B.D. terms to domestic cus-

[5] For a more detailed description of the types of export letters of credit see, *Credit Management Handbook, op. cit.*, pp. 726–33.

tomers and the same terms apply to foreign customers. Notable among these are some heavy machinery lines and automobiles.

DIRECT VERSUS INDIRECT EXPORTING

Most of the problems discussed to this point in the chapter are those encountered by marketing institutions which sell directly to foreign buyers. Manufacturers who sell direct usually do so because of the attractiveness of this alternative. To market products directly to overseas buyers does, however, require that the manufacturer possess the necessary capital, organizational and manpower requirements. An export credit policy must be developed, capital must be sufficient to finance the slow turnover of receivables, and a host of details and incidental problems create the need for qualified personnel.

The use of middlemen, or indirect marketing, is as plausible and advantageous in export trade as it is with some domestic trade. Clearly the use of sales agents, factors, export commission houses, export brokers, and other export marketing agencies serve to shift the functions and some risks from the manufacturer. In many instances varying export arrangements can be worked out with the export agency so that a major portion of the sales expenses can be shifted to it. Likewise, some of these agencies assume all credit and exchange risks. The factors to consider when arriving at the decision to market products overseas either directly or indirectly are: (1) the percentage of manufacturing output to be marketed for export, (2) the gross margin, (3) the personnel qualifications versus personnel requirements, (4) the degree of control the manufacturer desires over his product, (5) the need for service and product guarantee maintenance, and (6) financial requirements.[6]

REVIEW AND DISCUSSION QUESTIONS

1. What postwar developments have contributed to American manufacturers' attempts to expand their markets overseas?
2. What are the conditions which magnify the problem of credit risk evaluation on foreign creditors?
3. What is the present-day status of export credit insurance?
4. On what bases can you justify the government underwriting of export credit insurance? Discuss.
5. Enumerate the differences and similarities between domestic and foreign sources of credit information.

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[6] *Ibid.*, pp. 707–8.

6. Why are commercial banks an especially good source for information on foreign customers?
7. Under what conditions would you use consignment terms? Open-account terms?
8. Distinguish between a time draft and a sight draft.
9. What is an irrevocable letter of export credit? What institution(s) issues them?
10. "For all practical purposes an irrevocable letter of export credit results in a cash sale." Discuss this statement.
11. Do any American industries customarily sell on C.B.D. terms? If so, which ones?
12. How can a manufacturer, lacking adequate financial means, enter the export trade market?

PART V

MANAGEMENT AND ANALYSIS OF COMMERCIAL CREDIT

CHAPTER 22

Management of Commercial Credit Sales

THE PRESENT-DAY commercial credit manager occupies an important position among credit executives. The reasons for this are: (1) commercial credit is heavily relied upon as a means of short-term financing by practically all production and marketing institutions, (2) commercial credit so pervades the industrial and commercial scenes that it is not only a customary means of selling goods and services, it is also the most frequently used type of business credit, (3) the volume of commercial credit is far in excess of most other types of business credit. Some indication of the importance of the commercial credit executive in our economy can be gained from the quantitative estimates of the volume of commercial credit. In Chapter 1 it was estimated that 90 to 95 per cent of all commercial and industrial transactions between businessmen are made on the basis of commercial credit. While it is very difficult, if not impossible, to estimate the volume of commercial credit we do know from U.S. Bureau of Census data that manufacturers' sales, wholesalers', and other middlemen's sales when multiplied by our estimate, result in a figure far in excess of the volume of any other types of business credit. This does not, however, account for the turnover factor of manufacturers' and wholesalers' receivables and, hence, the yearly volume would be further increased. Further evidence of the dominance of commercial credit is provided by the fact that as of June, 1957, 9,200 manufacturing corporations had $16.8 billion of commercial credit outstanding compared with $8 billion of short-term commercial bank loans.[1]

[1] FTC-SEC, *Quarterly Financial Report,* United States Manufacturing Corporation, 2nd Quarter, 1957 (Washington, D.C.: 1957), p. 30.

Other studies show that commercial credit is several times that of commercial bank credit.

Clearly, the above evidence must be interpreted as lending great importance to commercial account receivables as a device for financing the short-term needs of American businesses. The receivables item on most manufacturers' and wholesalers' balance sheets is one of their largest and most liquid assets. It, therefore, must be emphasized that commercial credit management is concerned with a financial aspect of business which, in many respects, is as demanding, important, and as significant as many other financial tasks. It is imperative that commercial credit management safeguard the receivables asset with sound, intelligent, and effective credit and collection policies.

THE COMMERCIAL CREDIT EXECUTIVE—HIS STATUS, PLACE, AND FUNCTIONS

The commercial credit manager occupies a respected and responsible post in his company's organizational structure. He manages the acceptance of customer's credit and the collection of their debts. As simplified as this may appear at first glance, effective credit management involves several major tasks, all of which are dependent upon numerous routine operations.

One complicating aspect of commercial credit management stems from the fact that a sale of merchandise or services takes place and as a result of this transaction a credit act takes place. Commercial credit, then, as contrasted with other forms of credit is not entirely financial in character, but it is directly concerned with both the sales and financial problems of a company. The purpose of any business enterprise is to earn a profit. Profits are derived from the company's sales which in turn involve a commercial credit transaction. The aim of credit managers is, hence, the same as the objective of their companies—to earn a profit. With this guiding principle directing the credit manager the implications of his policies throughout any given company cannot be overemphasized. If his attitude and policies are those which tend to create an ultraconservative atmosphere, then customers whose credit is less than "prime" must go elsewhere to purchase. On the other hand, the attitude and policies of the credit manager may be too lenient and the company is then involved with an unsatisfactory quality of receivables. In the former instance sales and the financial gain of the company have suffered, while in the latter instance sales may increase, but the company suffers financial losses on a low quality group of credit customers. In view of the far-reaching effects of commercial credit management, it would seem that—*manag-*

ing commercial credit sales is the efficient employment of all devices at one's command to create the most profitable balance between company sales and company revenue.

Changing Status and Qualifications of Credit Management

The major factor contributing to the changing status and qualifications for commercial credit management has been the rapid and tremendous growth of American industry and commerce. When business was largely under the control of a sole proprietor and relatively small in size the approval of credit was a simple, but personal matter. It was once customary, 50 to 75 years ago, for buyers to visit markets once or twice a year. After having an opportunity to "size up" the buyer, the proprietor would either approve or disapprove his credit. As commerce developed the personal relationship was lost and some other basis was needed to manage commercial credit.

It was logical that the task should fall on someone within the company, and hence for a number of years the "bookkeeper" was in control of credit for a large number of concerns. As commerce and industry grew, it became apparent that the work of the "bookkeeper—credit man" would have to be divided. Paralleling the commercial and industrial developments of the present century, we attained a high degree of administrative efficiency through better organization and specialization.[2]

With the organization of the National Association of Credit Management in 1896 and several other developments, the significance of professional credit management came to be realized. Improved sources of credit information developed; better accounting methods became universal and the techniques of financial statement analysis were refined; management recognized the professional character of credit work and its significant relationship to the marketing and financial operations of their businesses; and an increased number of highly qualified people sought out credit work as a career and profession. The complexities of modern-day business and the need for specialization created the conditions which fostered the status held by today's credit managers. It is well for the aspiring reader to recognize that "credit management has moved up to the status of an established business profession, with prerogatives, responsibilities, standards, and ethics."[3]

The changed status and present-day professional character of credit

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[2] Albert F. Chapin, *Credit and Collections in Principles and Practice* (5th ed.; New York: McGraw-Hill Book Co., Inc, 1947), pp. 133–34.

[3] William J. Shultz and Hedwig Reinhardt, *Credit and Collection Management* (2d ed; New York Prentice-Hall, Inc, 1954), pp 19–20.

management necessitate changed qualifications for success in this field. It is no longer possible to get along with a "bookkeeping" knowledge as it was many years ago; nor, is it a task which relies solely on accounting principles and financial statement analysis. This latter concept of the qualifications for credit management was held not too many years ago, and it is still entertained by a number of business and educational people. Modern business techniques and the operation of an effective credit department demand that credit management be intimately knowledgeable of the relationships of credit to the business finance, production, marketing, and other aspects of the business. All this has entailed a broadening of the base of qualifications with greater emphasis upon formal training in both the specialized and general areas of credit management.

In recognition of the broader base of qualifications the National Association of Credit Management (NACM) has done much to make available the types of training needed by credit department personnel and particularly those who aspire to management positions and those already in responsible posts. Specialized training is offered through the National Institute of Credit which is one of the activities of the Credit Research Foundation of the NACM. The Institute offers a nation-wide program especially designed for credit personnel from the time they enter the work through their first eight to ten years experience. The program is conducted through local NACM associations in co-operation with major colleges and universities. Accreditation for study in the specified fields of credit is given in the form of awards. The Associate Award is given for satisfactory completion of basic education in the field of commercial credit management provided the student has had three years credit department experience. A Fellow Award is given to those who meet the same academic requirements but have six years experience.

Since 1947, Graduate Schools of Credit and Financial Management of two weeks duration each summer are held at Stanford University and Dartmouth College. These schools operate in co-operation with the graduate schools of business administration at the respective institutions. The student entering one of these programs is expected to be well versed in credit fundamentals, accounting, finance, and economics. The graduate program includes courses of study and seminars in credit policy, financial management, executive development, and related high-level fields. To complete this program attendance for three summers is required. The credit personnel attending these sessions are nominated by their companies and are expected to possess management capabilities sufficient to qualify them for executive credit positions.

In the banking field the American Institute of Banking sponsors similarly excellent programs for commercial bank personnel.

In addition to the above specialized and general educational programs, many of our nation's colleges and universities offer day school and evening school programs designed to help equip the modern-day credit manager. The best equipped to handle the programs seem to be the schools of business administration which offer broad training in the liberal arts and sciences and a specialized training in marketing, management, finance, economics, and accounting. Whatever a person's educational background it is not too difficult, with the offerings discussed above, to develop the *personal, experience,* and *educational* qualifications necessary to the credit management profession.

The Credit Department in the Organizational Framework of the Company

A systematic organization will clearly define the lines of authority and responsibility and insure the effective performance of the delegated credit functions. In the organization of the credit department the numerous routine (but essential) activities, the decision-making processes, the collection phases of the operation, and the supplemental services to customers and the company must be provided.

After the commercial credit department has been organized, the question of its place in the organizational framework of the company arises. This is not a question that can be easily reconciled because of variations in size of company, size of department, and the principal business activity of the enterprise. Service companies generally have fewer credit problems and less opportunity to fulfill all basic functions completely. Manufacturers and wholesalers, especially large ones, need a full-fledged effective operational department. Small concerns will frequently delegate credit and collection functions among the owners, the salesmen, or accounting personnel.

In large companies where the credit function plays an integral role in accomplishing major objectives, we find variation in the place of the credit department in the organizational structure. Some concerns place the credit department in the sales division, others with the financial division, and still others in the accounting department.

Credit Department in Sales Division. It is prevalent to have the credit department in the sales department when the company is in a highly competitive industry; when the policies of the company are almost entirely sales-orientated; and, when great emphasis is placed on credit service to customers. The principal arguments advanced for and against this type of organizational plan are:

Arguments for

1. Both sales and credit have the same objective—maximizing sales.
2. The gathering of credit information is facilitated by having salesmen perform some of this work.
3. Closer co-operation of sales and credit personnel.
4. Better opportunity for the credit manager to build good will by keeping alert to weak customers and new customers as reported by sales personnel.
5. The processing of sales orders is facilitated.

Arguments against

1. The sales department philosophy is too liberal with respect to credit risk.
2. Over liberal policies can as easily create ill will among customers as an overly strict credit policy.
3. Objectivity in the decision-making process is not free from subjective influences.

Credit Department in the Financial Division. A very large number of credit managers are under the supervision of the treasurer. In these companies, they place great emphasis on the concept and function of utilizing invested capital efficiently. The arguments for and against this type of organizational plan are:

Arguments for

1. The control of funds invested in accounts receivable is improved.
2. A better working relationship between the treasurer and credit manager is fostered.
3. Current financing of the company is closely related to the performance of the credit department.
4. The total financial plan of the company includes accounts receivables and the treasurer needs control to forecast financial requirements of the company.

Arguments against

1. The maximizing of sales function is likely to suffer under the financial-orientated and not sales-orientated department
2. The treasurer is more importantly charged with management of company debt and not customers' credit.
3. The credit and collection policies will tend to be conservative and harsh, hence creating poor customer relations.

Credit Department in the Accounting Department. While most credit departments are placed under the sales division or the treasurer's office, there is much to be said in placing it with the accounting department. Those who argue in favor of this type of organizational setup believe that there are particular advantages to the record-keeping task. Both the accounting department and the credit department must under-

stand the significance of the accounts receivable ledger. It is usually maintained by accounting personnel to satisfy both departments, and with this apparent advantage there is no reason to separate one department or the other from the valuable accounting record. The ready accessibility of all pertinent data on current and inactive accounts is then centralized and mutually available. If this arrangement exists it is desirable that positions of co-ordinate rank be established for credit management and accounting management. The principal objection to this arrangement, is that the credit manager may fail to realize his greatest potential by being *inward* rather than *outward* in his policies and decisions to the detriment of other departments of the company and its customers.

The Independent Credit Department. Irrespective of the place of the credit department in many companies it enjoys an independent atmosphere in its operations. If some high degree of independence is not granted the department it may be desirable to create this situation by means of changing the organizational structure. Whether or not this is necessary depends, of course, on the management personalities involved. In some companies it may not be desirable to separate the credit department from the control of another executive because of the incapabilities of the credit manager himself. Conversely, it may be desirable to establish a separate credit operation because of the strong dominance, shortsightedness, and lack of appreciation of credit's role by the sales executive, the financial officer, or the accounting head.

If an independent credit department is organized, it is the responsibility of the senior executives and the credit manager to see that a close co-operation between function and operation exists between the various departments in the company. Furthermore, if the role of commercial credit is as important as we believe it is, the credit manager should occupy a co-ordinate place in the structure with other executives. The independent credit department should be able to function more effectively as it is free of being subject to the supervision of other department managers. Without the one-sided dominance of another department the co-operation between all other departments is unquestionably enhanced.

Basic Functions of Commercial Credit Management[4]

A further understanding of the status and qualification of modern-day credit management may be had by a realization of its basic functions.

[4] This section adapted from Theodore N. Beckman and Robert Bartels, *Credits and Collections in Theory and Practice* (6th ed.; New York: McGraw-Hill Book Co, Inc., 1955), pp. 68–70.

These functions believed to be first conceived by Dr. Theodore N. Beckman of The Ohio State University are as follows:

1. To maximize sales.
2. To minimize bad-debt losses.
3. The efficient utilization of invested funds.
4. Co-operation with other internal and external departments.

Maximizing Sales. The commercial credit manager can accomplish this function in two ways. First, he must work in harmony with the sales department of his company, and second he must lend his knowledge and experience to foster good relations between his company and its customers. If a company is to realize its maximum profit and grow competitively the volume of sales will be directly affected. The credit department, and for that matter all sales-supporting departments, must lend its support to the sales department. Hence, the credit manager in shaping his policies and departmental operations should avoid hindering the sales and the operations of the sales department. The credit policies adopted and placed into effect should: (1) smooth the path for salesmen by eliminating all nonessential credit and collection duties; (2) handle all orders promptly and speedily so as to assure meeting delivery schedules; and (3) accept all credit when the facts indicate that there is a reasonable certainty of payment.

The credit manager is in an excellent position to create good customer relations for his company and thereby build sales volume. He is in the best position to counsel with marginal or poor customers and oftentimes suggest remedies which result in their rehabilitation. If he is alert he can adivse the sales department on the potential purchases of a customer in his company's line of products. Furthermore, his correspondence to customers can be used to develop customer confidence and good will. Finally, to some extent he can propose special terms or special credit services to customers in order to aid the sales-building function.

Minimizing Bad-Debt Losses. It is a very simple matter to operate a credit department with infinitesimal losses. In operating with the sole objective of minimizing credit losses only the most acceptable credit risks are taken. Excessive losses, as it was shown earlier in this chapter, can be as equally destructive to the business' objective as no losses at all. It is a difficult and demanding task to accept that quantity and quality of credit which produces the optimum profit at a minimum of loss. To put this in another way, credit department policy should develop its policies not to avoid *all* bad debts but to insure against *excessive* losses.

Good credit management can do much to minimize losses. It is not

only a matter of rejecting the poor risks, but it also requires that management be watchful of the risks that grow weak while on the books. Credit decision making is not infallible, hence some accounts will develop weaknesses and defects. Here again, the counseling services of the credit department should be directed toward the elimination or lessening of these weaknesses and defects.

Perhaps the most effective way to keep losses at a minimum is a good collection policy. This subject is discussed fully in subsequent chapters, but it should be noted here that an effective collection system depends on adequate records, the prompt handling of delinquent accounts, and a series of collection devices and actions. Above all, some credit losses are inevitable. If losses do not occur, then the credit policies and/or the collection policies of the department are not founded on sound judgment.

Efficient Utilization of Invested Funds. Commercial credit management is charged with the responsibility of managing accounts receivable. This item is frequently one of the most valuable and liquid assets of a business enterprise. Similar to all other assets in a business, accounts receivable are financed either by the owner's investment or outside capital. The turnover of the receivables will affect the company's ability to meet current operating expenses. If the turnover is slower than normal outside sources of financing may be necessary. As turnover increases it yields a higher return on the investment in receivables. As credit management conceives its role as the guardian of the investment in receivables, it follows that it must develop and follow policies best suited for the most efficient utilization of said investment. Credit policies, collection policies, the use of factors, and the assignment of accounts receivable are devices available to credit management to insure or reduce the investment in receivables.

Co-operation with Other Internal and External Departments. It is apparent from the above that credit department activities have a strong impact on the policies and activities of other departments. The sales, accounting, and financial divisions of the business are but a few of the many influenced by the credit manager's policies. Close co-operation and assistance to all departments is paramount. The day is long past when business enterprises could grow and prosper as a result of the direction of one man. When the credit manager clearly visualizes his responsibility as contributing to the total effectiveness of his company rather than narrowly regarding his department as segmented from the company's objective, he has taken the major step toward being of greater value to his company.

Co-operation with external departments means that the credit manager can better perform his functions when he works closely and in harmony with other credit-granting institutions, credit-facilitating agencies, and other business organizations. Perhaps no field is as dependent upon mutual exchange of information, co-operation, and collective action as is the credit profession. Credit-reporting agencies, the direct interchange of information among creditors, and the educational ventures undertaken by the profession are widely recognized as dependent upon collective action. When business debtors weaken to the degree of approaching failure the independent action of a single creditor is censured. Adjustments, assignments for the benefit of creditors, and other settlements in or out of court should be the mutual interest of all interested creditors. Much can be gained from co-operation with external departments and agencies to improve the techniques of the credit profession and lift the quality of the business credit structure.

OPERATION OF THE COMMERCIAL CREDIT DEPARTMENT

The day-to-day operations of a commercial credit department involve a large number of routine functions performed by the employees of the department; and, the handling of special problems, execution of credit policies, and the making of decisions by the credit executive and his assistants. The more or less routine operations of the department are:[5] (1) checking new and old orders for credit, (2) the filing of all credit information and data pertinent to existing accounts, (3) the revising of credit information and ratings at established intervals, (4) the recording and checking of all credit accepted and all payments and deductions made, (5) collecting accounts by rendering statements, invoices, or other methods, (6) handling customer inquiries concerning their shipments and/or their accounts, and (7) the answering of credit inquiries from other interested creditors.

The credit manager and his assistants direct their attention to the following special problems which often require an authoritative decision:[6] (1) the periodic review of the operational procedures, credit information, and policies employed by the department, (2) handle all requests for special terms, extensions, and part payment of invoices, (3) make decisions with regard to questionable credit risks, (4) decide on what action to take to solve special collection problems, (5) establish

[5] *Credit Management Handbook*, A publication of the National Association of Credit Men (Homewood, Ill.: Richard D. Irwin, 1958), pp. 385–86.

[6] *Ibid.*, pp. 386–88.

credit limits on new orders and approve increased limits on old orders, (6) counsel with financially weak customers and deal with the financially distressed customers, and (7) resolve, if possible, by study and research the credit problems of other departments in the business. In addition to the above array of activities the credit manager will be charged with the responsibility of rendering summary credit and financial reports to higher echelons of management. From such reports the company can evaluate the effectiveness of the department and use the financial data for long-range planning. It is apparent that this department, similar to the accounting, sales, and finance departments must maintain accurate, revealing, and continuous records.

Handling Orders from New Customers

When an order from the sales department is received in the credit department, the procedures for immediate processing of the account are set in motion. The first step of the department will be the credit investigation.

The Credit Investigation.[7] Whether the order from the new customer will be approved or not depends upon the credit strength of the company. It is necessary to conduct a credit investigation so as to marshall the facts upon which a credit decision can be based. The extent of the credit investigation and the types of credit information needed will, however, vary with the size of the order. Small orders may be evaluated on the basis of credit ratings found in one of the several credit reference books of the credit reporting agencies, or it may be evaluated on the basis of the salesman's report and appraisal of the risk. If the limited information available on the small order is favorable it is likely to be approved and passed on to the shipping department. Whether additional information will be gathered depends on the creditor-firm and the potential of future business from the account.

Large orders from new customers will be investigated more thoroughly. The information needed to make an accurate decision includes: (1) the identity and legal responsibility of the firm, (2) its history and business background, (3) the character and responsibility of the company's management, (4) and, its financial ability, strength, and outlook.[8] Unfortunately most credit decisions are made with less information than the credit analyst would like to have. It is more common for the credit man to act without complete information. Although this

[7] For a detailed account of factors to investigate, the sources of credit information and their significance to the credit decision see Chapters 23, 24, 25, and 26.

[8] See Chapter 23 for a complete discussion of these factors.

may lead him into error, it must be remembered that a complete credit investigation takes time and costs money. Too little information, or underinvestigation results in the scarcity of facts upon which to base a credit decision. The ideal credit investigation is one which secures just the information essential to a sound credit decision and obtains it from sources best prepared to supply it speedily and at minimum cost. Careful analysis of the risk within the department and an imaginative interpretation of the information at hand will overcome many of the deficiencies of the credit investigation.

If, after the credit investigation and the analysis of the information at hand, the order appears to be a poor risk, judgment may be withheld pending further investigation. If it is rejected, or rejected after more investigation, the sales department is notified. Above all, the sales department should be notified *promptly* so that the action of the credit department can be transmitted to the rejected customer.

In the event the analysis of the credit information proves favorable and the account is accepted, the next step is the assignment of the credit terms and the setting of the credit line. The routines of preparing credit reference cards, opening a credit folder, and recording the information in the customer's ledger are accomplished and then approval of the new account is sent to the sales department. Similar information is sent to all other interested departments and an authorized order releasing shipment is sent to the shipping department.

Handling Established Customers. When an old, established account orders merchandise the credit department procedures are greatly simplified. In-file information previously recorded and filed in the credit department is referred to so as to determine whether the account is in good standing or not. Most commercial credit departments accumulate credit information and revise credit limits on established accounts periodically. Hence, in-file data is usually reasonably current and this leads to a rapid credit decision. If the order is acceptable, and when added to any existing balances is within the assigned credit limit, it is approved and sent to the shipping department where the order is filled and shipped to the customer.

If, however, the account is not in good standing because of previous balances remaining unpaid or because the credit limit would be greatly exceeded, the order is sent to the credit manager for decision. With all in-file data before him he may revise the credit limit upward, or rather than assume greater risk from the customer, notify him of the negative decision. If the account is seriously overdue, shipment may be withheld pending receipt of a check from the customer to defray the previous bal-

ance. In this event, the customer must obviously be notified as to the reason for the shipping delay.

Speed—Essential to Handling Orders. In the operation of a commercial credit department, *speed* in the processing and resulting action on orders is imperative. Much of this is accomplished by routinizing the credit-decision task through the maintenance of the department's in-file information. Current in-file information on customers and the use of credit limits safely permit automatic approval of a large volume of orders. New accounts on which no in-file data exists and old revived accounts must be processed quickly and the credit investigation commenced without delay.

The basis for the above contention lies in the strong competitive conditions under which many companies market their products. Speed of action is perhaps one of the most important considerations when customers have the alternative to purchase elsewhere. Delays, withheld shipments, and unreasonable requests for credit information destroy the desirable customer relationships which were once developed by the sales department. Retention of present customers and the gaining of new customers are as much dependent on this seemingly minor point as are the other important considerations of price, quality, service, personalities, and the like.

DATA-RECORDING METHODS IN THE CREDIT DEPARTMENT

The methods employed in recording credit department data are for the most part hand operations. In recent years a large number of medium-size and large companies have adopted some of the high-speed mechanical devices which save processing time and reduce clerical errors. Bookkeeping machines are used by most companies that process a large number of accounts. This device is highly efficient in maintaining the accounts receivable ledger and processing customers' invoices. Punch card procedures have come into common use since World War II. While punch card systems are by no means widely used, the advantage in the system is recognized as saving time in routine clerical operations. The type of data possible to record on punch cards is essentially of an accounting nature. Order writing, billing, ledger data, payment experiences, and similar types of data are rapidly and accurately recorded by means of this system. Credit managers who require a substantial number of statistical reports find the speed and accuracy of the punch card system far excel the efficiency of "hand" operations.

A more recent development in the mechanical-processing field is the

high-speed electronic data processing machines. As of this writing the commercial credit departments of only a few major corporations are using the devices. Electronic data processing can: (1) process information faster than any other known means for better and more rapid decisions by management, (2) integrate the data from many business operations and variables, and, (3) mechanize practically all routine procedures. These possibilities give business managements the opportunity to consider more departmental relationship in an integrated report and hence study more alternatives.[9] Cost savings is generally not attained through the use of electronic equipment, but time savings and other advantages mentioned above may outweigh this consideration. It appears as though the credit departments of large business enterprises may look forward to the day they program their information for electronic processing. Credit managers and students may be well advised to take advantage of the training offered in this specialized area.

REVIEW AND DISCUSSION QUESTIONS

1. In what way may the credit manager's attitude and policies affect the credit operations and the basic objectives of his company?
2. Explain the conditions which have contributed to the changed status and qualifications of today's credit managers.
3. What are the arguments for organizing the credit department within the sales department? Within the financial division?
4. Do you believe it is most effective to have an independent credit department? Why or why not?
5. What four basic functions are usually attributed to commercial credit management? Evaluate the probable effects of placing too much emphasis on any one of these functions.
6. Outline the routine, but necessary, operations of a commercial credit department.
7. What special problems often arise that require the individual attention of the credit manager or one of his assistants?
8. How would you proceed to handle a sizable order from a new customer? From an established customer?
9. Speed in handling and processing orders is said to be imperative. Why is this?

[9] Harold Koontz, "Top Management Takes a Second Look at Electronic Data Processing," *Business Horizons,* School of Business Bureau of Business Research, Indiana University, Vol. II, No. 1. (Spring, 1959), pp. 74–84.

CHAPTER 23

Basis of the Commercial Credit Decision

COMMERCIAL CREDIT management is not unique in that it, too, is confronted with the inherent uncertainties and risks caused by the time element in the credit transaction. Because of this fact, decision making is the hard core of commercial credit management just as it is with credit management concerned with other types of credit. The decision maker attempts to improve the quality of credit accepted and to assure a more profitable relationship by minimizing risk on one hand and establishing a basis for confidence on the other. Unfortunately for creditors there has been little scientific progress toward the elimination of uncertainty or risk inherent in the credit transaction. But confidence, based upon past and present facts, soundly obtained and appraised can remove some uncertainty.

To gather the essential facts needed to reduce uncertainty and risk a credit investigation should be conducted. The credit investigation should marshall facts of sufficient quantity and quality bearing on the account so that the credit decision can be rational and sound. It does not necessarily follow that losses will always occur if creditors accept credit by the "hit-or-miss" method. There is, however, a correlation between the quality and amount of credit information and the frequency with which credit losses occur.

Credit information alone is not sufficient to create a credit decision which is based upon rational and sound judgment. The accurate interpretation of the facts gathered by commercial credit management is the other essential requisite to assure, with a minimum of uncertainty, a profitable business relationship. Each commercial account or customer

must be considered as an individual problem of analysis and interpretation. This is true because customers have no fixed value, and the range of risk is likely to have great variation. Additional complications arise for the commercial decision maker because of the unique characteristics of his customers. Accounts are typically some distance from the creditor. Manufacturers and wholesalers frequently distribute their products to unknown customers many hundreds of miles away. These same customers range from the small, individual proprietorship to the complex vast corporate enterprise. The amount and quality of credit information will vary with the differences in organizational structure, size, and financial strength of the customer. Some customers have many lines of specialized activity while others have a limited scope of operations. Furthermore, creditors have no fixed standard of acceptability to guide their decision-making process, and the house standard of the individual concern will fluctuate with ever-changing conditions. Despite the great variation in commercial credit customers and the fluctuations of the house standards, credit management is interested in a reasonably certain affirmative answer to the questions: "Can the account or customer pay?" and "Will the account or customer pay?"

The key to ascertaining the solution to the above queries lies in the credit manager's ability to recognize what he has to know. In other words, he should ask himself, "What must I know before I accept or reject this account?" If the decision is favorable, then the amount of credit must be determined. This brings up the question, "In light of the existing information on this account, what should be the line of credit extended to this firm?" Whether the evaluation is for the purpose of accepting or rejecting the account, or for the purpose of setting the line of credit, the factors of appraisal are generally the same.

The Need for Credit Information

The question of whether an account *can* and *will* pay can be answered only after a series of more specific questions about the risk have been raised and answered. Even though no two customers are alike, the same specific questions are likely to arise and the types of information needed to answer these questions will be quite similar. To answer finally the "can" and "will" of paying, credit management is confronted with the task of discovering the answers to the following questions:

1. Can the *identity and legal responsibility* of this account be established so that we can ascertain that this order represents a request from a bona fide business house?
2. What is the *history and business background* of this account and what elements in its background contribute toward making the decision?

3. What is the general *character and responsibility of the management* we will be doing business with? Are these factors of a quality that we can anticipate a continuous and healthy business relationship?
4. What is the *financial ability and capability* of this customer?
5. What is the *financial strength and financial outlook* for this account?
6. Does its *past and present payment record* reveal confidence or not, and what are the future expectations in this regard?

To provide the credit analyst with either affirmative or negative answers to these questions, a credit investigation must be conducted. The sources from which credit information may be drawn and the types supplied by the various sources are numerous. Credit management may find it desirable to use several sources or to vary their use depending upon the particular needs of his firm. An experienced and resourceful credit man will have little difficulty in selecting the most suitable combination of sources to supply useful data, quickly, economically, and accurately.

Classification of Sources of Commercial Credit Information

The sources of credit information available to commercial and other business-type creditors may be classified as internal or external as follows:

I. Internal information.
   A. Credit manager's personal knowledge.
   B. In-file information on previously established accounts.
II. External information.
   A. Mercantile agencies.
      1. General.
      2. Special.
      3. Interchange bureaus.
   B. Trade association credit bureaus.
   C. Interviews.
      1. By salesmen of the creditor.
      2. By credit manager and other authorized representatives of the creditor.
   D. Financial statements furnished by the account or new customer directly to the creditor.
   E. Banks.
   F. Attorneys.
   G. Public records.
   H. Correspondence with subject, creditors, or references.
   I. Investor's manuals and services.
   J. Newspapers, magazines, trade journals, and other publications.

It is readily apparent that the sources of credit information are not only internal or external, but that they are also commercialized or noncommercialized. The commercialized sources are: the mercantile agencies, trade association credit bureaus, and investor's manuals and services. An

organization which has as its dominant function the supplying of credit information in return for compensation may be termed a "commercialized source of credit information."

On the other hand, it is obvious that none of the internal sources of information is a commercial venture in itself and thus, they may be termed "noncommercialized." The credit manager's personal knowledge and in-file information on previously established accounts are contributory information which is available to most credit analysts. Several of the external sources of credit information are also noncommercialized such as: banks, attorneys, references, interviews, and other creditors who are often willing to supply information for the benefit of creditors, or because of reciprocity, custom, courtesy, or informal compensation. Most of the noncommercialized sources are available to all credit men on a "more or less" equal basis. The amount and usefulness of information secured from these sources will depend upon the type of business activity, the creditor's contacts, and the efficiency of the credit department.

It is imperative that credit managers be thoroughly acquainted with the various sources of credit information and the types of credit information supplied by each source. He must know how the available types of information will best serve the needs of his firm, and what value each source can contribute toward a sound credit decision. By having an intimate knowledge of the sources the credit manager will be able to draw information at the proper time, of adequate amount and quality, and within the cost limits imposed by his budget and the characteristics of each account or customer. The subjects of internal information and direct investigation are treated in subsequent sections of this chapter, whereas information supplied by the mercantile agencies is examined in the next three chapters.

Selecting Sources of Credit Information

The selection of the particular sources of credit information to be used in appraising the credit worthiness of each customer is dependent upon the characteristics of each source. The most important factors which should be taken into consideration are: accuracy of information, content of reports, speed of reporting, cost of the service, trade coverage, geographical coverage, variety and number of reports, and the supplemental services which fulfill particular or occasional creditor needs.

Accuracy of Information. The accuracy of the information supplied to a creditor is obviously of utmost importance. Without this single quality creditors would have little or no basis for relying on credit in-

formation to make their decisions. While most of the sources have no other purpose than to report all facts accurately, human frailties cause some errors. Safeguards against errors have, however, been developed in recent years with the advancements made in automatic processing and duplicating equipment. Foremost to take advantage of these technological improvements have been the mercantile agencies. Much information, and particularly financial data supplied to the agencies by firms being reported on, is today duplicated by mechanical means. The adoption of the more reliable methods of recording facts is in stark contrast to the manual operations which at one time were prevalent. It is hardly necessary to point out that to adequately appraise risk and arrive at a clear-cut credit decision, accuracy of information is paramount.

Content of Credit Reports. Credit report content will vary with the source rendering the report and with the characteristics of the business reported. Comprehensive and detailed reports are required to answer questions raised on new accounts, whereas periodic revision of existing accounts may be adequately accomplished with limited information of a specific nature. In appraising the credit worthiness of most accounts, commercial credit management will find it necessary to have a complete financial picture. If adequate financial data are not available from the mercantile agency sources, such information should be requested from the customer or other sources which have the capability of supplying the information. Because this type of information is essential to the appraisal and decision-making function, reports which contain adequate financial information are regarded most favorably. Each credit instance will dictate the kind and amount of additional information needed to reach a decision. It may be that the situation dictates the aging of accounts payable, the aging of accounts receivable, or even the current status of inventories and other pertinent information. Payment record (ledger) information will be required in most new account instances because it reveals the likely payment pattern which a creditor may logically expect. Whatever the dictated requirements of a particular case may be, there exists a source from which the information can be requested. Prudence, however, will dictate the desirability of obtaining the information within the cost and time restrictions.

Speed of the Reporting Service. Speed is of importance so as to assure the credit decision within a reasonable time. Modern communication systems and duplicating devices have greatly speeded the compilation of credit information. Despite these improvements some types of information can be gathered only with considerable expenditure of time and effort. Furthermore, it is not reasonable for the credit department

to delay a sale or shipment until *all* sources of information have been tapped. Competitive conditions in the market establish the speed requirement to prevent lost sales. While it must be recognized that many credit losses occur when decisions are based on inadequate information, the credit manager must decide at what point he must sacrifice adequacy for speed or vice versa.

Cost of Credit Information. Credit costs must be evaluated and justified the same as other marketing costs. Creditors dealing with a nominal number of accounts may spend a few hundred dollars a year to acquire credit information, whereas large business enterprises doing business with thousands of accounts may spend as much as $50,000 in subscribing to the services of a single credit information source. The cost of the mercantile agencies service is scaled so that the unit cost decreases as the quantity of reports and number of services increase.

The cost of acquiring and maintaining up-to-date information on each individual account is nominal when the unit sale is of sizable proportions. On the other hand, the cost to investigate small orders is frequently out of proportion to their value. To compensate for the relatively high cost to investigate small orders, the credit investigation may be relaxed and costs correspondingly reduced. Some business concerns do not investigate exceptionally small orders. Whether or not a credit investigation is warranted depends on the profit in the order; whether the order is a "one-time" customer; and, whether over-all losses justify the costs.

Another aspect of costs concerns the risk involved. Obviously, the exposure to great risk will dictate more effort, greater costs, and more complete information. It is a generally accepted view that alert and efficient credit management must consider all factors in order to keep costs in line with the risk and profit involved.[1]

Trade Coverage and Geographical Coverage. Geographical coverage of the credit information source should correspond to the scope of operations and the market geography of the creditor. Business enterprises selling in a number of markets and to different types of customers need sources of information capable of supplying information from these several markets and on the various types of customers. Not all agencies have national and international coverage, nor do all of them report on customers in all lines of trade. Credit managers must have knowledge of these factors in order to select the most effective source to serve their

[1] *Credit Management Handbook,* A Publication of the National Association of Credit Men (Homewood, Ill.: Richard D. Irwin, Inc., 1958), pp. 156–57.

company needs. The variations in these factors become apparent in the next few chapters.

Variety and Number of Reports. The variety and number of reports supplied by the various sources differ to a considerable degree. Some accounts can be appraised most accurately with particular types of reports which are supplied on credit department requests. Other accounts, particularly those where the degree of risk is great and continuous, require a series of reports supplied at specified intervals. Again the characteristics of individual accounts must correspond to the services rendered by the information source.

Supplemental Services. Services such as credit reference books, making of recommendations, decisions or rendering opinions, foreign credit reports, and supplying standardized financial statement forms, fulfill particular or occasional creditor needs. Credit reference books are of particular value in making a preliminary credit check and in appraising the reliability of small orders which do not warrant a credit investigation. Some sources make recommendations with regard to the acceptability of an account. This service may influence the use of the source when the credit department is staffed by a part-time credit manager or because of other circumstances it is desirable to shift the decision-making process. It should be quite clear that most creditors' needs are not completely satisfied by the *basic* credit information services. Supplemental services add refinement to the decision-making process and overcome peculiar circumstances which are inherent in trading with a diverse group of customers.

INTERNAL INFORMATION AND DIRECT INVESTIGATION

In some respects there is no better source of information than the internal information on the business itself, or the information gathered by direct investigation. There is, however, an ever-growing tendency toward large-scale production and more complex management. Paralleling these developments has been the tendency for customers to be increasingly removed geographically from their sources of supply. Each of these developments has restricted the ability of creditors to gather sufficient credit information by these means. Despite these limitations, these approaches are still used by many business houses to gather firsthand information. For example, even though it is seldom possible for a credit manager to interview the customer personally, other company representatives may have this opportunity. Typically the creditor's salesmen have

direct contact with the account, and it is mutually beneficial for both the credit department and sales department to co-operate in the gathering of credit information. Credit information available within the creditor organization and by direct means is of such distinct value that it is desirable to examine briefly some of these sources.

Internal Information

The credit office is literally a storehouse of credit facts. Each time a new account is accepted a file on the customer is established. The information contained in these files is known as "in-file information." This source of information combined with the credit manager's knowledge represent the principal sources of internal information.

Perhaps the most arbitrary factor affecting the credit risk and yet a valuable source of information is the credit manager himself. The information which he has acquired throughout his years of experience in the credit field, and what he already knows about his customers will sharpen his decisions and method of operation. Much of what he knows has been acquired through his attention to in-file information in making the difficult decisions; and through the help he has loaned his office associates in making routine decisions.

The customer's ledger record should not be overlooked as a valuable source of information. Each time an active account or inactive account reorders an opportunity arises to review the recorded data and predicate a decision on the assumption that past experience will be repeated again. The credit analyst may note the size of the new order and make comparisons with previous orders obtained, and if radical differences are evident and the time between orders is lengthy, a new investigation may be initiated. An opportunity to review the customer's ledger also presents itself when other creditors request ledger experience. Impressions are made upon the credit manager's mind and his knowledge of the risk is constantly being strengthened. Although not more than a supplemental source of data, it has a modifying influence on the credit decision.

Direct Investigation[2]

The term "direct investigation" is applicable when a creditor is *directly* involved in gathering basic credit facts from any of the several noncommercialized sources of information. It involves either (1) direct

[2] *Ibid.*, adapted from pp. 139–42; and unpublished thesis of Robert S. Hancock, *A Quantitative and Qualitative Analysis of the Sources of Mercantile and Retail Credit Information* (Urbana: Graduate College, University of Illinois, 1949).

contact with the customer with the aim of acquiring credit information, or (2) direct contact with individuals and institutions who may have some particular type of useful credit information bearing on the account. It does not include information supplied by any of the several commercialized sources.

Customer-Supplied Information. The owners or principals of a business are the best source of information available to credit management. From this source, the most accurate information about the operation and financial condition of a business can be acquired. Even though the customer is in a position to supply financial data, trade and bank references, and much other pertinent information, there are limitations affecting the use of this source. Direct contact with the customer will depend upon his degree of co-operation, the distance from the creditor, the time available to conduct the investigation, and the amount of the credit requested.

Direct contact with the customer may be made by correspondence, by telephone, and by personal interview. These methods afford the creditor the opportunity to establish good will and an enduring business relationship. In addition to gathering the needed credit information, direct contact can be used to clarify credit and collection policies and answer questions posed by the customer. It should be remembered that the first contact with a customer is perhaps the most important. If the creditor's information requirements are firmly, but courteously, stated during the first contact, this will avoid future resistance when larger amounts of credit may be requested. If a customer understands the initial and periodic information requirements, he has little logical basis to refuse releasing the much needed information at later dates.

Correspondence. This is the most frequently used, as well as the most economical, means of direct contact. Letters sent to new and existing accounts should acknowledge the amount of credit; the credit standing of the customer, honestly appraised at the time of writing; and, if applicable, the established relationship which may exist. Financial statements are customarily requested by letter. The convenient financial statement form supplied by the National Association of Credit Management, illustrated in Figure 23–1, can be enclosed with the letter. When completed and returned, this statement provides the creditor with essential financial information.

Personal Interviews. Personal interviews by salesmen or a credit department representative are another excellent means of gathering credit information. Interviews with the customer have the advantage of getting those facts and observing firsthand the important operating pro-

FIG. 23–1. Financial statement form approved by the National Association of Credit Management.

Form 4 Date 195

FINANCIAL STATEMENT OF

Kind of Business Address

At Close of Business on 19 City State

ISSUED TO ← { Name of firm asking for statement

[THIS FORM APPROVED AND PUBLISHED BY THE NATIONAL ASSOCIATION OF CREDIT MEN]

For the purpose of obtaining merchandise from you on credit, or for the extension of credit, we make the following statement in writing, intending that you should rely thereon respecting our exact financial condition.

[PLEASE ANSWER ALL QUESTIONS WHEN NO FIGURES ARE INSERTED, WRITE WORD NONE]

ASSETS	Dollars	Cents	LIABILITIES	Dollars	Cents
Cash (In Bank)			Accounts Payable (for Merchandise)		
(On Hand)			Notes & Acceptances Payable		
Accounts Receivable			Owe to Bank		
(Amt Past Due $)			(When Due Secured) (Unsecured)		
(Amt Sold or Pledged $)			Income Taxes, Accrued		
Notes and Trade Acceptances Receivable			Other Taxes, Including Sales Taxes, Accrued		
(Amt Sold or Pledged $)			Interest, Accrued		
Merchandise Inventory (Do not include Merchandise on Consignment) at Cost or Market, whichever is lower			Rental, Payrolls, etc., Accrued		
(Amount Pledged $)			Payables to Partners, Relatives		
Other Current Assets (Describe)			Other Current Liabilities (Describe)		
TOTAL CURRENT ASSETS			TOTAL CURRENT LIABILITIES		
Land and Buildings (Depreciated Value)			Mortgage on Land and Buildings		
Machinery, Fixtures and Equipment (Depreciated Value)			Chattel Mortgage on Mdse. or Equipment		
			Liens on Mdse. or Equipment		
Due from Officers or Non-Customers			Other Liabilities, No Current (Describe)		
Other Assets (Describe)					
			TOTAL LIABILITIES		
			Net Worth or { Capital $ / Surplus $ }		
TOTAL ASSETS			TOTAL NET WORTH AND LIABILITIES		

STATEMENT OF SURPLUS (or of NET WORTH if not Incorporated)

Surplus (or Net Worth at beginning of period) dated 19 $

Add Profit for Period $ and Adjustments $ $

TOTAL $

Deduct Loss for Period $ and Dividends (or Withdrawals, if not Incorporated)

$ and Adjustments $ $

SURPLUS (or NET WORTH) in Statement Above $

STATEMENT OF PROFIT AND LOSS FOR PERIOD FROM TO

			DETAILS OF EXPENSE OF OPERATIONS		
1. TOTAL SALES FOR PERIOD					
(Cash $) (Credit $)			Salaries, Owners		
2. Inventory at Start of Period $			Employees		
3. Purchases for Period $			Rent		
4. Total (Item 2 plus Item 3) $			Heat, Light, Other Occupancy Expense		
5. Deduct Inventory at Close of Period $			Advertising		
6. COST OF SALES			Interest		
7. GROSS PROFIT			Taxes, except Income Tax		
8. Less Total Expense			Depreciation, Fixtures, Trucks, Etc.		
9. NET PROFIT			All other Expense		
10. Less Income Taxes					
11. NET PROFIT After Taxes			TOTAL OPERATING EXPENSE		

Amount you are liable for as endorser, guarantor, surety $

Amount of merchandise held on consignment $

Amount of machinery or equipment held under lease $

Amount of machinery or equipment under conditional sale $

Amount you pay per month on lease or conditional sale contract $

What books of Account do you keep?

Date of latest inventory

Date of latest audit

Title to business premises is in name of

If premises leased state annual rental

Expiration date of lease

Name of your bank(s)

Do you have a Credit Department?

INSURANCE CARRIED

Fire
Merchandise $
Furn & Fixt $
Building $
Extended Coverage $
U & O $

Liability
General $
Auto & Truck $

Life for Benefit of Business $

The statement above and on the back of this form has been carefully read by the undersigned (both the printed and written matter), and is to my knowledge, in all respects complete, accurate and truthful. It discloses to you the true state of my (our) financial condition on the day of 195. Since that time there has been no material unfavorable change in my (our) financial condition, and if any such change takes place I (we) will give you notice. Until such notice is given, you are to regard this as a continuing statement. The figures submitted are not estimated. They have been taken from my (our) books and physical inventory taken as on date shown.

Name of Individual or Firm

If Partnership, Name Partners / " Corporation, " Officers

How long established Previous business experience

Where

Date of Signing Statement Street City State

Witness Signed by

Residence Address of Witness Title

(Over)

FIG. 23—*Continued*

BUY PRINCIPALLY FROM THE FOLLOWING FIRMS

NAMES	ADDRESSES	AMOUNT OWING

DETAILS OF LAND AND BUILDINGS

DESCRIPTION & LOCATION	TITLE IN NAME OF	Cost	Accumulated Depreciation	Depreciated Cost	Assessed Value	ENCUMBRANCES	
						Amount	To Whom

cedures which may be closely related to the needs of the creditor. The speed with which information can be acquired and the freshness of the information gained by means of the interview will often offset the cost and time expended in doing so.

Whether the interview is carried on between the customer and the credit manager, or the customer and a credit department representative, the information obtained should be of equal value. Such a desirable circumstance can be had only if credit department representatives are trained in the technique of interviewing customers. Interviewing technique should be studied and the questions asked should be planned in order to assure the uncovering of the facts sought. When the interview is conducted by someone who knows how to get adequate information, and by a person who has intimate knowledge of sound credit and collection practices, the quality of the data thus secured is enhanced. In conducting the interview, such vital points as the inventory, sales and management problems, future plans, capital responsibility, and various aspects of the financial statement can be discussed. This information combined with the firsthand observations can be used in "sizing up" the business ability, credit standing, and financial condition of the customer. Also, but supplementary, the information can be used as a basis of interpreting commercial agency reports. Information that is gathered during the interview should be recorded and filed in the credit office. Filed information eventually results in customer "case histories" for reference use when accounts are subject to revision.

Salesmen are frequently in an excellent position to furnish the credit department with valuable information pertaining to their customers. Few salesmen, however, are suited to be good credit reporters because their interests, experiences, and temperaments usually are not conditioned toward this aim. On the other hand, it is in their interests that they

supply information to the credit department when possible, in order that the account may be adequately appraised and credit approved quickly.

A salesman is usually the first contact with the customer, and if all goes well, he may be the only company representative who calls upon the account. During these calls the salesman can become acquainted with the business operations and local reputation of the customer. He should be able to furnish information on the following points: business identity and legal responsibility, management ability, habits, local reputation, desirability of location, local conditions, bank and creditor references, and some indication of the financial status of the business.

It is apparent that much of the information furnished by salesmen is in the nature of opinions. Hence, the value of the information must be considered relative to the knowledge, experience, and attitude of the reporting salesman. Another factor affecting the quality of information is the relationship between the credit department and sales department. E. B. Moran, Executive Vice President, National Association of Credit Management, in recognizing the need for close co-operation between credit and sales writes:

> . . . a salesman is in a position to obtain and pass along valuable information which will help his credit department to better help him This is particularly true in the case of new accounts. This is why progressive management today requires the closest possible cooperation between the credit manager and the salesmen; why credits and sales are being coordinated as never before; why frequent consultations and conferences between those in sales and those in credits are necessary if the business is to prosper and grow.[3]

In view of the foregoing, it should be apparent that both the credit manager and sales manager are justified in insisting upon each other's co-operation. The wisdom of this attitude needs no explanation for progressive sales and credit people. It is desirable that the credit department supply salesmen with printed forms which, when completed, will reveal the types of information previously outlined. Financial statement forms are usually left with the customer for his completion and direct return to the credit department.

Direct Interchange. Other creditors who are known to have had experience with the subject under investigation are another source of credit information. It is common practice for creditors to exchange their experience as evidenced by accounting records and also to give their personal opinion of credit risks. Some credit men believe this source to be one of the most valuable at their disposal.

[3] Edwin B. Moran, *The Credit Side of Selling* (Chicago, Illinois: Dartnell Corporation, 1947), pp. 13–14.

The direct interchange of ledger information may be effected either by correspondence or personal contact with other creditors, or through trade group meetings sponsored by the National Association of Credit Management. Personal contact is the most costly method and it consumes the valuable time of the credit manager or his representative. Therefore, this method should be limited to those cases in which there is substantial credit exposure for the inquiring creditor, and in which other methods are clearly not practicable. On the other hand, correspondence with other interested creditors is low in cost and obligates a minimum of the credit manager's time. The creditor employing the correspondence method must be prepared to cope with delays caused by the respondents' lack of promptness and delays caused by other contingencies of sending inquiries through the mails.

Trade group meetings, sponsored by the National Association of Credit Management, take place each month throughout the country. Credit executives in the same, or allied lines of business, or selling the same customers, meet to discuss their joint problems and their experience with individual accounts. Some of the trade groups represented are food, drugs and chemicals, hardware and building materials, iron and steel, textiles and ready to wear, petroleum and auto accessories, and the electrical industry. At present, several hundred such meetings occur each month in the major metropolitan areas.

Typically, trade group meetings are conducted so that all members have an equal opportunity to request exchange of experiences with individual accounts. Those desiring information submit the names of the accounts on which information is sought to a group chairman or secretary. In some localities, the procedure is quite formalized and the names are circulated among the members in advance of the meeting. Hence, creditors are prepared to reveal the needed information. In most areas the account names are called off at the meetings and those recalling their experiences voluntarily relate them to the group. This method results not only in an interchange of ledger facts, but also an interchange of other confidential facts that could only have been acquired by personal contact with the account in question.

Although the quantity of information supplied by direct interchange may vary with the approach used and the type of creditors contacted, this source can supply the age of the account, the highest recent credit approved, the manner in which the account has been paid, and the terms of sale; and an indication of the current status of the account and trade abuses. Furthermore, many credit managers get the responding credit managers' personal opinions regarding the credit worthiness of the cus-

tomer in question. The advantages of soliciting information from other creditors are:

1. The information is the result of other creditors' experiences. The inquirer can reasonably expect his experience to correspond to that of other creditors.
2. The information is divulged by one who is qualified to recognize the problems confronting a fellow creditor.
3. The inquirer will endeavor to solicit data from those credit managers who have demonstrated their co-operativeness, reliability, and good judgment.
4. The information, under most circumstances, can be obtained more quickly.
5. The information is up-to-date and therefore is of current value.
6. Financial conditions of a mutual customer change from time to time. Contacts with others who are selling the same account prohibit debtors from becoming seriously past due without it being known by other houses.

Banks. The name of the customer's bank can be obtained by direct inquiry, from a commercial agency's report, or by noting the bank on which his checks are drawn. Once this is known another source of useful information is available to the credit representative.

Banks and commercial creditors are in a position to be of mutual assistance with respect to the gathering of credit information. This is true because of the large number of banking accommodations used by the typical business enterprise, and the frequency with which they use their bank accommodations. Similarly, most business concerns are dependent upon commercial credit to meet their inventory, equipment, and miscellaneous requirements. Hence, both banks and commercial creditors have much the same credit information needs. They complement each other in that they both maintain rather extensive credit files.

Despite the help each could be to the other, both banks and commercial creditors fall short in reaching the co-operative ideal. Presumably some banks refuse to reveal some or all of the data requested, and commercial creditors are more inclined to inquire of banks than banks are to inquire of them. An informal check with a number of commercial creditors lends support to unfavorable bank attitudes and the lack of understanding existing between these two creditors. To improve relationships with banking institutions it may be well for commercial houses to examine their methods of approach and the content of their requests. One of the best ways to get complete information from a bank is by personal contact. Credit managers should make it a point to become well acquainted with the members of their bank's credit department. It is quite possible that bank personnel are not aware of the storehouse of facts maintained by many commercial creditors. Furthermore, the credit

manager may be able to exert some influence in the placing of his company's deposits. Once this relationship has been cultivated and a higher degree of mutual confidence is developed, the possibility of acquiring more complete information exists. Requests for information should be by letter which explains clearly the purposes of the inquiry, the nature of the creditor's experience with the subject, and the banking connections of the subject. In general, inquiries should be made to the bank with which the subject does business. Under some circumstances bank credit departments are willing to make inquiries of other banks in behalf of their customer-creditor. The specific procedures to follow should be discussed by the creditor with his bank's credit department.

Commercial banks are in a position to supply the following information to commercial creditors.[4]

1. The length of the experience with the depositor and/or borrower.
2. An indication of the average bank balance on deposit expressed in general terms as "medium four-figure balance," "high five-figure balance," or "low six-figure balance."
3. How the subject meets obligations of which the bank has knowledge such as notes and trade acceptances.
4. The frequency and form of borrowing as well as other bank accommodations used by the subject.
5. The form of security required if any.
6. An evaluation of the subject's financial condition in general terms.
7. The local reputation of the enterprise and its principals.

When the above facts are furnished by the bank, they contribute importantly to the process of measuring the acceptability of the applicant's credit. These data permit the analyst to verify more closely the reliability of the stated values as shown on the financial statement(s) furnished by the customer. Furthermore, an indication of the local reputation and some idea of the capabilities of the business and its principals are revealed.

Even though the customer under consideration may not be a borrower from the bank, it should be noted that the bank may have had experiences with him in the past. The customer may have made requests of the bank for credit which have been denied; or, he may have had overdrafts, or made unusual demands of the bank. Banks will frequently reveal this kind of information as well as the other types already noted.

Attorneys. Attorney credit reports are not used as extensively today as they were in the past. Because the attorney is situated locally, he is qualified to give information based on his professional associations and

[4] Adapted from Watrous H. Irons and Douglas H. Bellemore, *Commercial Credit and Collection Practice* (2nd ed.; New York: Ronald Press Co., 1957), pp. 146–47.

local observation. But, there is little value in seeking the services of an attorney located in large metropolitan centers where it is difficult for him to observe particular business concerns or associate with those who are acquainted with the subject enterprise. Furthermore, it is not possible for creditors to provide sufficient monetary inducement to attorneys who might otherwise be willing to search for credit facts regarding a subject.

When the credit risk operates a business in a smaller community there is a likely possibility that an attorney can be helpful in supplying information he already possesses. If this is the case the compensation for completing a credit report can be quite nominal. Some attorneys will furnish information free in return for the understanding that they will handle any collections and suits in their area at their regular fee.

In inquiring of this source, creditors can use letters or forms so designed that the attorney's report will include an appraisal of business ability, habits, location, local reputation, local conditions, estimated net worth, value of real property and encumbrances thereon, and any claims and suits. Information on these factors would be a substantial addition, in a supplementary way, to the larger mass of data before the credit analyst. The greatest value of the attorney's report lies in the fact that it is up to date; it permits verification of some of the stated values on financial statements; it contributes a firsthand observation of reputation and business ability; and, it may inform the creditor of existing local conditions which have a tendency to affect the quality of the risk.

Other Sources. The reading of publications will contribute to the resourcefulness and general knowledge of any credit man. Often, information of general character appears in business magazines and trade publications which help the reader to keep abreast of the times. Articles and data dealing with changing economic conditions and effects of developments upon specific fields of endeavor are valuable types of information.

Under certain circumstances the facilities of local retail credit bureaus, the Retail Credit Company of Atlanta, or the Hooper-Holmes Bureau may be helpful to the credit manager. These agencies, while devoted primarily to retail credit reporting, perform a number of special investigations. In particular they are useful and valuable sources of information when the identity of a business account and an individual are one and the same. A sole proprietorship, of which there is a great number, is a case in point. One of these sources may also be utilized when company officers or the value of their personal guarantees need further investigation to establish a more accurate appraisal of the degree of risk.

EVALUATION OF INTERNAL INFORMATION AND DIRECT INVESTIGATION

It is apparent from the foregoing analysis that the noncommercial sources of credit information can be used by most credit managers. The types of information supplied by these sources can be helpful in determining the credit worthiness of new accounts and in revising credit lines of existing accounts. Earlier it was established that the credit analyst needed various types of credit information in order to pass objectively on the acceptability of a customer's credit. Before commercial creditors could adequately appraise an account, it was shown that they would have to reconcile the answers to questions involving an account's identity and legal responsibility, history and business background, character and responsibility of management, financial ability and capacity, financial strength and outlook, and payment record.

By tapping the noncommercial sources credit managers may be able to acquire all the needed information to make a logical and sound credit decision. For example, there is no better nor more complete source of information than the subject business enterprise itself. All information, whether acquired directly or indirectly, originates with the account under investigation. Practically, however, it is seldom that a single source of information supplies *all* the data needed to fulfill the creditor's concept of "adequate information." Recognizing the deficiencies inherent in contacting one source, credit managers can inquire of other noncommercial sources. They can check the subject's record by examining their own files; they can inquire of other creditors regarding their experiences; they can develop financial information and verify the stated values on financial statements by contacting the customer's bank; or, they can tap any other "free" source.

Despite all these possibilities confronting the credit manager, it is neither good judgment nor prudent to rely entirely on the limited number of noncommercial sources. Accounts deserving of rejection can keep their record clean with a limited number of suppliers. They may even be regarded highly by their bank, by close business associates, and by the creditor's salesmen. In other circles financial deterioration is known to have set in. It is not unusual practice for businesses experiencing difficulty to channel their remaining strength into those hands which can be most helpful in maintaining their credit reputation.

Of more importance to all credit managers is the fact that they are too concerned with other financial problems of the business to become expert credit investigators. Therefore, the noncommercial sources are best uti-

lized when regarded as a supplemental source of credit information. Even though the credit manager frequently uses the noncommercial sources, he should not fail to recognize that it augments the purchased information which comes to him from a much greater storehouse of credit facts.

Of all the sources of credit information available to the credit analyst, the most extensive are the reports of the commercialized organizations which are discussed in subsequent chapters. They have as their major purpose the gathering and reporting of all types of information which affect the quality of a business's credit. This perhaps accounts for the fact that they are also the most frequently used sources.

REVIEW AND DISCUSSION QUESTIONS

1. What general questions must be answered before a commercial credit customer's credit can be objectively appraised?
2. In selecting particular sources of credit information a number of the characteristics of the various sources must be evaluated. What are these? Which two do you regard as the more important characteristics to look for? Discuss.
3. What comprises internal credit information?
4. Why should salesmen be required to gather credit information? Are they always in a position to co-operate with the credit department?
5. What is meant by the term "direct interchange"?
6. How are the trade group meetings of the NACM conducted?
7. What are the advantages of credit managers soliciting credit information from other interested creditors?
8. Enumerate the steps that might be taken so as to improve the relationship between commercial credit men and bank personnel dealing in credit work?
9. What types of credit information can usually be supplied by banks?
10. Assume you are a commercial credit manager: Would you utilize direct investigation to acquire credit information? Why or why not?

CHAPTER 24

Basis of the Commercial Credit Decision (cont.) Dun & Bradstreet, Inc.

THE DEGREE TO which the credit analyst uses the noncommercial sources of information discussed in Chapter 23 will depend on his judgment of the particular needs of the typical credit cases before him. While internal information and direct investigation are essentially noncommercialized sources of information, credit management has at its disposal a variety of commercialized sources of credit information. As pointed out earlier a commercialized source of credit information is one that has as its dominant function the organized supplying of credit information in return for compensation. In this chapter and the several chapters that follow is presented a discussion and analysis of the commercialized sources of information at the disposal of commercial creditors and commercial bank creditors. The commercial sources of credit information are of three principal types. For purposes of clarity they may be classified as follows:

1. *The general mercantile agency*—reports on *any* business enterprise to subscribers upon request.
2. *The specialized mercantile agencies*—report on business enterprises in *particular lines of trade* to subscribers upon request.
3. *The Credit Interchange Bureaus of the National Association of Credit Management*—operate for the systematic exchange of ledger information among members.

It will soon be apparent that the services of the commercialized sources of credit information are quite varied and somewhat complex. It

is therefore imperative that credit management be thoroughly familiar with these sources, just as it is necessary that it be well acquainted with the kinds of information it can obtain internally and by direct investigation.

THE GENERAL MERCANTILE AGENCY

The activities of Dun & Bradstreet, Inc. are more extensive than any other credit reporting organization, and it is frequently referred to and classified as the only "general mercantile agency." The general agency has a multitude of activities, but its primary function is to supply credit reports on business concerns of *all sizes, in all lines of trade,* and *located anywhere in the United States* and many foreign countries. When contrasted with the limited scope of operations of the several specialized agencies, Dun & Bradstreet is appropriately classified as the general mercantile agency. Even with the widespread operations and numerous services Dun & Bradstreet does not occupy a monopolistic position in the field of credit reporting. The various specialized agencies are its competition, and these agencies operate in particular lines of trade in which management may select the services of the general agency or one of the specialized sources of information. In fact, as treated elsewhere credit management may find it quite desirable to utilize the services of a specialized agency because it may serve the creditors' interests more completely, economically, and effectively. Despite the competitive atmosphere of this field, Dun & Bradstreet has grown and prospered with the commercial development of the country. Its scope of operations is so vast that it is the most frequently used source of credit information, with offices in 140 principal cities in the United States and in the leading centers of world trade.

Origin and Development of Dun & Bradstreet, Inc.

The need for credit information developed from the needs of businessmen whose areas of trade expanded with the widening frontiers. A century ago, or even less, there was only a remote possibility of securing organized and factual data with which to make a credit decision. Credit decisions were made by the "hit-and-miss" method. Terms were long; the relationship was often a personal affair; and some credit transactions were based solely upon references furnished by customers. These methods resulted in large credit losses which had to be offset by greater margins of profit.

During the period of 1820–40, the economic and social pattern of

the United States underwent radical changes. The Erie Canal was opened in 1825, and railway building was begun in 1828. Settlers began to pour into the new West to cultivate the fertile lands of the Ohio-Mississippi Valley. The factory system appeared and began to expand rapidly in New England; the growth and movement of the population commenced the development of new urban areas. This expansion in turn, created new markets for the industrial products of New England and the agricultural products of the farmers. This period of expansion was also one of inflation which finally culminated with the panic of 1837. A large number of business firms failed and credit losses skyrocketed until the end of the depression in 1843.[1]

During the panic, the firm of Arthur Tappan and Company failed. A brother, Lewis Tappan, who was associated with the firm, had gained a wide reputation as an excellent judge of a credit risk. His personal interest in the subject of credit investigation, his reputation in appraising a credit risk, and the steadily growing nation suggested the idea of organizing a central credit reporting bureau. On June 1, 1841, he organized The Mercantile Agency to collect and disseminate information for the benefit of creditors.[2]

America continued to experience a rapid rate of expansion and prosperous economic conditions, with the exception of several occasional setbacks, until 1900. These years were characterized by marked commercial expansion with the milling, meat packing, and iron and steel industries being the three leading industries late in this period. An increasing number of immigrants entered the country; more new territories of the West were opened up; the railroad industry was expanded beyond all proportion to the immediate needs of the country; and roadways formed a web-like network through the settled areas. The abundance of natural resources, the development of modern means of communications, and the like, all contributed to the continued expansion and development of our vast modern nation.

The impetus for the development of organized sources of credit information grew out of the uncertainties and losses experienced during the Panic of 1837, the rapid changes in the economic structure, and the expansion of trading areas. For manufacturers and suppliers an increase in the use of credit was essential to trade over the wider geographical

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[1] Reginald C McGrane, *The Economic Development of the American Nation* (Boston: Ginn & Co., 1942), pp 220–87 and pp. 389–93

[2] For an authoritative and detailed account of the origin and development of Dun & Bradstreet see Roy A. Foulke, *The Sinews of American Commerce* (New York: Dun & Bradstreet, Inc., 1941).

areas. This meant that no longer could credit judgment be founded on personal relationships, nor could adequate information be gathered in the immediate vicinity of the creditor. Consequently, paralleling the economic development of the nation, there evolved a system of organized credit reporting which was designed to eliminate some of the major uncertainties of trade.

Soon after Arthur Tappan founded The Mercantile Agency at New York in 1841, a branch-office system was developed which penetrated into the major trade centers. Reporters made visits to each community to interview the new and established businessmen. R. G. Dun was employed by The Mercantile Agency in 1851, and became the sole proprietor of the company in 1859. He changed the name shortly thereafter to the R. G. Dun & Co. In 1849 John M. Bradstreet, an attorney in Cincinnati, founded The Bradstreet Company. This company operated in manner similar to The Mercantile Agency and served the same fields of trade for many years. Their coexistence ended in 1933 when the two firms were merged under the trade name of Dun & Bradstreet, Inc.

The development of organized sources of credit information has contributed heavily to greater confidence between debtors and creditors. By virtue of these developments, businesses of all types have had eliminated for them many of the uncertainties surrounding their credit transactions. Credit judgment thus became more logical. Regardless of the location of the customer, the investigative procedure was speeded. The mercantile agencies have facilitated the breaking down of the barriers of distance so that a merchant may trade as safely with customers in remote parts of the country as with those situated close at hand.

THE ORGANIZATION, SERVICES, AND ACTIVITIES OF DUN & BRADSTREET, INC. TODAY

The activities and services of Dun & Bradstreet, Inc. are more extensive than any other credit-reporting organization. To facilitate the tremendous task of collecting, assembling, analyzing, and disseminating credit information, it employs the services of some 2,000 full-time reporters and approximately 20,000 part-time correspondents who gather credit information from business enterprises throughout the United States and Canada. In addition there are correspondents in many other parts of the free world. The reporters' activities are supported by a staff of 8,000 analysts, supervisors, and clerks in the various offices located in the principal trading centers of United States and Canada. To administer and control its activities and services the United States is divided into 12

regions and further subdivided into 42 districts. Under the supervision of the district offices there are 140 offices located in the larger cities of the various districts. The operations in Canada consist of 18 offices operated by the wholly owned subsidiary, Dun & Bradstreet of Canada, Limited. The files of the mercantile agency contain information on approximately 3,000,000 business concerns in the United States and Canada. A complete file on each of the many business houses is maintained in the New York and Chicago offices alike. The entire operation of Dun & Bradstreet in the United States, Canada, and its foreign branches and foreign correspondents is administered and controlled from the general offices located in New York City.

Principal Activities of Dun & Bradstreet

The activities of Dun & Bradstreet in serving the needs of businesses are both numerous and varied. Its principal activity is that of supplying credit information, but over the years it has developed a number of services which are of primary interest to business management and the business community. The diversity of its activities may be summarized as follows:

1. *Credit report services*—investigates, analyzes, and edits credit reports on commercial and industrial enterprises and municipalities. Reports have the same basic characteristics but are prepared to reflect the varied complexities of financial structure.
2. *Reference book service*—compiles and publishes a credit reference book six times a year which contains almost 3,000,000 business concerns in the United States and Canada. The January and July revisions are also published in State Editions, and City Editions are available on several of the larger cities. The "pocket editions" are useful to executives and salesmen active in the field.
3. *Apparel trades service*—a service designed to meet the special needs of business firms trading in the apparel field. This service is rendered through the Credit Clearing Division formerly known as the Credit Clearing House. This division renders credit reports especially designed to fit the needs of the apparel lines and supervises the publication of the Apparel Trade Book four times a year.
4. *Mercantile claims division*—a collection service which collects past-due accounts through the mails or by means of personal call.
5. *Marketing research services*—provides a wide range of business research services to clients. Studies and surveys include industry appraisals, market appraisals, sales potentials, consumer attitude studies, and others.
6. *Municipal service department*—serves financial and investment enterprises in rendering credit reports on states, counties, cities, and other governmental units. Studies include economic and social characteristics,

management of the municipality, the debt record, and current operating data.

7. *Publications*—publishes *Dun's Review and Modern Industry,* a monthly magazine with articles concerning business conditions and techniques that are of interest to business management. Also publishes a wide variety of business statistics, business charts, and business operating ratios which are useful to business management in many phases of their operations

Of all the activities of Dun & Bradstreet the one which is generally considered of outstanding importance is the collecting, assembling, and analyzing of credit information. It is this function on which the many other activities are intricately dependent.

Methods of Collecting Credit Information[3]

To accomplish the tremendous task of collection credit information, Dun & Bradstreet employs personal investigations and mail inquiries. The personal investigations are made by one of the four types of reporters which the general agency has found necessary to gather effectively credit information under all conditions. *City reporters* make credit investigations on businesses located in those cities where Dun & Bradstreet maintains a branch office. They are usually assigned a particular territory within the city so as to become more intimately acquainted with the sources of credit information and with managements of businesses in the section. In the larger cities of the country businesses are further classified by their common characteristics and a city reporter will investigate particular types of firms within the specified geographical division. *Resident reporters* operate from their homes located in the important cities or towns nearby the larger metropolitan areas. For example, resident reporters in the New York City area include the communities of Middletown, Newburgh, White Plains, Jersey, and Stanford in Connecticut.[4] This type of reporter receives his lists of concerns to be investigated by mail and he returns his findings in the same way. He is not so highly specialized as the city reporter inasmuch as he is required to investigate business concerns of all types and sizes. *Traveling reporters* have the task of revising and bringing up to date the credit information currently in the files of the supervising office. This is known as "automatic revision." Unlike the other reporters he seldom is called upon to perform immediate investigations. As he goes on his circuit he periodically mails the revised and new information to his supervising office. The

[3] For a more detailed account of Dun & Bradstreet's methods of collecting credit information the reader is referred to *The Stneus of American Commerce,* pp 305–10.

[4] *Ibid.,* p. 307.

information he gathers is used to keep the latest available information which the system affords in the files of Dun & Bradstreet offices. His schedule provides for a visit to each business concern in his territory once each year irrespective of the visits that may have been made by other reporters. *Local correspondents* are bankers, attorneys, real estate men, merchants, and the like who devote only part of their time to credit investigations. Typically they are located in most of the cities, towns, and villages which do not have established Dun & Bradstreet offices. Their task is to perform immediate investigations at locations where resident reporters are not maintained or between the visits of the traveling reporter.

Most credit investigations of business concerns follow a similar pattern. The reporter first interviews the principals of the business, confirms ownership, notes details of its operations and methods, obtains a financial statement, and discusses future plans and sales trends. He may also investigate outside the business concern to gather additional facts or verify existing information. Interviews with bankers, accountants, and other informed sources are typical. The reporter may also be required, by virtue of necessity, to check court and other public records. City reporters also analyze the information and prepare the credit report, but those reporters who send data through the mails to their supervising office do not prepare the report. "Report writers" located at the many branch offices analyze the credit information received from the outlying areas and prepare the credit report.

Simultaneously with the gathering of information by personal interview and mail inquiries, the home office has been sending out trade inquiries to the subject's creditors throughout the country. These inquiries reveal the manner in which the subject is paying current obligations. This information includes the recent high credit, the terms of sale, amount owing, amount past due, and remarks which reveal the terms and manner of payment. Combined with information gathered by reporters, the report writer has all pertinent data available for analysis and inclusion in the written report.

Principal Types of Credit Reports

Dun & Bradstreet issues several kinds of credit reports, varying in degree of comprehensiveness or adapted to the particular sales and credit needs of subscribers. For commercial and industrial enterprises the regular report and analytical report are the most comprehensive and frequently used. The analytical report is written on large, financially complex concerns and the regular report is prepared on all others,

mostly the smaller concerns. Dun & Bradstreet international reports are written on overseas concerns operating in the world markets; municipal reports are issued which analyze municipal finance operations; fire insurance reports are prepared for the special use of fire insurance companies and underwriting firms; and Personal Security and Key Employee reports are written for subscribers when knowledge of an employee's character and loyalty is required.

Regular Reports

A typical, though fictitious, regular report is illustrated in Figure 24–1. In addition to the heading, which identifies the credit subject and shows the latest available rating, these reports are divided into five principal sections. The sections are designated *Summary, History, Operation-Location, Financial Information,* and *Payments.*

The *Summary* is a condensation of the material contained in the body of the report. In all instances it covers starting date, net worth, payments, and sales. These elements are followed by a narrative statement summarizing the important features of the business. This statement may be a concise, single sentence, or it may be more detailed and consist of several brief statements. Its precise content is quite obviously dependent on the nature of the enterprise and the amount of credit-worthy information gathered by the reporter.

Under the *History* section, the names and ages of the principals or owners of the concern and their business experience are revealed. This section emphasizes the length of time the principals have been associated with this business, their past business experience, their other or outside business affiliations, and the financial difficulties that they may have experienced in the past.

The *Operation-Location* part of the report describes precisely what the enterprise does and the nature of its location. Considerable detail may be necessary in this section to describe adequately what products or services are produced or marketed; the pricing and credit policies; the character of the operation and its class of customers; the seasonal aspects of the business; the number of employees; and the like. The physical characteristics are also covered by describing the business location, its physical proportions and characteristics, and the equipment used. In other words, this section details the production and marketing aspects of the business.

Financial Information is included in all Dun & Bradstreet reports. In most reports there is a financial statement which the investigation has supplied. If available, comparative financial data are presented for three

FIG. 24–1. Typical regular report prepared by Dun & Bradstreet, Inc. (fictitious).

Dun & Bradstreet Report

RATING UNCHANGED

SIC	NAME & ADDRESS	STARTED	RATING
	CD 13 NOVEMBER 4 1959 N		
59 12	KENT DRUGS	1949	E 2
	124 KENT ROAD ST BERNICE MICH CARLTON COUNTY	TRADE SALES WORTH EMPLOYS	DISC $ 89,232 22,901 2 PART TIME
	MILES GROSS, PARTNER HANNAH (MRS MILES) GROSS, PARTNER		

SUMMARY SALES ARE INCREASING AND FINANCIAL CONDITION IS SOUND

TRADE

HC	OWE	P DUE	TERMS	Oct 21 1959	
2431	2000		10th of Mo	Disc	Sold over 3 yrs
300	200		2-10-N 30	Disc	Sold 2 yrs Last Sale 6-59
250			2-10	Disc	Sold over 3 yrs
136	136		2-10th Prox	Disc	Sold over 3 yrs
75			2-10-EOM	Disc	Last Sale 10-59
15			30	Ppt	Sold 2 yrs

FINANCE

Statement Sept 30 1959 -

Cash on hand	$ 304	Accts Pay	$ 3,724
Cash in bank	1,872		
Merchandise	14,450		
Total Current	16,626	Total Current	3,724
Fixt & Equip	9,913		
Deposits	86	NET WORTH	22,901
Total Assets	26,626	Total	26,626

Net sales from Oct 1 1958 to Sept 30 1959 $89,232; gross profit $26,181; salaries and drawings of partners $6,732; net profit over and above salaries and drawings of partners $3,457. Monthly rent $150 on a five year lease. Signed Oct 20 1959 KENT DRUGS by Miles Gross, Partner
Received by Mail, No accountant indicated

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Residential construction has stepped up in this section with the result that both sales and profits of this business have mounted steadily. Part of earnings have been re-invested in the business every year to finance its steady growth.

On Nov 4, 1959 Miles Gross stated that sales are now picking up slightly, as is usual in the Fall. Some thought has been given to opening a second store, he said, but so far he has not been able to find the right location.

OPERATION Operates a pharmacy and soda fountain. Drugs and prescriptions account for 50% of sales, with the remainder equally divided among fountain, sundries and confectionery. Fixtures and a twenty-foot soda fountain are new. Both partners are active and there are two employed on a part-time basis. LOCATION: Rents first floor of a two story building in good condition. Store measures about 20 x 50 feet. It is located in a residential section developed during the past ten years.

HISTORY The style, "Kent Drugs" was registered by the partners on April 30, 1949.

This firm was formed April 1949, starting capital consisted of $10,500 savings, a $3,500 loan from Teachers Credit Union, and a $3,000 loan from the partners' families, making a total of $17,000. Loans have since been repaid.

Miles Gross 41, is native born and a registered pharmacist. He was graduated from Columbia College of Pharmacy. He then was employed as pharmacist by Liggett Drug Co. and by Ray Drug Co. until this business was started.

Hannah (Mrs Miles) Gross is 36. She was a school teacher prior to formation of this firm.

11-4-59 (874 85)

PLEASE NOTE WHETHER NAME, BUSINESS AND STREET ADDRESS CORRESPOND WITH YOUR INQUIRY.
The foregoing report is furnished at your request under your Subscription Contract in STRICT CONFIDENCE by DUN & BRADSTREET, Inc. as your agents and employees, for your exclusive use as an aid in determining the advisability of granting credit or insurance and for no other purpose ORS 2 (30453)

years. Balance sheet data are usually supplemented by profit and loss information together with information on leases, fire insurance coverage, and other pertinent financial information. Following this a statement is made regarding the sales and profit trends.

When no statement is furnished by the subject, the financial information is prepared by the credit reporter who may get information from any source which is prepared to estimate financial conditions. When this is done the financial information is based on interviews with banks, courthouse and realty records, or calls on the "trade" and other logical sources of financial information.

The *Payments* section records the manner in which the subject pays his obligations. It is a reflection of suppliers' ledger experiences and each line in the *Payments* section represents the experience of one supplier. The six columns of this section show for each reporting creditor the highest amount of credit extended to the subject during the past year, the amount now owing, the amount past due, the terms of sale, the manner of payment, and any clarifying or explanatory remarks about the account.

Analytical Reports

The subscriber who requests a credit report on a business concern which is large and financially complex will receive an analytical report. A fictional analytical credit report similar to an actual report prepared by Dun & Bradstreet is shown in Figure 24–2. This report has the same basic characteristics as the regular credit report just discussed. The credit elements needed to arrive at a sound and rational credit decision are the same whether the business concern be large or small. Typically, larger concerns have more information to reveal and it may be presented in a more formal style. The more complete accounting reports and the ease with which financial data can be gathered on larger concerns contribute to the completeness of the credit information contained in the analytical report.

Inasmuch as extensive amounts of credit are required by large enterprises the analytical report expands on those elements most pertinent to the credit analyst. In addition to the expanded sections pertaining to the business concern's history and operation-location, it should be noted that much emphasis is given to comparative analysis of financial statements, ratio analysis of such statements, banking connections, and other financial aspects. All of this is the result of the more complicated financial and organizational structure of the larger concerns, and the need for a more complete and otherwise more satisfactory analysis of the firm. As the title of the report suggests, it is the most extensive and voluminous

FIG. 24–2. Analytical report prepared by Dun & Bradstreet, Inc. (fictitious).

ANALYTICAL REPORT

RATING CHANGE

D U N & B R A D S T R E E T, I N C.

2071 (A) CD 4 AUGUST 18 195-
BRISTOL CANDY CORP MFG
BRISTOL 3 PA
BUCKS COUNTY
100 EDGELY ROAD

Chester G. Hoover - President F. Charles Young - Vice President
Henry T. Conroy - Secretary & Treasurer

DIRECTORS: The officers and Mrs. Mary S. Lawrence

RATING: B I to B+ I

STARTED: 1916 (Present Control 1946) PAYMENTS: Discount
NET WORTH: $312,817 SALES: $1,106,165

SUMMARY

LAST MARCH THE PLANT WAS EXPANDED GREATLY TO INCREASE PRODUCTION AND LOWER COSTS. CURRENT FIGURES SHOW THE INITIAL RESULTS. SALES ARE UP ABOUT 40% AND EARNINGS ARE UP EVEN MORE. THE FINANCIAL POSITION CONTINUES STRONG.

HISTORY

STARTED: October, 1916 by F. Bradford Lawrence, who died in March, 1946. Under the provisions of his will, the three key employees were bequeathed a 50% interest in the business and the subject corporation was formed to carry out this provision.

INCORPORATED: June 29, 1946 under Pennsylvania laws.
Authorized Capital Stock: 250,000 shares Common $1.00 par value.
Outstanding Capital Stock: 150,000 shares.

MANAGEMENT & CONTROL: Mary S. Lawrence, the widow of F. Bradford Lawrence, the founder, owns 50% of the outstanding capital stock. The remainder is owned by Chester G. Hoover (25%), Henry T. Conroy (15%), and F. Charles Young (10%). Life insurance of $25,000 is carried on each officer with the corporation as beneficiary.

Chester G. Hoover, born 1886, married. Employed sales department, Federal Biscuit Company, Philadelphia, 1913-1923. Since associated with this business as General Sales Manager to June, 1946 when he was elected President and General Manager.

Henry T. Conroy, born 1903, married. Cashier of Fidelity Trust Company, Baltimore 1924-1931. Then employed as Office Manager of this business to 1946 when he was elected Secretary and Treasurer.

F. Charles Young, born 1898, married, was employed in the plant from 1923 to 1935 when he became Plant Superintendent. Elected Vice President in June, 1946.

Mrs. Mary S. Lawrence takes no active part in the management.

OPERATION LOCATION

Products: Manufactures packaged confections, including chocolates, hard candies, and novelty sweets, (U.S. SIC #2071). Seventy-five percent of the volume is in chocolates which retail from $1.25 to $2.50 a pound. Brand Name: "Honey Crunch".

Distribution: To retail candy (35%), chain (25%), drug (20%), grocery (10%) and department stores (10%).
Number of Accounts: 2,000 active.
Terms of Sales: 2%-15-Net 30.
Territory: The Eastern Seaboard from Maine to Florida.
Seasons: Sales are highest in November and December (40%).
Salesmen: 10 on salary and commission.
Employees: 125.

Production Facilities: Owns and fully occupies a three-story brick building, sprinkler equipped, comprising 50,000 square feet of floor space. Also an adjacent two-story brick building which formerly housed the plant but is now used for warehousing. The buildings, machinery and equipment are in excellent condition.

(CONTINUED)

FIG. 24-2—*Continued*

ANALYTICAL REPORT

RATING CHANGE

D U N & B R A D S T R E E T, I N C.

BRISTOL CANDY CORP
Page 2 (A)

BRISTOL 3 PA
AUGUST 18 195-

COMPARATIVE FINANCIAL STATEMENTS

	Jun 30 195-	Jun 30 195-	Jun 30 195-
Cash	$ 78,171	$ 72,913	$ 87,486
U.S. Govt Bonds	36,710	70,126	---
Accounts Receivable	38,040	29,584	68,640
Inventory	58,053	71,874	138,442
TOTAL CURRENT ASSETS	210,975	244,499	294,570
Fixed Assets	31,232	28,549	253,755
Cash Value Life Insurance	4,154	5,047	6,416
Prepaid Expense	2,036	1,947	6,496
TOTAL ASSETS	248,398	280,043	561,237
Due Banks	---	---	25,000
Accounts Payable	20,179	9,802	10,654
Federal Income Taxes	30,395	38,712	79,131
Accruals	18,049	12,816	8,635
TOTAL CURRENT LIABILITIES	68,624	61,331	123,420
Due Bank-Deferred	---	---	125,000
Common Stock	150,000	150,000	150,000
Earned Surplus	29,774	68,712	162,817
TOTAL LIABILITIES	248,398	280,043	561,237
NET WORKING CAPITAL	142,350	183,168	171,150
CURRENT RATIO	3.07	3.98	2.38
TANGIBLE NET WORTH	179,774	218,712	312,817
Net Sales	735,198	771,035	1,106,165
Net Profit	54,774	68,938	124,105
Dividends	15,000	30,000	30,000

CENTS OMITTED. The foregoing figures were prepared from annual financial reports of the auditors, James Wheaton & Co., C.P.A.'s, Philadelphia, Pa. Statements were received by mail accompanied by transmittal letters signed by Henry T. Conroy, Treasurer. At the last statement date, Accounts Receivable were net of a reserve for bad debts of $3,106. Fixed Assets were net of reserves for depreciation of $31,612. Inventory consisting of finished goods $44,106, in process $14,719 and raw materials $79,612, valued at the lower of cost or market under the "Lifo" method. Fire Insurance: Inventory - maximum coverage $200,000 under a monthly reporting policy; Fixtures and Equipment - $75,000; Buildings - $200,000. Contingent Debt: None

(CONTINUED)

FIG. 24-2—*Continued*

ANALYTICAL REPORT

RATING CHANGE

D U N & B R A D S T R E E T, I N C.

BRISTOL CANDY CORP
PAGE 3 (A)

BRISTOL 3 PA
AUGUST 18 19--

ANALYSIS

Annual sales volume has been at a high level since formation of this corporation. Net profits were correspondingly high and, except for moderate dividends, were retained and invested in Government bonds to finance a plan of plant modernization and expansion. Construction under this plan of fixed asset expansion was started early in the last fiscal year and completed in March. The cost of approximately $250,000 was financed with an unsecured term bank loan of $150,000 and liquidation of Government bonds. The term bank loan is payable $12,500 semi-annually for six years.

Net sales were 43% larger in the last fiscal year. This increase in the dollar volume resulted from both a 25% price increase in August, following a rise in raw material and labor costs, and increased unit sales subsequent to March. Net profit also was higher as a result of the sales expansion and lower unit production costs subsequent to March, when the plant and manufacturing improvements were completed.

In prior years, seasonal use was made of unsecured bank loans up to $100,000. There has been no recourse to this type of financing during the last three years as inventories were turned rapidly and the collection experience was excellent. Financial position at the last fiscal closing was sound. Compared to net sales of that period inventory comprised primarily of raw materials was equivalent to 45 days sales while accounts receivable were equivalent to 22 days sales.

TRADE INVESTIGATION

Sugar, the basic raw material used, is purchased on a sight draft basis under annual contract with one broker. Such drafts have been honored on presentation. Other raw materials, such as cocoa, flavorings, nut meats, and packaging materials are purchased from seven suppliers. Recent experience of the principal suppliers are included in the following results of a trade survey completed August 12,19--

	HIGH CREDIT	OWE	PAST DUE	TERMS OF SALE	PAYMENTS
1.	$ 30,000	3,450	-0-	2-10-30	Discount
2.	25,000	-0-	---	2-10-30	Discount
3.	5,555	-0-	---	2-10	Discount
4.	5,399	---	---	2-10-31	Discount
5.	5,000	---	---	2-10	Discount
6.	4,939	264	---	2-10-30	Discount
7.	3,000	---	---	2-10-30	Discount
8.	658	---	---	2-10	Discount
9.	Requirements	---	---	Sight Draft	Prompt

BANKING RELATIONS

An account is maintained at a local bank. Balances average in medium to high five figures. In 19--, a five-year, unsecured, term loan of $150,000 was granted. Other details of this loan are outlined under "Analysis". A low six-figure line of short term, unsecured, bank credit which is available has not been used in recent years.

8-18-5 (803 I 29)

type of credit report typically supplied to the subscribers of Dun & Bradstreet services.

Continuous Service

When a creditor subscribes to the Dun & Bradstreet services, he automatically becomes entitled to "continuous service" in addition to the regular and analytical reports supplied by the agency. This means that the agency will send the subscriber copies of all reports on the same account for one year from the date of initial inquiry. There is no additional charge for this service during the one-year period, but a charge is made for the successive years of service on any particular account. In this way subscribers can keep their credit files current for one year after showing an interest in an account without charge, and for longer periods by paying the nominal successive yearly charge.

The supplemental or revised reports furnished by this service are prepared for a variety of circumstances. The subscriber may receive a supplemental report because of a "rating change" which indicates a changed credit situation. Another may be issued because it is the "automatic revision" of the file which is accomplished every six months. Still another report may be issued when a new financial statement has been received by the agency. Finally, a special-notice supplemental report is part of the continuous service. This report may be issued by the agency because of other important changes which have a bearing on the credit information of the credit customer.

Key-Account and Special-Purpose Reports

Subscribers who have need for information beyond that found in the regular or analytical report, or beyond that supplied by continuous service, have available to them the agency's key-account reports and special-purpose reports. Each of these reports is designed to furnish comprehensive and detailed information specially requested by the subscriber. Key-account reports provide facts on important credit customers on which specific questions have been raised. Each such report attempts to answer fully the specific point(s) raised. This service continues for one year or until such time as the subscriber's interest in the account is satisfied. Special-purpose reports are designed to provide information necessary to make important business decisions. Such reports provide information necessary to appraise properly a wide variety of management, credit, and marketing problems.

Subscribers in need of these services indicate the nature of their question or problem on a special-request form. Each report is then prepared

so as to meet the particular need. Because of the comprehensive nature of these reports, the detailed and lengthy investigation, and the time necessary to accomplish them, these reports are quite costly.

Use of Credit Reports by Subscribers

Detailed credit reports are used by subscribers for both credit purposes and sales purposes. While it is obvious that credit reports are most usually requested to serve credit purposes, some of the same information is valuable to the sales department. Subscribers normally request reports for the following credit purposes:

1. To appraise the credit worthiness of a new account on which no data are on file and the reference book rating alone is not sufficient basis for a rational credit decision.
2. To review active credit files so as to keep informed regarding the progress and current condition of accounts. Periodic review of accounts is the basis on which customers' lines of credit and terms of sale are adjusted to their financial standing.
3. To determine the underlying causes of slow and doubtful accounts. Current information contributes to alert handling of these accounts which often may be converted from marginal accounts to profitable customers.
4. To provide a sound basis for decision when customers desire to expand their line of credit or when marked changes in paying habits occur.

In addition to the more normal uses cited above, credit reports should be requested whenever the credit manager's confidence in the debtor has been shaken. There are a number of circumstances which can create this condition such as radical fluctuations in the buying policies and financial dealings of a concern, or such things as fraud, misrepresentation, legal proceedings, and "acts of God" which vitally affect financially weak customers.

The use of credit reports by sales departments is of secondary importance but of sufficient value as to suggest their use for this additional purpose. Credit reports on new business enterprises and prospective customers are used not only to provide a basis for extending credit in the future, but also to determine the sales potentiality of the prospect. Salesmen are better equipped to sell when they have advance knowledge regarding a prospect's operations, scope of activities, and financial capacity. Similarly, when the periodic appraisal of old accounts warrants an upward adjustment in the line of credit or when it is determined that the full sales potential of a customer has not been reached, it is to the credit and sales departments' mutual advantage that this information be communicated to the salesmen.

The co-ordinated use of detailed credit reports as suggested above results in the greatest possible advantages to the subscriber concern. When credit reports serve a dual business purpose it is a simple matter to justify their costs before other business management.

THE DUN & BRADSTREET REFERENCE BOOK

The reference book department publishes the famous *Dun & Bradstreet Reference Book* which contains the names and credit ratings of approximately 3,000,000 commercial and industrial enterprises located throughout the United States and Canada. Although the agency is perhaps best known for this single activity, it should be abundantly clear that the preparation of credit reports is the backbone of the business. Some of the information gathered for credit reports contributes to the construction of the listings, financial ratings, and changes that occur in the reference book. Despite the fact that this function is of secondary importance in the operating scheme of Dun & Bradstreet, reference book ratings are frequently referred to by credit managers. In fact, the credit rating of a business enterprise is frequently the first step in credit risk appraisal. In many instances the rating alone, which is a composite summarization of financial strength, is sufficient to reveal a high degree of credit worthiness.

Contents of Reference Books

The reference book is published every two months and leased to subscribers. In addition to the larger volume which contains a complete listing of most businesses in every city, town, and village in the United States and Canada, it is also available in an edition covering only United States, and in a number of sectional editions which include listings of several states. Fifty-six pocket-size state and metropolitan editions are also published. These smaller editions are exact copies of the state and/or metropolitan information contained in the larger volumes. Company representatives, especially salesmen, use the "state" editions so as to appraise customers conveniently, build prospect lists, and gain helpful information about their territory.

The books contain the ratings on manufacturers, wholesalers, retailers, and other businesses on which Dun & Bradstreet has written a credit report. The plan of arrangement is strictly alphabetical by state, then by town within the state. Following the town name is the population, the county in which the community is located, and the name of the local

bank or banks. If no banking facilities are available the nearest community having such facilities is shown. These data are followed by the alphabetical listing of business concerns.

Each business name is preceded by a Standard Industrial Classification code number which indicates the nature of the business. For example, 52 51 is the code designating hardware. Similarly all hardware stores have this code number preceding their business name. Following the business name is an abbreviated description of the nature of the business such as Hwr, Dg. Htgsup, Wrwr which mean hardware, drug, heating supplies, and women's wear, respectively. The numeral immediately after some of these abbreviations indicates that the business was started within the last 10 years. The numeral is the last digit of the year within the 10-year period. To the extreme right, and following this information, appears the rating assigned to the concern. If the business concern's name was added with the current edition of the reference book, the letter "A" is posted to the left of the business classification code; the letter "C" appearing in the same place means a rating change has been accomplished with that particular edition. An illustration of a reference book page is shown in Figure 24–3.

Explanation of Ratings

A Dun & Bradstreet rating consists of two elements showing (1) the estimated financial strength, and (2) the composite credit appraisal. Figure 24–4 is the Dun & Bradstreet key to ratings. The "estimated financial strength" is expressed in the letter portion of the rating. This letter, which is one of sixteen code letters, designates the range of net worth or pecuniary strength of the risk. The "composite credit appraisal" is a general credit grade of high, good, fair, or limited and expressed by numbers and fractions.

"Estimated financial strength" is a conservative estimate of tangible net worth of the business. This is arrived at after analysis of the concern's financial statements or other financial data, after allowances for intangible items such as good will, patents, and other intangible assets.

The credit rating or "composite credit appraisal" is an estimate of the concern's ability and willingness to pay and its past history in meeting its obligations. It is based on the length of time in business, the abilities of management, general financial condition, the trend of the business, trade record data, and the like. If these factors are judged strong, a concern may be assigned a "high" credit rating, whereas factors judged to be weak will influence the setting of a lower rating. The exact credit rating

FIG. 24–3. Specimen page from *Dun & Bradstreet Reference Book.*

CALIFORNIA

59 82 Oliver V L.....BottledGasApl F 3
57)2
55 41 Pogany C F.....Sstn E 2
59 12 Robeck E W.....Drg E 2
54 13 Siepman Bernard A & Ardith (Mrs B).....GrMtLockers 1 —
42 33)2
52x62 Tidball Samuel B.....ImptAts C 2½

JAVA ▲ Walworth 72

Bk town Clintwood

12 11 B & H Coal Co .....Min 6 —
(Also Drill)
59 71 Becker's Jewel Box.... Jly 5 F 3
59 BA Bokay Flowers ..... Flor 6 F 3
59 32 Buston Geo & Mary.....Antiques E 2½
24 21 C & A Lumber Co Inc.. .... 2 K 3
27 11 Clinch Valley News ....PubgPrtg D+1½
C 55 99 Clinch Valley Trailer Sales.... —
55 41 Cline William M. .....Sstn J 3½
12 11 Consumers Mining Corp...MinGs F 3
55 41 Neel & McCann Motor Service 5 H 3½
(Also Richlands) Atrp
12 11 New Garden Coal Corp ... Min C 1½
57x22 Northrup Cecil .....AplEqpRp 6 H 3½
76 21 Patterson Radio & Television Service .....3 F 3
55x31 Peery & Hilton ...AtpartsAss 6 E 2½
HwrElcapl
52x51 Peery & St Clair Inc.....HwrFrn —
72 62)2 Mort
54 13 Perry C T & Sons.....GrMt D+ 2
59 71 Pobst Jewelry Store..... D 2
12 11 Ridgewood Coal Co*.....Min 1 —
(Also Peach Creek Ala)
32 71 Riverside Block & Supply Co Inc K 3
53 92 Sayer Bros ..... Gmds —
(Br of Logan Wash)
75 38 Sheets Robert C.....AtrpTrkg 7 F 3
42 12)2
C 15 11 Shrader Roy J.....Bldr 5 F 3
53 93 Smith Edward..... .....Gs 5 H 3½
51 37 Southern Coal Export Co..Sales 7 —
Agt
(Subv of Jewell Ridge Coal Sales Co Inc Tazewell)
12 11 Swords Creek Mining Corp...Min H 3
53 93)2 (Also Swords Creek) Gs
55 11 T & T Pontiac Co.....Ats 3 F 2½
52x62 Tazewell Equipment & Motor Corp H 4
FrmmchAts
50 MA Tazewell Oil Co Inc.....Petrpdt B 1½
(Also Branches)
53 31 Tiller Arthur D.....Ds ★★
(See Norton)
55 21 Unique Motors Inc.....UAts 5 G 3½
57 23 Van Dyke Claude H. .RadiosTv 2 E 2½
59 12 Vines John W.....Drg 0 F 3
57 38 Walk Tom.....Atrp 2 H 3½
24 21 Wright Lumber Co Inc..... —
(Br of N Y City—Manhattan)

JEFFERSON ▲ Union 90

Bk town Elk Point

53 93 Bauer & Sons.....Gs D+1½
51x35 Java Equity Exchange Inc...Grn D+1½
BulkstnLbr
12 11 Jewell Eagle Coal Co Inc..Min 3 1
53 93)2 (Also Branches) Gs
58 12 Job Minnie & Tillie.....Rst H 3½
54 12 Kary E.....Gr 7 —
55 21 M & W Motors Inc.....UAts 5 —
56x12 McGuire M H Jr.....MBWncl 3 E 2½
76 21 Patterson Radio & Television Service .....3 F 3
17 11 Permann Fred.....PlbgHtg G 3½
53 93 Schlepp Gilbert G & Larayne (Mrs G G).....Gs 1
75 38 Spiry & Sons.....Atrp F 2½
53 93 Stenseth Jake H . ... Gs G 3½
76 11 Weisgram Frank.....Bsmith J 3½
52 51 Wolf Ervin .....Hwr 4 E 2½

JOUBERT (See Harrison)

JUNIUS ▲ Lake 260

Bk town Selby

54 13 Authier Rene H.....GrMt 3 G 4
58 13 Bernard B M. ..... .Tav 3 H 3½
76x11 Bernard Herman J...BsmithWldg G 3½
54 13 Bladen Frank E..... .GrMt G 3½
51 21 Bosse Martin F. BulkPlant D 2
48 11 Connors Kenneth .TeleEvchElcapl E 2½
57 22)2
17 11 Evien Carroll. . .. ...PlbgHtg K 4
42 EA Farmers Elevator Co*...GrnCoal D+ 2
55 41 Garvis Leonard J ....Sstn F 3
59 VA Guillaume Rose CoinOpermch 0 —
58 12 Hittle Al & Martha .....Rst 2 H 3½
59x12 Kent John P .. .. DrgLq F 3
55 41 La Fleur Raymond . ....Sstn 0 G 3½
58 13 Murphy Marty & Blanche...Tav 2 H 4
57 21 Stevens Electric... ElcaplWiring F 3
17 31)2

KAYLOR ▲ Hutchinson 90

FARMERS STATE BK. $65M
John Strickerz Pr A B Turbak Cas
52x11 Anderson J F Lumber Co .BldmtlAA A1
(Br of Minneapolis Minn) Coal
70x11 Boock Miss Alma D..... .HtRst F 3
15 11 Brakke Keith M..... BldCntr F 3½
55x41 Breese Earl ..... SstnGr 4 H 3½
55 41 Burns John A .. .SstnBulkPlant D 2
51 21)2 (Also Branches)
76 21 Carson Carol A . ..RadioTvrp 6 H 3½
70 31 Collins Russell O.....Cabins 3 G 3½
59x12 Goins W S ..... .DrgSstn D+ 2½
52 62 Gorman Andrew John ... Impt C+ 1
16 21 Grable Clarence. DitchingCntr 4 H 3½
58 12 H & H Cafe.. ....Rst 4 C+ 1½
72 62 Hall Frank M.....Mort ★★
(See Philip)
55 11 Hemmingston Harold.....AtsGar D 2½
75 38)2
53 93 Herring Emory... .....Gs 5 3
52x51 Hogen Marvin & Florence ...Hwr D+ 2
Atacc
55x11 Hortman & Wilmarth....AtsSstn E 2¼
55 41 Jeffords Max . .....Sstn 5 G 3½
24 21 Jones G Cleve. .. ..Sawmll F 3½
(Also Coalwood Ga)
42 EA Kadoka Equity Union Exchange Inc —
Grn
C 48 11 Kadoka Telephone Co... ..... D 2
55 11 Kilgore Emory R & John W.. Ats —
54 13 Kinder W Frank .. ...GrMt 0 G 3½
53 93 Kuhn William E Jr..... ..Gs D 2½
50 47 Lambert Jules L.... .MtProd 6 H 3½
75 38 Leggett Orville & William . Atrp F 3
59 BA Lester Zella W.. .... Flor 1 F 3½
C 57 12 Lewis Robert H & Clara..NUFrn 6 F 3
12 11 Lynn Camp Coal Corp....MinGs B 1
53 93)2 (Also Branches)
52 62 McRae Harold.....Impt E 3
54 12 Mullen Charles. ..... Gr 2 F 3
42 33 Nielsen Andrew P.....ColdStor E 2
54 22)2 LockersRetMt
58 12 Olson Orrin L..... Rst 0 J 4½
52x62 Patterson Bird J.....ImptAplAts C+ 1½
(Also Branches)
55 41 Peters Freddy..... Sstn 7 J 3½
70 11 Renning Arthur C..... HtRst 4 F 3
16 11 Rock Construction Co... DirtCntr D+ 2½
27 11 Rock Orville J..... .... Prtg F 3½
56 12 Stewart Harold J.... ...Mcl 2 F 3½
59 62 Tri-State Milling Co Inc.....FF ★★
(See Rapid City)

Names on this page are fictional and used for display purposes only.

FIG. 24–4. *Dun & Bradstreet Reference Book* key to ratings.

KEY TO RATINGS

ESTIMATED FINANCIAL STRENGTH				COMPOSITE CREDIT APPRAISAL			
				HIGH	GOOD	FAIR	LIMITED
AA	Over		$1,000,000	A1	1	1½	2
A+	Over		750,000	A1	1	1½	2
A	$500,000	to	750,000	A1	1	1½	2
B+	300,000	to	500,000	1	1½	2	2½
B	200,000	to	300,000	1	1½	2	2½
C+	125,000	to	200,000	1	1½	2	2½
C	75,000	to	125,000	1½	2	2½	3
D+	50,000	to	75,000	1½	2	2½	3
D	35,000	to	50,000	1½	2	2½	3
E	20,000	to	35,000	2	2½	3	3½
F	10,000	to	20,000	2½	3	3½	4
G	5,000	to	10,000	3	3½	4	4½
H	3,000	to	5,000	3	3½	4	4½
J	2,000	to	3,000	3	3½	4	4½
K	1,000	to	2,000	3	3½	4	4½
L	Up	to	1,000	3½	4	4½	5

CLASSIFICATION AS TO BOTH ESTIMATED FINANCIAL STRENGTH AND CREDIT APPRAISAL

FINANCIAL STRENGTH BRACKET		EXPLANATION
1	$125,000 to $1,000,000 and Over	When only the numeral (1, 2, 3, or 4) appears, it is an indication that the estimated financial strength, while not definitely classified, is presumed to be within the range of the ($) figures in the corresponding bracket and that a condition is believed to exist which warrants credit in keeping with that assumption
2	20,000 to 125,000	
3	2,000 to 20,000	
4	Up to 2,000	

NOT CLASSIFIED OR ABSENCE OF RATING

The absence of a rating, expressed by the dash (—), is not to be construed as unfavorable but signifies circumstances difficult to classify within condensed rating symbols and should suggest to the subscriber the advisability of obtaining additional information

INVESTIGATING

"Inv" in place of the rating is an abbreviation of "investigating" It signifies nothing more than that a pending investigation was incomplete when the book in which it appears went to press

The letters "N. Q." on any written report mean not listed in the Reference Book

Dun & Bradstreet, Inc.

used depends on the strength or weakness of the above factors in relation to each other.

In some instances a capital or credit rating or both cannot be assigned to a business enterprise. The symbols used to denote these more uncommon circumstances are explained in Figure 24–4 in the key to ratings.

Use of Reference Books by Credit Managers

There is no question that reference books contain a large amount of useful information for credit managers. In general they are regarded highly throughout the credit profession. Experienced credit managers, however, use them with caution because they clearly understand reference book shortcomings. Any publication effort as vast in scope and detail as the general agency's reference book cannot be accomplished without some errors. Even though the agency exercises great care and has excellent facilities with which to produce such a volume, errors are a natural occurrence of the task.

It may be that the more serious shortcomings are not concerned with the publication task, but are due to the nature of the investigating task. With almost 3,000,000 names which appear in the reference book, it is impossible to investigate each one immediately preceding the issuance of each revised edition. Furthermore, the ratings are the result of human judgment based on the information which the editors had available to them. No rating system is entirely infallible and it cannot compensate for the deficiencies in human judgment. Credit reporters may gather insufficient information or rely too heavily on indirect sources of information. Some business houses will not co-operate with the reporter in revealing their financial condition and other facts. In such cases the reporter must rely on the best available sources of indirect information that are available to him. When this is the case, *estimates* of financial condition are made, errors in judgment occur, and the actual status of the enterprise may not be fully revealed.

Despite these limitations, reference book subscribers can use the book to:[5]

1. Check new and unsolicited orders.
2. Set up credit limits based on ratings.
3. Select prospects in a given area or analyze accounts receivable by lines, by size, by year of establishment, or by rating.
4. Prepare special mailing lists of names by SIC [Standard Industrial Classification] numbers, town location, or rating.
5. Classify new prospects by reviewing the added names, preceded by the letter "A."
6. Re-classify prospects whose ratings have changed (C's).
7. Review credit limits and sales potential estimates on *accounts* with changed ratings (C's).

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[5] *Your Dun & Bradstreet Service, Subscriber's Manual* (New York: Dun & Bradstreet, Inc., 1957), p. 7.

EVALUATION OF DUN & BRADSTREET

In appraising the services of the general mercantile agency it is desirable to examine whether the determinants in the selection of a source of information are met, and whether the services supply the information needed by the credit analyst. The important selection factors which should be taken into consideration were set forth in the preceding chapter, and are: accuracy of information, content of reports, speed of reporting, cost of service, trade coverage, geographical coverage, variety and number of reports, and the supplemental services offered. The information needed by the credit manager was also considered in Chapter 23 as follows: identity and legal responsibility, history and business background, character and responsibility of management, financial ability and strength, and payment record experience.

While the agency is not free of limitations and errors, it can reliably be stated that it meets the above criteria. The agency's only interest is to report facts as accurately as possible. Its continuation over the years as the most comprehensive source of credit information depends on its reporting the facts as it knows them. The procedures of reporting are constantly being improved and Dun & Bradstreet solicits the reporting of known errors from its subscribers.

An old criticism of Dun & Bradstreet was that too much time was necessary to gather current information and finally report it to interested creditors. Slowness in acquiring information resulted in delays and a loss of customer good will. Modern communication systems and mechanical devices used to duplicate and process data have met this problem. Today, Dun & Bradstreet leases 16,000 miles of private-wire service. This network connects 79 branch offices from coast to coast. This is one of the largest private-wire systems in the country, and it has greatly speeded the flow of credit information from distant points to the creditor. The agency reports that more than 90 per cent of its credit report inquiries are met in the space of one working day.

The trade coverage and geographical coverage of the agency are the most complete in the credit reporting industry. With its large number of reporters and correspondents gathering information throughout the United States and Canada, the agency can supply a credit report on any business located anywhere in the country. Dun & Bradstreet does not claim to gather information from sources that would be unavailable to creditors. It acquires its information from the same sources available to all credit managers. A direct investigation could be undertaken by the

creditor, but Dun & Bradstreet's facilities are tailored to do this for him. Furthermore, in most instances, a direct investigation by the creditor would entail greater costs but less efficiency.

The content of Dun & Bradstreet reports gives the creditor much of the information which is necessary to make an intelligent credit decision. If certain types of credit information are not available or the customer has failed to supply financial statements, such shortcomings in the data are clearly apparent to the subscriber. Direct investigation can then be undertaken in an attempt to acquire the data if it is deemed essential to a sound decision. The agency's variety of reports, continuous report service, reference book, and collection services are all designed to fulfill as completely as possible the particular requirements of most commercial creditors. The problems associated with making credit decisions, controlling and collecting accounts, and periodically revising them are greatly eased by the broad scope of the agency's services.

REVIEW AND DISCUSSION QUESTIONS

1. Why is it necessary for a credit manager to be knowledgeable of a variety of sources of credit information even though he uses only a few?
2. Why is Dun & Bradstreet termed the "general mercantile agency"?
3. It is sometimes said that Dun & Bradstreet enjoys a monopolistic position in the field of commercial credit reporting. Discuss the validity of this view.
4. How did economic and business developments of colonial times influence credit risk and the need for organized sources of credit information?
5. List the principal activities of Dun & Bradstreet and explain each one briefly.
6. Of the various activities of Dun & Bradstreet, which one is the "backbone" of the agency's business? Why?
7. Distinguish between the regular report and the analytical report reproduced in Figures 24–1 and 24–2.
8. Analyze the credit reports referred to in question 7 above. Would you accept credit requests supported by reports containing these qualities? If so, how much credit would you accept? Discuss the basis for your action.
9. Discuss the credit managers' need and usefulness of the agency's key-account service. The continuous-report service.
10. Under what circumstances would you request use of the agency's credit reports? Why would you not request them for each credit decision?
11. What is the basis for the ratings use in the reference books published by the agency?
12. What credit uses and other business uses do reference book ratings serve?
13. Do the services of Dun & Bradstreet fulfill the credit information needs of credit management? Can you note any deficiencies in the services?

CHAPTER 25

Basis of the Commercial Credit Decision (cont.) Commercial Credit Reporting by Specialized Agencies

IN ADDITION TO Dun & Bradstreet, Inc. the network of mercantile credit reporting is comprised of an undetermined number of specialized credit reporting agencies. Some of these agencies are corporate enterprises while others are operated by trade associations. The specialized mercantile agencies may be distinguished from the general mercantile agency in the following ways: (1) all of them restrict the credit information which they gather and the reports they render to a single line of trade or to a limited number of allied trades; (2) the geographical coverage by some of the specialized agencies is restricted to a particular territorial region;[1] and (3) some of the agencies restrict their credit information to a special type, or concentrate on services which are of particular value to the trade. The outstanding example of an agency reporting only one type of information is the Credit Interchange Bureaus operated by the National Association of Credit Management. On the other hand, several specialized agencies render services and report information which is as varied and comprehensive as the general agency.

Manufacturers, wholesalers, and other suppliers who merchandise their products to business houses in a particular line, or to those concentrating in a few allied fields are the users of the specialized agencies'

[1] Typically, when this is the case, the territory covered corresponds to the geographical concentration of the trade.

services. As will be shown in subsequent sections, much of the value in using these sources of credit information stems from the specialized nature of their activities.

DUN & BRADSTREET'S INTEREST IN SPECIALIZED CREDIT REPORTING

While Dun & Bradstreet's interests are principally concerned with the activities of the general mercantile agency, it entered the field of specialized credit reporting upon its acquisition of National Credit Office, Inc., in 1931 and Credit Clearing House, Inc., in 1942. Credit Clearing House now operates as a division of Dun & Bradstreet while the former functions independently from its New York headquarters and branch offices.

Credit Clearing Division

It has long been recognized that the apparel trades is a highly competitive industry permeated with style hazards and a high mortality rate among retail outlets. Because of these characteristics business houses selling to the apparel trades are confronted with a degree of risk not ordinarily found in other industries. In recognition of this special need Credit Clearing House, established in 1888 in St. Paul, Minnesota, became one of the largest specialized credit reporting agencies. Now as a division of Dun & Bradstreet, Credit Clearing House investigates, rates, and prepares credit reports on concerns in the apparel trades. A few allied industries such as jewelry, notions, and furnishings are included in its scope of operations.

Because of the hazards existing in the highly competitive apparel industry, speed and accuracy in answering credit inquiries are of utmost importance. Furthermore, manufacturers in this industry are seldom large enough to employ a full-time credit manager, and the management of the seller's credit department may be delegated to someone who is charged with other duties.

A unique feature of Credit Clearing House's operations which compensates for the absence of trained credit management is the Credit Recommendation Service. This service is designed to help suppliers arrive at a rapid credit decision on the bulk of their customers. When a subscriber desires advice on a new customer or an existing customer, he notifies the agency of the business name and address of the customer, the amount of the order, selling terms, and previous ledger experience. In return, the subscriber will receive specific advice which either (1) recommends the account with little or no reservation, or

(2) recommends the account, but with clear-cut reservations. Credit Clearing House does not give advice not to accept an order. If one of the above recommendations cannot prudently be made, the decision is reverted to the subscriber. In such cases a current Dun & Bradstreet credit report as described in Chapter 24 is forwarded to the subscriber for his own analysis and decision. This procedure avoids agency decisions which may be incorrect when based on inadequate information, but more accurate when considered in the light of the subscriber's knowledge of circumstances or conditions peculiar to the customer's business. When the decision is reverted the subscriber should evaluate the credit report information together with the size of the order, the profit margin involved, the competitive atmosphere, the degree of risk involved, and other factors known to him.

Credit Clearing House analysts, who are familiar with the purchasing habits, trade customs, and seasonal factors of the industry, base their recommendations on Dun & Bradstreet reports and the master card maintained on apparel retailers and wholesalers. The master card reveals the purchase record and payment experiences of the retailers and wholesalers, as reflected in inquiries made on them by subscribers. From the division's files in New York, information of this type is disseminated daily to all branch offices in the country, thereby making it available to subscribers in markets anywhere in the United States.

This division also supervises the publication of the *Apparel Trades Book* which is issued every three months in February, May, August, and November, and rates over 200,000 wholesalers and retailers in the apparel industry. The arrangement of the *Apparel Trades Book* is similar to that of the *Dun & Bradstreet Reference Book,* except that the ratings are somewhat more complex. Whereas the Dun & Bradstreet rating consists of two elements, the Credit Clearing House rating consists of three elements. A code letter indicates the estimated financial strength; a number 1, 2, 3, or 4 indicates the payments appraisal; and, a letter A, B, C, or D indicates the composite appraisal. Figure 25–1 shows the *Apparel Trades Book* "Key to Ratings" which explains the rating system in complete detail.

National Credit Office, Inc.

The National Credit Office, Inc. is the largest specialized mercantile agency with executive offices in New York City and branch offices located in Atlanta, Boston, Chicago, Cleveland, Detroit, Los Angeles, and Philadelphia. Established in 1900, it offers the most comprehensive services on manufacturers, converters, assemblers, importers, exporters, and

FIG. 25–1. Credit Clearing House "Key to Ratings."

APPAREL TRADES BOOK

KEY TO RATINGS

		Estimated Financial Strength	Payments Appraisal	Composite Appraisal
‡B-	A	Over $1,000,000	1 2 3 4	A B C D
	- - - -	See Note[1] - - - -	1 2 3 4	A B C D
	C	Over 500,000	1 2 3 4	A B C D
‡F-	D	Over 300,000	1 2 3 4	A B C D
	E	Over 200,000	1 2 3 4	A B C D
	- - - -	See Note[1] - - - -	1 2 3 4	A B C D
	G	Over 100,000	1 2 3 4	A B C D
‡K-	H	Over 50,000	1 2 3 4	A B C D
	J	Over 30,000	1 2 3 4	A B C D
	- - - -	See Note[1] - - - -	1 2 3 4	A B C D
	L	Over 20,000	1 2 3 4	A B C D
	M	Over 10,000	1 2 3 4	A B C D
‡S-	O	Over 5,000	1 2 3 4	A B C D
	R	Over 3,000	1 2 3 4	A B C D
	- - - -	See Note[1] - - - -	1 2 3 4	A B C D
	T	Over 2,000	1 2 3 4	A B C D
	V	Over 1,000	1 2 3 4	A B C D
	W	Up to 1,000	1 2 3 4	A B C D
X - - - - - - - -		Not Classified - - - - - - - -		See Note[2]

§ The symbol § preceding a rating indicates that an important part of the total worth consists of assets not usually considered working capital

Note[1] The letters B, F, K and S in the Estimated Financial Strength column, preceded by the symbol ‡ indicate in a general way what is considered relative in size. To illustrate the letter B indicates size comparable to concerns classified in the range A to C inclusive, the letter F, comparable to those from D to G inclusive, the letter K, comparable to those from H to M inclusive, and the letter S, comparable to those from O to V inclusive

Note[2] The letter X is not to be construed as unfavorable but, in the column or columns in which used, signifies circumstances difficult to definitely classify within condensed rating symbols and should suggest to the subscriber the advisability of reading the detailed report

CREDIT CLEARING HOUSE

DUN & BRADSTREET, INC.

SERVING THE APPAREL LINES NATIONALLY

wholesalers in the metals, electronics, rubber, paint, leather, furniture, and textiles industries. No retail concerns are reported on except large department stores, chain stores and large furniture stores. In other words, National Credit Office, Inc. concentrates its reporting services on suc-

cessive stages of handling, converting, manufacturing, and wholesaling in its several fields of specialization. For example, in the woolen industry this agency investigates and reports on: raw wool dealers, spinners of woolen and worsted yarns, mills which weave woolen and worsted cloth, jobbers of woolen and worsted cloth, manufacturers of ladies', men's, and boy's woolen and worsted garments, and manufacturers and wholesalers of knitted woolen underwear and outwear. In the final stage, only department stores and chain stores specializing in piece goods are reported on.

Credit Reports. Individual departments are operated for each trade line of specialization. All departments of the National Credit Office, Inc. operate in a similar manner and each performs essentially the same types of services. That is, methods of gathering credit information are the same and the content and structure of all credit reports coincide. Credit investigations by salaried reporters and mail correspondence with the source of information are the two principal methods used in gathering data for credit report inclusion. Individual credit reporters on the staff of National Credit Office are highly trained to specialize in a particular trade line. In fact, many of them not only devote the major portion of their time to one major industry, but to a group of accounts within the industry. Such close association with the same accounts year after year gives the credit reporter an intimate knowledge of each concern assigned to him.

The investigative procedure employed by National Credit Office involves a personal interview with the management of the subject enterprise. During the interview the antecedents, method of operation, and financial data are sought. Externally, the credit reporter endeavors to secure credit information from trade and credit references, banks, and other creditors' ledgers. Mail correspondence is used to gather similar information when the situation does not require a reporter's personal attention. Clearly there is little difference in the methods used to gather credit information by this agency and those employed by Dun & Bradstreet, Inc.

The credit reports tendered to all subscribers have three basic sections as follows: (1) *Current Information;* (2) *Antecedents and Method of Operation;* and (3) *Financial Statement.* The current information section commences with the name of the concern, its address, and the names of the officers or principals. Following this the reports contain a brief synopsis regarding the record of the principals, the trend of the business, its summarized current financial condition, a current detailed trade investigation, names of important sources of supply, an analysis of the

financial record and conditions, and finally a suggested line of credit. The antecedents section includes the complete business record of the principals, a description of the method of operation, and the name of the subject's bank. In the financial section there appears a detailed current financial statement usually on a National Credit Office form and reproduced photographically. The credit reports of this agency are revised automatically every six months, as are those of Dun & Bradstreet, Inc. Figure 25–2 is illustrative of the three sections of typical National Credit Office credit reports.

The most distinguishing feature of National Credit Office reports as contrasted with the reports rendered by other mercantile agencies is the suggestion of a definite line of credit. Statements such as "An excellent risk for requirements," "Reasonable trade needs," or a definite line of credit such as $500, $1,000, $2,000, or no line are illustrative of the credit suggestions made by the agency's analysts. These appear in the current information section of the credit report. If a specific line of credit can reasonably be suggested, it is determined by dividing the normal seasonal purchase requirements of the subject by the number of merchandise suppliers. Hence, a concern which would normally purchase $60,000 a season to meet its inventory requirements from some 30 distributors, would receive an average line of credit of $2,000.

Metals and Electronics Industry Survey. National Credit Office does not publish a rating book for all of the industries in which it specializes. It does, however, publish a *Metals and Electronics Industry Survey* which is a rating book of interest to credit managers in the metals and electronics industries. As is the case with other credit reference books, it is designed principally for use by credit management, but may also serve a useful purpose by providing a source of sales leads for the sales department. The *Metals and Electronics Industry Survey* is in looseleaf form. Unlike the *Dun & Bradstreet Reference Book* and the *Apparel Trades Book,* it is relatively easy to read and interpret. Only two elements comprise the rating system used. A letter is used to denote the desirability of the account listed as follows:

A. Credit requirements or trade needs.
B. Reasonable credit, moderate credit, or small trade needs.
C. Caution advisable or information incomplete.
D. Credit questioned, or cash terms.

The second element of the rating is a group of numbers with three ciphers omitted, which denote the net worth of the listed business enterprise. For example, "C 182" would mean a net worth of $182,000 but

FIG. 25-2. National Credit Office—credit report showing current information.

NCO *Specialized Service* CURRENT INFORMATION

SELECTION ELECTRONICS, INC. MFRS. COILS, TRANS- CHICAGO, ILL.
AHB:HR-886-B FORMERS & TUBES 2413 Credit Ave.
FEB. 20, 195

ANTECEDENT COMMENT - Records clear. Incorporated 1914. Management headed by John Broadcast who is a leader in line.

FINANCIAL	4/30/5	4/30/5	4/30/5	
Cash	$218,700	$198,000	$ 99,000	
Receivables	496,200	423,200	438,500	
Merchandise	724,800	645,300	589,700	
Tax Claim	-	-	119,200	
Current Assets	1,439,700	1,266,500	1,246,400	
Current Debts	531,100	319,600	447,800	
Working Capital	908,600	946,900	798,600	
Deferred	458,000	412,000	366,000	
Fixed Assets	958,300	943,500	904,500	
Net Worth	1,449,800	1,517,800	1,363,500	
Sales	3,026,100	3,212,600	2,326,700	
Profit	74,100	98,700	119,000	(Loss)
Dividends	None	47,300	27,300	

TRADE - SATISFACTORY

HIGH CREDIT	OWING	PAST DUE	TERMS	PAYMENTS
$27,000	14,000	0	N30	ppt-good acct.
26,000	26,000	0	1/10/N30	dis-ppt
23,000	15,000	7,000	1/10/N30	dis-30 slo
18,000	10,000	4,000	1/10/25	ppt-15 slo
17,000	0	0	1/10/N30	dis
15,000	1,000	4,000	N30	ppt-disputes
8,000	1,600	0	N15 prox	ppt
5,000	500	0	1/10/25/N30	dis

SUPPLIERS
Sturdy Steel Corp., Fostoria, W. Va. Bright Wire Corp., Fearless, Ohio
Ideal Components Corp., Sterling, Wisc. Ultra Glass, Inc., Avia, Kan.

OPERATIONS - 28% decline in sales 1954 reflecting industry conditions caused loss. Also wrote off $44,000 of obsolete inventory. Profits previously reported since 1941. As a result of economies placed operations on successful basis in closing quarter. Now hold $400,000 backlog.

FINANCIAL CONDITION - Satisfactory. Receivables well controlled. Inventory turnover fair. Current debt ratio good. Trade debt sizable. Occasional trade delinquency not stressed. Bank loans total $266,000 unsecured.

DEFERRED - Due Insurance Co. of America, secured by first mortgage on plant and equipment. Repayable $30,000 annually. Final payment 1963.

CREDIT SUGGESTION - REASONABLE TRADE NEEDS.

- S A M P L E -

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14431

FIG. 25-2—*Continued.* National Credit Office—credit report showing antecedents section.

NCO *Specialized Service* **ANTECEDENTS & Method of Operation**

SPECIALIZATION, INC. MFRS. AERO & AUTO PARTS DETROIT 12, MICH.
WAD:HR-886 FEB. 22, 195 900 Auto Road

Robert M. Dooley, Pres. O. A. Brown, Vice-Pres.
Albert J. Boston, Vice-Pres.-Treas. Louis C. Schauble, V-Pres.-Gen. Mgr.
Edgar C. Pauls, Secy. A. M. Lawrence, Vice-Pres.

DIRECTORS - The officers and E. L. Couch.

HISTORY - Established 1929 as partnership. Incorporated Ohio laws same year. Name originally was Industrial Sheet Metal Works, Inc. Present style adopted 1943. Stock listed Midwest Stock Exchange.

PERSONNEL - R. M. Dooley, born 1899 and married. Employed in an engineering capacity by Bowser Mfg. Co., 1920-1929. In charge of sales. Has been with the company since inception. Holds a 13% interest. Life insured for $60,000 for the benefit of the business.

Albert J. Boston, born 1899 and married. Holds a 34% stock interest. Handles finances. Employed as a salesman by R. C. Mable Co. until joining subject 1929. $285,000 life insurance carried on his life for the benefit of the company.

O. A. Brown was born 1884 and married. Owns 34% of the outstanding capital stock. Gained his original experience as an engineer of Ford. Acted as Pres. 1929-1948. Now semi-retired. $255,000 life insurance carried for the benefit of the company.

E. C. Pauls, born 1903 and married. Employed by a car dealer in an accounting capacity until joining company 1943. In charge of purchasing.

METHOD OF OPERATION - LINE - Manufactures clutches, radiators, torque converters, hydraulic and fuel pumps.
DISTRIBUTION - Sold to manufacturers of passenger cars, trucks, buses and tractors. Terms net 30. Also direct to airplane manufacturers on special contract.
EQUIPMENT - Own 300,000 sq. ft. modern brick plant. Lease 25,000 sq. ft. warehouse, Alpena, Mich. Employ 450.

SUBSIDIARY - Aero Specialties. Formed 1945. Acts as sales company in Calif.

BANK - Safety Bank & Trust Co Detroit

- S A M P L E -

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that caution should be exercised in accepting the credit of the firm, or that information on the subject listed firm was incomplete.

Bank Service Department. The service of this department is not of fundamental interest to commercial credit management, but it is utilized by banks for which the service was designed. This department writes reports on all concerns offering commercial paper in the open market. The commercial paper of each company reported upon is graded in one of the following categories: prime, desirable, satisfactory, fair, or not recommended. The credit reports prepared by this department have no outstanding distinguishing characteristics, except for the information pertaining to commercial paper.

Other Services of National Credit Office, Inc. In addition to the specialization of National Credit Office, Inc. in a number of important trades, it offers a number of other services for the benefit of its subscribers.

As a special service to its membership trade group meetings are held in New York and other trade centers for the express purpose of discussing specific accounts and other topics of interest to credit management. The agency prepares the material for the meetings of these groups and participates in the discussions together with a panel of credit men. The membership of each group is comprised of credit men in the respective fields of concentration. Each member has the privilege of submitting account names for discussion, and prior to the meeting the subjects are turned over to the National Credit Office for clearance to obtain all available up-to-date trade experiences. This up-to-date information, combined with any information a member may have, provides a basis for reviewing the current financial condition and paying habits of the customer.

Marginal account registration is another activity of this agency. Accounts that appear borderline because of financial weakness, because of a slowing in trade payments, or because of recent managerial changes, or for other reasons are listed as "Marginal Accounts." Accounts appearing on this list are revised every three months instead of the usual six months.

Credit News, a weekly publication of the agency, is a listing of concerns, by industry, showing changes of credit significance that have just taken place. Incidents such as "selling assets," "liquidated," "management change," and "credit suggestion revised" are typical of the brief comments included in *Credit News.* This publication is sent to all subscribers of the agency's service. A collection service is also available to creditors. This department corresponds with past-due accounts, but does

FIG. 25-2—*Continued.* National Credit Office—financial statement.

FINANCIAL STATEMENT SUBMITTED TO NATIONAL CREDIT OFFICE, INC.

Name: Franklin & Adams, Inc. Business: Machy.-Mfrs.

Street and No 100 Washington Ave. City: Burgoyne, Zone: State: N.Y.

Owner—Partners—Officers and Directors	Title	% Ownership	In charge of
J. Clark Franklin	Pres.	25%	Gen. Mgr.
Earl W. Wilson Exec.	V-Pres.	25%	Mgr.
John C. Adams	V-Pres.	25%	Engr.
Roy A. Jefferson Secy.	-Treas.	25%	Prod.

STATEMENT OF (DATE) May 31 **195**

ASSETS			LIABILITIES		
CASH IN BANK $ ON HAND $	$ 82,932	38	ACCOUNTS PAYABLE	$ 30,167	82
U.S. GOVERNMENT SECURITIES			DUE TO CONTRACTORS (without offset)		
RECEIVABLES for Mdse Sold to Customers (Age on opposite page) ACCOUNTS $ 82,968.04			UNSECURED LOANS PAYABLE		
Less Res for Discounts $			To Banks	40.000	00
Less Res for Doubtful $ 2,372.19	80,595	85	To Partners or Officers		
NOTES & TRADE ACCEPTANCES (less $ discounted)			To Others		
DUE from FACTOR or FINANCE COMPANY			SECURED LOANS PAYABLE		
			Owing to		
PHYSICAL INVENTORY OF MERCHANDISE (Valued at lower of Cost or Market)			ACCRUED WAGES & EXPENSES	41,418	18
Raw Materials $ 20,004.05			TAXES—Accrued and Payable:		
In Process $ 25,021.40			a. Withholding & Payroll		
Finished Mdse $ 81,410.07	136,435	52	b Federal & State Income	45,014	31
			c All Other	13,952	32
CURRENT ASSETS	299,963	75	RESERVE for Income Taxes since last closing		
Due from Partners, Officers, or Employees	4,000	00	MORTGAGE—DEFERRED DEBT— Due within 12 mos		
Due from Affiliated or Assoc Companies			CURRENT LIABILITIES	170,552	63
LAND & BUILDINGS $			MORTGAGE—DEFERRED DEBT— Due after 12 mos	15,000	00
Less Depreciation $			LOANS Subordinated until 1/1/60 (date)	39,341	75
MCHY., EQUIP., FURN., & FIXT $ 174,371.09			TOTAL LIABILITIES		
Less Depreciation $ 47,421.84	126,949	25	IF CORPORATION		
INVESTMENTS (Describe on opposite page)	2,500	00	Capital Stock Pfd $		
PREPAID & DEFERRED	8,601	01	Capital Stock Common $ 100,000		
Deposits	240	00	Capital Surplus $ 50,000		
			Earned Surplus $ 63,359.63		
			Deficit (red) $		
			CORPORATE, PARTNERSHIP, or INDIVIDUAL NET WORTH	213,359	63
TOTAL ASSETS	435,254	01	TOTAL LIABILITIES & CAPITAL	435,254	01

DEPOSITORY BANKS First National Bank Burgoyne, N.J.

INSURANCE—Fire: Mdse $ 200,000 Bldg & Fixt. $ 150,000 Use & Occup $ 100,000 Burglary $ Life, Benefit Business $ None on

ACCOUNTANT — Was above statement prepared by an outside accountant? Yes ☒ No ☐ Is he C P A ? ☒ Registered? ☐ Licensed? ☐

Accountant's Name J. M. Authenticate

Address Banks Bldg., Newark, N.J.

On what date are your books closed? May 31

PROFIT AND LOSS STATEMENT

FOR PERIOD FROM June 1 195__ TO May 31 195

GROSS SALES		$860,421.33
Less RETURNS	$	
Less DISCOUNTS	$	$ 15,319.03
NET INCOME FROM SALES		$845,102.30
Inventory—begin'g	$ 120,383.02	
Purchases—Net	$ 481,496.04	
Labor	$ 112.899.93	
Factory Overhead	$ 54.737.81	
Total	$	
Inventory at end	$ 136,435.52	
Cost of Goods Sold		$633,081.28
GROSS PROFIT ON SALES		$212,020.02
Selling & Ship. Exp.	$ 62,178.05	
Salaries—Officers or Principals	$ 45,000.00	
Adm & Gen. Exp.	$ 50,111.84	
Bad Debts	$ 2,100.00	
Depreciation	$ 27,873.00	$
INCOME or (LOSS) ON SALES		$ 24,757.13
Other Income (exclude discount earned)		$ 251.30
Total		$ 25,008.43
Deductions from Income		$ 954.30
NET PROFIT or (LOSS) before Income Taxes		$ 24,044.13
Provision for Federal & State Income Taxes		$ 12,320.00
NET PROFIT or (LOSS)		$ 11,624.13

RECONCILIATION OF SURPLUS OR NET WORTH

Beginning (date) 5/31		$ 56,735.50
ADD Profit for Period	$ 11,624.13	
Other Credits to Surplus	$	$ 11,624.13
Total		$ 68,359.63
DEDUCT:		
Loss for Period	$	
Div & Withdr'ls	$ 5,000.00	
Other Charges to Surplus	$	$ 5,000.00
NET WORTH or SURPLUS at end		$ 63,359.63

EXPLANATION OF ASSETS AND LIABILITIES

RECEIVABLES

For goods shipped during months of:

a. May	$ 60,250.02
b. April	$ 15,700.01
c. March	$ 4,050.00
d. Prior Months	$ 2,968.01

Do these include any consigned goods, uncredited returns, or unshipped merchandise? No

Have all bad accounts been charged off or reserved? Yes

During the past year have you sold, pledged, or assigned any receivables? No If so, name financing concern and describe transaction

Unfilled orders on hand $ (date)

MERCHANDISE

If not valued at Lower of Cost or Market, state basis used

Is original inventory record retained by you ☒ or outside auditor ☐

Is any merchandise pledged as security for any debt? No

If so, state amount so pledged $

Merchandise Purchase Commitments as of (date) $

INVESTMENTS — Describe

a. U.S. Govt. Bonds $ 2,500.00

b. $

(If in subsidiary or affiliated concerns state % owned)

LIABILITIES

Merchandise received or charged to you but not included in Assets or Liabilities $ None

Amount of Contingent Liabilities $ None

Are any liabilities secured in any way? No If so, state amount, creditor, and nature of security:

Annual Rent $ Lease Expires

NET WORTH

Has this been decreased since statement date by withdrawal, retirement of capital, payment of dividends or bonuses? No

If so, by what amount? $

TAXES

Have all Federal, State, and Local tax assessments been paid or shown accrued on statement? Yes

Tax Closing date? Date of latest return examined by Internal Revenue Service?

TO NATIONAL CREDIT OFFICE, INC.
Two Park Avenue
New York 16, N. Y.

- S A M P L E -

The undersigned warrants that the foregoing figures and answers are true and accurate in every respect and orders this statement mailed to you with the intention that it shall be relied upon in the extension of credit or insurance by such concerns, including factors or agents, who may subscribe to your service now or hereafter. My (Our) accountants are authorized to supply you with any supplementary information that may be required.

Dated at Newark this 7th day of July 19 5

Franklin & Adams Inc.
(Name of Corporation, Partnership or Proprietorship)

Signed in the presence of:

Name Anna Choff

Address 2 Seward St., Union, N.J.

By J. Clark Franklin
President
(Signature of Officer, Partner or Owner) (Title)

NATIONAL CREDIT OFFICE, INC. • TWO PARK AVE., NEW YORK 16, N. Y.

not take legal action. The educational activities of the agency include courses in the principles of credit analysis. Classes are conducted in New York, and correspondence courses are offered to all subscribers.

LYON FURNITURE MERCANTILE AGENCY

The Lyon Furniture Mercantile Agency, established in 1876 by the late Robert P. Lyon, is the oldest and one of the most important special trade agencies. In continuous operation since that date, the Lyon agency has expanded its operations over the years so that today it reports on credit risks in the furniture, interior decoration, major home appliance, and funeral trades, as well as on department stores and general stores. Within the mentioned trades there is a large number of allied fields which are included in the scope of Lyon's activities. For example, in the furniture trade it reports on risks in the carpet, floor covering, upholstery, bedding, bed springs, juvenile furniture, baby carriage, and toy fields; and, in the interior decoration trade the drapery, mirror, picture frame, lamp, lamp shade, gift, and home furnishings fields are reported on. Also allied to these trades are the veneer, plywood, and hardwood lumber industries. Although this listing is incomplete it indicates the extensive coverage of the Lyon agency in its specialized operation.

The subscribers to the Lyon agency's services are manufacturers, jobbers, and wholesalers selling in the several fields of specialization. According to a statement made by management of the agency, more than 95 per cent of the units in the industries it serves are subscribers to their services. A credit investigation by Lyon will be conducted on any business concern located anywhere in the United States provided it buys from the specified trades. To provide nation-wide coverage eight active service offices are located in New York, Chicago, Boston, Philadelphia, Grand Rapids, Cincinnati, Los Angeles, and High Point, North Carolina. The executive offices of the agency are in New York City.

The principal services rendered to Lyon subscribers are credit reports, the publication of a rating book with weekly supplements, a weekly interchange of trade experience, and a collection service.

Lyon Red Book

As is often the case with mercantile agencies, Lyon Furniture Mercantile Agency publishes a rating book known as the *Lyon Red Book*. The organization of the listings in the *Lyon Red Book* is similar in form to that of the general mercantile agency. Unlike Dun & Bradstreet, however, the rating system does not include a single key to indicate composite credit appraisal. Instead, the *Lyon Red Book* rating system gives a

FIG. 25–3. *Lyon Red Book*—credit key.

LYON RED BOOK—CREDIT KEY

CAPITAL RATINGS
Estimated Financial Worth

A	$1,000,000	or over	
B	500,000	to	$1,000,000
C	300,000	to	500,000
D	200,000	to	300,000
E	100,000	to	200,000
G	75,000	to	100,000
H	50,000	to	75,000
J	40,000	to	50,000
K	30,000	to	40,000
L	20,000	to	30,000
M	15,000	to	20,000
N	10,000	to	15,000
O	7,000	to	10,000
Q	5,000	to	7,000
R	3,000	to	5,000
S	2,000	to	3,000
T	1,000	to	2,000
U	500	to	1,000
V	100	to	500

Z—No financial basis for credit reported.

INDEFINITE RATINGS

F—Estimated financial responsibility not definitely determined, presumed high

P—Estimated financial responsibility not definitely determined, presumed moderate

W—Estimated financial responsibility not definitely determined, presumed small.

Y—Estimated financial responsibility not definitely determined, presumed very limited

The omission of a rating is not unfavorable, but indicates that sufficient information is not at hand on which to base rating.

PAY RATINGS
Based on suppliers' reports

1—Discount.
2—Prompt.
3—Medium.
4—Variable, prompt to slow
5—Slow.
6—Very slow.
7—C. O. D. or C. B. D.

8—Pay rating not established, but information favorable.
9—Claims to buy always for cash.

SPECIAL CONDITIONS

12—Business recently commenced.
13—Inquire for report.
21—Buys small, usually pays cash.
23—Sells on commission.
24—Name listed for convenience only.
29—Rating undetermined.
31—Financial statement declined, or repeatedly requested and not received.

SYMBOL INTERPRETATION

● or 12—Business recently commenced.
✦ or 116—New statement recently received.
▲—Indicates information of unusual importance.
⊙—Sells on installment plan.
(?)—Sells from residence, office or catalogue.

CREDIT GRANTORS—NOTE

No system of ratings can ALWAYS convey an accurate summarization of existing conditions Book ratings reflect conditions believed to exist when assigned, and are based upon information obtained from financial statements, from the trade, special reporters, correspondents, financial institutions and other sources deemed reliable, but the correctness thereof is in no way guaranteed.

Conditions are constantly changing, and changes as made are shown in the "LYON Weekly Supplement and Report", and in Lyon Credit Reports.

Should any error, or inaccuracy in rating be noted, it should be reported only to the Agency, in order that correction may be made.

Inquire for Detailed Credit Report on all NEW ACCOUNTS, and make inquiry at least once a year on old accounts or when change in rating is indicated in the "LYON Weekly Supplement and Report"

capital rating, which is designated by letters, a pay rating designated by numbers 1 through 9, and a large number of special conditions which are designated by a two- or three-digit number. Figure 25–3 is a reproduction of the *Lyon Red Book*—"Credit Key." Use of this key will show

that the rating W 2 should be interpreted to mean that the listed concern has a "small undetermined financial responsibility," and that the pay rating indicates "prompt." The rating 13 L 2 should be interpreted as "inquire for report," a capital rating of $20,000 to $30,000 and the subject's pay rating is "prompt."

To keep the *Lyon Red Book* current between its semiannual publication dates in January and July, the agency publishes a *Weekly Report and Supplement.* This information sheet is distributed to all subscribers of the *Lyon Red Book* service and gives them a record of changes in ratings, new businesses, dissolutions, successions, assignments, receiverships, failures, bankruptcy, petitions, current business changes, and accounts placed for collection. The *Weekly Report and Supplement* is a continuous service to the rating book user.

Interchange of Trade Experience

Perhaps the most outstanding feature of Lyon's services is the interchange of trade experience among Lyon subscribers. Each week a national interchange of trade experience is obtained by a "tracer sheet" which is sent to all subscribers. The tracer sheet includes a listing of businesses which have been selected for clearance because of some circumstance affecting their credit position. The subscriber is requested to indicate his ledger experience with the listed concerns by placing a check mark in one of the seven columns opposite the subject's name. The seven columns denote the manner of payment as discounting, prompt, medium, slow, very slow, and C.O.D., or C.B.D. The creditor also indicates the "amount owing" and the "amount past due" in appropriate columns. Hence, the manner in which a risk is currently paying his obligations is portrayed by a national survey. The results of the tracer, upon return to the Lyon office, are consolidated and transcribed to a form titled "Result of Tracer" which is made available to all co-operating subscribers. The distinct advantage of this service is that credit men in allied trades and involved with the same credit risks have an opportunity to exchange ledger experiences. A system of this type prevents any risk from becoming seriously delinquent without the co-operating credit men of the trade becoming fully aware of the condition.

Credit Reports

The Lyon Agency renders a single type of standardized credit report. The composition of their credit reports is similar to those of Dun & Bradstreet, Inc. The principal sections are: *Antecedents, General Information, Financial Information, Summarized Statements, Analysis, Bank*

Information, Trade Investigation including interchange results and collection record, and *Summary.* Despite their similarity to other agency reports, the credit analyst should note the detailed and comprehensive nature of the information included in a typical Lyon report, and the fact that the analysis section gives him a degree of ratio analysis. In this section it is common to find the current net worth and liquidity ratios, the turnover of inventory, and the average collection period for receivables. At the end of each report a rating is assigned the subject business house as reflected in the *Lyon Red Book,* or its supplements. A sample Lyon Mercantile Agency credit report is shown in Figure 25–4.

JEWELERS BOARD OF TRADE

The Jewelers Board of Trade serves as an example of specialized credit reporting conducted by a trade association. This association as a mutual nonprofit corporation was organized to promote the interests of the jewelry industry. Throughout the years it has placed increased emphasis on assisting members in matters relating to credit. The credit reporting activities of the association today is the result of an amalgamation of several credit organizations dating back to 1874, which operated in the jewelry field. The membership of the Jewelers Board of Trade is comprised of manufacturers, wholesalers, and importers of the jewelry and kindred trades. The operations of the association are national in scope with offices in New York, where its executive offices are located, Chicago, Providence, and San Francisco.

The services rendered include the issuance of credit reports, the publication of a reference book, and the handling of collections for members. An adjustment department located in Providence functions to protect members in their actions against businesses that have become financially embarrassed or are bankrupt. Supplementing the credit report services is the continuous service which provides subscribers all credit reports and special notices on subjects of inquiry for one year from the date of the original inquiry. The reference book which is published each March and September is supplemented by *Service,* a weekly bulletin which contains a record of changed ratings, dissolutions, incorporations, financial embarrassments, and other information of interest to the membership. The methods employed in gathering credit information and the types of credit information supplied creditors have no distinguishing features not covered elsewhere in this and preceding chapters.

In general, however, the costs of credit services provided by trade associations are quite nominal when compared with the costs of credit

FIG. 25–4. Lyon Furniture Mercantile Agency—credit report.

Form 20

LYON-RED BOOK REPORT

This report is furnished, at your request, in accordance with the terms of your contract with the Lyon Furniture Mercantile Agency. It is to be held strictly confidential It is for your exclusive use and to be used only as an aid to determine the advisability of granting credit

(SAMPLE REPORT - NAMES & ADDRESS FICTITIOUS)

DOE, JOHN CORPORATION FC&Apl 0 NEW YORK 16.....N.Y.
629 West 34th Street

Morris Doe, President, Age 48, Married
Frank Blank, Treasurer, Age 45, Married
John Smith, Secretary, Age 47, Single

Directors: The officers

REV: (amd-2) November 1, 1955

ANTECEDENTS

Incorporated under New York State laws March 15, 1939, continuing the business of the former John Doe Furniture Co., which had conducted business at this same address as a partnership between Morris Doe and Frank Blank.

Morris Doe is a son of the late John Doe who started in the furniture business February 6, 1900 as John Doe Furniture Co., at 1600 Dodge Street, New York, N.Y. John Doe died May 5, 1935 at which time a partnership was formed between his son, Morris Doe and Frank Blank, a son-in-law as John Doe Furniture Co. to continue the business which at that time moved to 629 West 34th Street Morris Doe had been assisting his father in the conduct of this business working part time while attending school and after graduating giving his full time to the business. Frank Blank had been employed by the late John Doe for about ten years.

The partnership between Frank Blank and Morris Doe continued until December 1, 1938, when they executed an assignment for the benefit of creditors. On December 5, 1938, an involuntary petition in bankruptcy was filed against them and at the Trustee's sale in bankruptcy the assets were purchased by the present corporation, the unsecured creditors of the partnership receiving a first and final dividend of 50% on November 28, 1939. The partners received their discharge from bankruptcy January 12, 1940.

Control of this corporation is divided equally between Morris Doe, Frank Blank and John Smith. John Smith joined with Morris Doe and Frank Blank in forming this corporation to acquire the assets at the sale in bankruptcy, previous to which time he had been employed for about eight years as a furniture buyer by the New York Department Store, New York, N.Y.

On December 16, 1944, a fire which occurred here as a result of the faulty operation of an oil burner, caused damage to stock of about $10,000, with insurance adjustment being received in that amount.

FIG. 25–4—*Continued*

Form 20

LYON-RED BOOK REPORT

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DOE, JOHN CORPORATION -2- NEW YORK.....N.Y.

November 1, 1955

GENERAL INFORMATION

Principals of corporation experienced and attentive, although the president and treasurer have been identified in the past with an unsuccessful venture.

Company occupies a three-story building which it owns in a good shopping center, each floor having about 10,000 square feet of display space, the basement being used for warehouse and storage purposes.

Corporation carries a complete line of home furnishings and has a good sized electrical appliance department handling only major appliances. Deals in medium to low priced lines, with about 90% of sales made on the installment payment plan. Company had enjoyed a fairly good sales volume during the past few years, however, there appears to have been some falling off in volume during the past several months with prospects at this time for a continuance of previous satisfactory sales volume appearing not favorable, local conditions of strikes resulting in unemployment of some weeks having curtailed sales volume in general.

FINANCIAL INFORMATION

Company has an authorized capital of $300,000, in preferred stock, divided into 3,000 shares with a par value of $100 each. The paid in capital is $150,000, $50,000 each having been contributed by the three principals.

COMPARATIVE SUMMARIZED STATEMENTS

DATE	ASSETS	LIABILITIES & RESERVES	NET WORTH	SALES
Dec. 31, 1940	261,724	101,827 2,428	157,468	
Dec. 31, 1952	317,062	122,674 7,260	187,127	220,647
Dec. 31, 1953	370,085	138,864 14,537	216,683	250,128
Dec. 31, 1954	384,117	147,824 17,027	219,266	270,877
June 30, 1955	371,780	138,473 18,236	215,070	125,608

The following statement, received by mail, showing condition from books and physical inventory of June 30, 1955.

ASSETS:			
Current Assets			
Cash on hand & in bank		5,096.28	
Accounts receivable, install		220,174.05	
Merchandise inventory		50,649.00	
	Total Current Assets		275,920.33
Fixed Assets			
Real estate		75,000.00	
Furniture, fixtures & signs		15,427.18	
Delivery equipment		4,908.76	
	Total Fixed Assets		95,335.94
Deferred Charges			
Prepaid insurance & interest			524.51
	TOTAL ASSETS		$371,780.78

FIG. 25–4—*Continued*

Form 20

LYON-RED BOOK REPORT

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DOE, JOHN CORPORATION -3- NEW YORK.....N.Y

November 1, 1955

FINANCIAL INFORMATION (cont'd)

LIABILITIES & CAPITAL:	
Current Liabilities	
Accounts Payable	89,452.02
Notes Payable Bank, secured by endorsement of president & treasurer	15,000.00
Taxes payable, Federal & State	1,521.87
Total Current Liabilities	105,973.89
Fixed Liabilities	
Real estate mortgage	32,500.00
Reserve for depreciation of Fixed Assets	18,236.20
	156,710.09
Capital	
100 shares preferred stock	150,000.00
Surplus	65,070.69
TOTAL LIABILITIES & CAPITAL	$371,780.78

Sales for six months ending June 30, 1955, $125,608 Insurance on merchandise, $45,000. Insurance on building, $60,000

(SIGNED) JOHN DOE CORPORATION
By: Frank Blank, Treasurer

ANALYSIS

Summarized statements show net worth has been steadily increasing from 1940 to 1954, but for the six months there had been some reduction in net worth

Comparison of current statement with that of December 31, 1954, shows a reduction in cash of about $47,500, accounts receivable have increased about $25,000, and inventory has increased about $10,000. Accounts payable have increased about $28,000. Bank indebtedness has increased about $5,000, while taxes have been reduced by about $2,400, and an item of about $40,000 previously shown owing to officers no longer appears in the statement, Mr. Blank stating upon interview that this had been paid to officers which also explained a good part of the reduction in cash position

Current statement shows a liquid ratio of about .57 to 1, and a current ratio of 1.05 to 1, both of which are well below accepted standard. Sales compared with receivables indicates average collection period of about 313 days which is slower than accepted standard, indicating that some of the accounts are becoming old on the books. Inventory compared with sales indicates a fairly satisfactory turnover of about 2.4 times a year

FIG. 25–4—*Continued*

Form 20

LYON-RED BOOK REPORT

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DOE, JOHN CORPORATION -4- NEW YORK.....N.Y.

November 1, 1955

ANALYSIS (cont'd)

While the current and liquid positions are below accepted standard, the net worth ratio, which is about 1.4 to 1, is satisfactory and there is indicated some margin of ratable worth placed at slightly better than $60,000, after allowing for adjustments and depreciation.

BANK INFORMATION

Satisfactory account maintained for several years. Balances previously averaging in moderate five figures, but at present average in moderate four to high four figures. Accommodation extended in high four to low five figures, secured by endorsements of principals and cared for as agreed.

TRADE INVESTIGATION

NATIONAL INTERCHANGE OF TRADE EXPERIENCE

March 25, 1955 - result - 18 houses reporting

PAYMENTS	OWING	PAST DUE
1-Discount	125	---
2-Discount	---	---
3-Discount	77	---
4-Medium	340	---
5-Medium	260	---
6-Medium	180	180
7-Medium	410	---
8-Medium	---	---
9-Medium	100	---
10-Slow	600	320
11-Slow	390	175
12-Slow	740	650
13-Slow	367	367
14-Slow	239	140
15-Very Slow	842	842
16-Very Slow	726	560
17-Very Slow	163	163
18-Very Slow	639	160

Inquiry of Sept. 16, 1955:

Manner of Payment	Days Slow	High Credit	Owing	Past Due	Date Last Sale
1-Medium	--	400	125	---	11/54
2-Medium	--	725	680	110	11/54
3-Slow	30	667	319	284	10/54
4-Slow	30	981	723	416	10/54
5-Slow	30-60	1,519	1,276	962	10/54
6-Slow	60	724	693	487	9/55
7-Very Slow	90	1,263	981	876	9/55
8-Very Slow	90	1,849	1,547	1,029	8/55
9-Very Slow	120	716	716	616	6/55
10-Very Slow	180	1,057	820	820	7/55

FIG. 25–4—*Continued*

Form 20

LYON-RED BOOK REPORT

This report is furnished, at your request, in accordance with the terms of your contract with the Lyon Furniture Mercantile Agency It is to be held strictly confidential. It is for your exclusive use and to be used only as an aid to determine the advisability of granting credit.

DOE, JOHN CORPORATION -5- NEW YORK.....N.Y.

November 1, 1955

COLLECTION RECORD

Mar. 7, 1955 - Claim (H-35872) $420.50 placed with High Point office for inv. 11/4/54. Collected by Agency 4/1/55.

Apr. 22, 1955 - Claim (C-48581) $232.60 placed with Chicago office for goods sold 1/55. Collected by Agency 4/26/55.

June 15, 1955 - Claim (H-36784) $195.80 placed with High Point office for inv. 2/5/55. Collected by Agency 7/7/55.

June 16, 1955 - Claim (H-36787) $527 placed with High Point office for inv. 1/5/55. Collected by Agency 7/8/55.

June 30, 1955 - Claim (N-57602) $947.18 placed with New York office for goods sold Dec. through Mar. 1955. Collected by Agency 7/26/55.

July 2, 1955 - Claim (N-58101) $624 placed with New York office for goods sold 2/21/55.

SUMMARY

PRINCIPALS EXPERIENCED AND ATTENTIVE, HOWEVER, PRESIDENT AND TREASURER HAVE BEEN IDENTIFIED IN THE PAST WITH UNSUCCESSFUL VENTURE. CURRENT STATEMENT SHOWS SUB-STANDARD WORKING POSITION, ALTHOUGH SOME RATABLE WORTH IS INDICATED. TRADE PAYMENTS DURING THE PAST FEW MONTHS HAVE BECOME SLOW WITH SOME CLAIMS APPEARING FOR COLLECTION.

Rate 13-H-5-116 (s.i.)

N:

services provided by private enterprise sources. Typically a given number of credit reports and the early phases of collection are free to members upon payment of the membership fee. After drawing the maximum number of reports a nominal charge is made for each additional report. Similarly, collection cases involving legal action are handled on a cost basis.

CREDIT EXCHANGE, INC.

Credit Exchange, Inc. is a large agency concentrating in the textile, apparel, and dry goods trades. Established in 1921, and with offices in New York, Philadelphia, Chicago, and Los Angeles, it follows the usual pattern of including antecedents, ledger information, and financial data in its credit reports. The agency, however, distinguishes itself in several ways. First, it does not publish a rating book as do most other specialized agencies. Second, a photographed copy of the financial statement exactly as received from the subject risk is attached to the credit report sent to the subscriber. Third, and more important, the agency renders definite opinions for its subscribers in the form of "Recommending Reports" or "Not Recommending Reports." When an account is not recommended it is substantiated by an opinion in the form of a "Personal Opinion Letter" which clearly sets forth the reasons why the agency regards the account negatively. The reasons Credit Exchange may decline an account may not be conclusive insofar as the creditor's business is concerned, and thus supplemental data are often included in the opinion letter. Such data, provided they are of sufficient strength, and when evaluated together with the creditor's business conditions, may finally cause the creditor to accept the account despite the agency's negative recommendation.

Credit Exchange also renders a credit recommendation service which involves a brief credit recommendation free of all details. Account names submitted for this service are either recommended or not recommended on appropriate and simple forms. A recommended account will have shown the manner of payment, the agency's high credit recommendation, and the decision to "o.k." the account. Those accounts not recommended are summarized in simple code such as "C," "L," and "M" which have the following meanings: C, 60 days slow; L, poor past record; M, local reports unfavorable. Similarly, other letters denote equally unfavorable credit elements.

The credit recommendations made by this agency, while similar to Credit Clearing House, are more definitive as well as clearly substanti-

ated by the firsthand knowledge of the agency's reporter. In those industries characterized by a large number of small enterprises, seasonal merchandising problems, and a relatively high cost of maintaining a full-time credit manager, it may be desirable to shift much of the burden of making credit decisions. Credit Exchange provides this possibility in the textile lines.

OTHER SPECIALIZED MERCANTILE CREDIT REPORTING AGENCIES

In addition to the several specialized agencies which have been treated in the preceding sections, there is a considerable number of similar agencies which specialize in other trades. A partial listing of other agencies is as follows:

Name of Agency	*Trade Coverage*
Shoe and Leather Mercantile Agency, Inc	Leather and allied trades
Produce Reporter Company	Fruits, vegetables, and other processed farm products
Lumberman's Credit Association	Lumber and woodworking trades
Credit Association of Building Trades	Construction industry
Stationers and Publishers Board of Trade	Stationery, typewriter, and office equipment trades

Most of the above specialized agencies follow the method of operation of the general mercantile agency, except for distinctive features that have been developed to meet the needs of credit management in particular trades. Although major contributors to the field of credit reporting, these agencies have limited their scope of trade coverage even more than the National Credit Office or the Lyon Furniture Mercantile Agency. Thus, their members or subscribers are somewhat fewer and the completeness of information interchanged among creditors is less. Some of the organizations fall short of having complete coverage in their specialized trades. In general, the service performed by the more limited concerns are highly flavored with trade information such as trade bulletins, advisory information pertinent to the trade, and rating books which serve only those in a specified field of endeavor.

APPRAISAL OF CREDIT SERVICES RENDERED BY THE SPECIALIZED AGENCIES

The extensiveness, particular features, types of credit information, and trade coverage leave little doubt that the specialized agencies are an important source of credit information. The fact that they tailor their services more closely to the needs of their trade implies that their contributions toward better credit judgment cannot be seriously questioned.

The specialized credit reporting agencies, as was shown to be true of the general agency, meet the needs of credit management by supplying data on a subject's identity and legal responsibility, history and business background, character and responsibility of management, financial ability and strength, and payment record experience. These are the criteria established in Chapter 23 against which the credit services of the previously mentioned agencies should be measured. The rather detailed description of the specialized agencies services lends credence to their value and importance in meeting creditor's needs. The flexibility of these agencies in adapting their services to the particular needs of the trade should not be overlooked as a superior feature when contrasted with the general agency.

It is generally believed that credit investigators and correspondents employed by specialized agencies gain a more thorough knowledge of their particular field. By confining their activities, the specialized reporter frequently has more intimate contact and knowledge which may contribute substantially to a more complete and otherwise more satisfactory type of credit reporting. It seems very plausible that by specialized research in particular trade lines, it may be possible to get more detailed information of broader significance to the credit manager. Detailed information, gathered in restricted trade lines, however, is not of credit significance to those credit men whose businesses are selling in a wide variety of markets. There are no specialized credit reporting agencies in trade lines such as tobacco, chemicals, coal, eating and drinking places, and many others, hence the general agency is an indispensible source of credit information for the many marketers selling their products in a large number and wide variety of markets. A common criticism registered by credit managers is that the ledger experiences of the specialized sources are often incomplete insofar as variety is concerned. It is entirely possible that an agency reporter, because of his preoccupation with a particular trade, may fail to investigate those markets in which the subject does the greater proportion of his purchasing. The additional fact that some of these agencies do not cover retailers, or if they do, their reporting is restricted to particular types of retailers, limits the usefulness of the specialized service.

Credit management is particularly aware that the quality of the information in credit reports and rating books is affected by time. That is, information which is intended to be of value and credit significance must be up-to-date. Somewhat allied to this criticism is the demand for speed in credit reporting. Accurate credit investigating always involves time, and especially so when the information must be concentrated from dis-

tant and varied sources. By means of automatic revision systems and the widespread use of wire services by the specialized agencies, their files contain adequate current information to supply the major proportion of all requests. The adoption of such procedures, similar to those of the general agency, puts current information in the hands of the creditor in a relative short span of time. To fulfill requests on which current information is not in file, the agency must sacrifice promptness for accuracy. Because of the very nature and character of the work involved, it seems improbable that speed and accuracy can be incorporated into every report.

Some functions of the specialized agencies as well as the general agency are not self-sustaining. A case in point is the trade information which is gathered from credit men who are representative creditors of another credit man's risk. Some credit managers believe a more active interest in the field of credit reporting on their part is necessary, and especially with regard to furnishing ledger experience. How well a system of ledger interchange works is dependent entirely upon credit men who hold the valuable information. The mutual advantage of giving and receiving needs no particular elaboration and should be clear, especially to credit management.

It is quite reasonable to conclude that the advantages of the specialized agencies, as contrasted with the general agency, are for the most part the result of trade specialization. They undoubtedly render very valuable types of information to creditors and are extremely useful to firms trading in a limited number of lines. The general agency, as evidenced by its very wide use and acceptance by credit men, has an undisputed place in facilitating the credit judgment of those who sell in a large number of diverse markets. In the aggregate, the commercialized sources of credit information treated thus far, plus the frequent use of "free" sources of information, provide credit management with an abundance of varying combinations which will help to meet most credit needs.

REVIEW AND DISCUSSION QUESTIONS

1. In what two ways do specialized agencies differ from the general mercantile agency? What, if any, are the advantages and disadvantages to specialization in the credit-reporting field?
2. Point out the differences and similarities of the following with Dun & Bradstreet:
   a) Credit Clearing House
   b) National Credit Office

3. Describe the rating system used by the *Apparel Trades Book.* Is this rating system superior or inferior to the system used by Dun & Bradstreet? Why or why not?
4. What are the advantages of photographed financial statements similar to that shown in Figure 25–2?
5. List the unique features of the services of Lyon Furniture Mercantile Agency. What allied fields does this agency serve?
6. Discuss the advantages and disadvantages of the *Lyon Red Book* Credit Key.
7. What is the most unique feature of the Lyon services?
8. List several other specialized credit reporting agencies and note their fields of concentration.
9. Assume you are a credit manager for a supplier concentrating in one of the fields serviced by a specialized agency. Would you purchase the services of the general agency or the specialized agency? Support your decision.
10. Evaluate the services of specialized agencies in regard to the quality of their services and the needs of credit managers functioning in specialized areas of trade.

CHAPTER 26

Basis of the Commercial Credit Decision (cont.) Credit Interchange Bureaus of the NACM

MANY OF THE problems involved in investigating a commercial or bank customer can be removed by the use of a source or a combination of the sources of credit information which have thus far been treated. There remains, however, one other major source of credit information which is of particular interest to credit management. This source, the Credit Interchange Bureaus of the National Association of Credit Management (NACM)[1] is the only credit reporting organization which renders a single type of credit information; namely, ledger experience. Since most customers purchase from suppliers located throughout the country, any direct attempt to secure a representative number of individual ledger experiences would involve much time and an unwarranted delay in making the credit decision. The need for a centralized point of inquiry from which to obtain such information stems from the weight given to ledger experience by credit executives and from the wastes as well as the inadequate results when direct inquiry is undertaken.

NATIONAL ASSOCIATION OF CREDIT MANAGEMENT

The National Association of Credit Management is the oldest and largest professional and service association representing commercial and financial credit men in the United States. In 1896, when the association was formally organized, the climate in which credit men operated was

[1] This association was formerly known as the National Association of Credit Men.

vastly different than that of today. The practice of fraud and misrepresentation by businessmen was common, and creditors were without adequate commercial laws to prosecute the guilty and protect their businesses. For example, it was almost impossible to prosecute the debtor who on the verge of insolvency would sell the assets of his business and pocket the proceeds. This type of action on the part of the debtor ignored the interests of creditors and violated the present-day theory that an insolvent business belongs to the creditors. This problem was further aggravated by the rapid growth of interstate commerce and the absence of a uniform federal bankruptcy law to deal with financially distressed businesses. The few state laws at that time were contradictory, complex, and generally failed to protect creditors.[2]

Financial statements, though at the time used infrequently in analyzing the credit worthiness of a risk, could not be relied upon and no laws protected the creditor. Co-operation among credit men in exchanging credit information was lacking and many creditors deliberately attempted to deceive by revealing either inadequate data or incorrect information.[3]

Any individual attempt to improve ethical standards of the profession or to raise the quality of the credit structure was recognized as futile. All credit men, however, working together could impose ethical standards on the industry, raise the quality of the credit structure, and develop a scientific approach to the mutual problems of credit management. The National Association of Credit Management was organized in 1896, when businessmen came to realize that co-operation was necessary to cope with their mutual problems which were being intensified by a growing demand for credit. From a humble beginning of less than 600 members, today it numbers more than 36,000 members from the leading manufacturing, wholesaling, and financial institutions of this country.

Organization. Today, with headquarters in New York City, the association is organized into 146 affiliated local chapters representing most of the major and minor markets of the nation. Each local chapter is governed by elected officers and most chapters employ a full-time administrator of the association activities as well as full-time clerical help. The local units are organized into departments for the various services they render such as legislation, education, interchange, collection, and the like.

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[2] *Credit Management Handbook,* A Publication of the NACM (Homewood, Ill.: Richard D. Irwin, Inc, 1958), pp. 676–77.

[3] *Ibid.,* p. 677.

The co-ordinating unit, of course, is the NACM which is also governed by elected officers and a board of directors. The activities of the national association are directed by a full-time executive vice-president and a paid staff. Membership in the association is both local and national by virtue of the fact that dues include membership in both the local chapter and the national association.

Activities. In addition to operation of the Credit Interchange Bureaus, the association fulfills its objectives and meets the individual needs of its membership by being engaged in the following activities.

1. *Fraud Prevention:* The fraud prevention department detects and prosecutes perpetrators of commercial frauds.
2. *Educational:* The National Institute of Credit offers educational opportunities in the credit, banking, business law, and merchandising fields to members, their associates, assistants, and others desiring to train for a career in credit work. Credit institutes and seminars are conducted at major universities throughout the country.
3. *Legislation:* The legislative department has a continuing program for the correction, modification, repeal, or enactment of both federal and state laws which affect credit and finance
4. *Adjustments:* Adjustment bureaus of the NACM are maintained throughout the United States and specialize in the orderly administration of distressed businesses. The bureaus function for the benefit of creditors by acting as assignee, trustee, or receiver and by attending creditors meetings and making recommendations.
5. *Collections:* A nation-wide collection service is operated for members.
6. *Publications:* Publishes the *Credit Manual of Commercial Laws* annually and *Credit and Financial Management* which is a monthly magazine.
7. *Research:* The Credit Research Foundation founded by NACM in 1949 sponsors and encourages credit research concerned with credit conditions and practices of either a general or specific nature. The foundation also administers the educational activities of NACM. It recently prepared and edited the *Credit Management Handbook.*
8. *Industry and Trade Group Meetings:* Sponsors industry and trade group meetings made up of credit and financial management people who meet regularly to discuss credit problems and economic trends. Trade group meetings also provide the opportunity for discussion of members' experiences with specific accounts.
9. *Foreign Credit Interchange:* The Foreign Credit Interchange Bureau established in 1919 provides a ready source of payment record data on thousands of foreign buyers located throughout the world. Members of NACM may subscribe to its services on a cost basis.

CREDIT INTERCHANGE BUREAUS

Credit Interchange Bureaus were at first operated on a local-market basis. It was soon found that information gathered from one market was insufficient for members' requirements and a system for the interchange

of ledger experience among bureaus was developed. This was accomplished in 1919 by the organization of a central bureau in St. Louis which enabled various bureaus, although independently operated, to exchange their information and reports. It was not until 1921 that NACM took over the central bureau, and with 15 participating bureaus it established the present National Credit Interchange System.

Organization. Today the National Credit Interchange System is entirely an operation of the National Association of Credit Management. The system is comprised of a co-ordinating unit, the Central Credit Interchange Bureau, located in St. Louis and 59 local bureaus covering major and minor markets of the country. Each local bureau operating in the system is member-owned and member-operated under the supervision of the local NACM association. In a few instances bureaus are under the supervision of the national association. Membership is limited to manufacturers, wholesalers, other middlemen, and bankers. There is no restriction by trade line or geographical location. The underlying principles of each bureau are (1) member direction and control, and (2) service charges just adequate to cover the costs of operation. The bureaus serve as mediums for the assembling and dissemination of credit information which is supplied and used by member-creditors.

The entire system is administered by the Board of Governors, NACM. The board prescribes operating procedures, standards, forms, and any changes needed to effectuate a more effective system.

Method of Operation. The successful and efficient operation of the National Credit Interchange System is almost entirely dependent upon the constant co-operation of its members. To encourage member co-operation and to perpetuate an efficient system, the mechanics of the operation have been co-ordinated and standardized to the extent that a minimum of effort is required of members.

The system operates on the basis of *sources* of information which are accumulated in the local bureaus by requiring each participating member in the service to:

1. Supply a complete list of the active accounts on his ledgers at the time he becomes a member of the service.
2. Supplement that list with new accounts (as they are opened) and reopened accounts after the original list is filed.
3. Furnish the names of all known creditors at the time of making an inquiry for a report on any customer.

Each member of a local bureau is assigned a code symbol which is known only by the member so designated and the officers of the bureau. A code number also designates each local bureau. As the names of members' active accounts and their new and reopened accounts flow into the local

bureau, a card is made out showing the name and address of the subject and the symbols of the members doing business with the account. The code number for each local bureau having an interest in the account is also shown on the subject's card. Thus, each local bureau has a ready reference file which shows all local members who have registered an interest in an account as well as information on the other bureaus that have an interest in the account. The constant flow of account names into the bureaus from members assures card files that are up-to-date.

Each of the 59 affiliated bureaus is allocated a "zone of operation," which is the normal trade territory of the market served by the bureau. Each bureau reports the names of all its members' customers outside its zone of operation to the bureau in whose zone of operation the customers are located. Thus, the files of each bureau contain two types of names: (1) customers located in the zone of operation, whose cards contain the names of suppliers located in that zone, as well as a list of other inter-

FIG. 26–1. Member's inquiry form.

MEMBER INQUIRY
Credit Interchange Bureaus
502 THORPE BLDG MINNEAPOLIS 2, MINN.

PHONE
FEderal 6-8356

PRO NO

SEND US REPORT ON DATE

NAME

TRADE STYLE

STREET ADDRESS

TOWN STATE

TYPE BUSINESS UNFILLED ORDER $

OUR EXPERIENCE (REPORT DOLLARS ONLY)

CHECK FOR AUTOMATIC REVISION
☐ 4 MONTHS
☐

☐ SEND PRELIMINARY REPORT
☐ SEND ONLY THE COMPLETED REPORT

HOW LONG SOLD	DATE OF LAST SALE	HIGH CREDIT	OWING (INCLUDE NOTES)	PAST DUE	TERMS OF SALE	MANNER OF PAYMENT
						☐ DISCOUNTS ☐ PAYS WHEN DUE DAYS SLOW

IMPORTANT LIST KNOWN SOURCES OF SUPPLY BELOW THE BUREAU WILL MAKE EVERY EFFORT TO OBTAIN THEIR INFORMATION AND INCLUDE IT IN THE REPORT

NAME ADDRESS

BANKS WITH

MEMBER

F-1

ested bureaus; and (2) customers located in *other* zones but sold by members in the local zone, whose cards contain the names of local suppliers and the other interested bureaus. In other words, the files of the local bureau on all subjects in its zone of operation constitute a record of all local creditors selling a customer, as well as all markets in which he is buying. When a clearance is made, members of all bureaus selling the customer under investigation are canvassed for information without regard to industry or location.

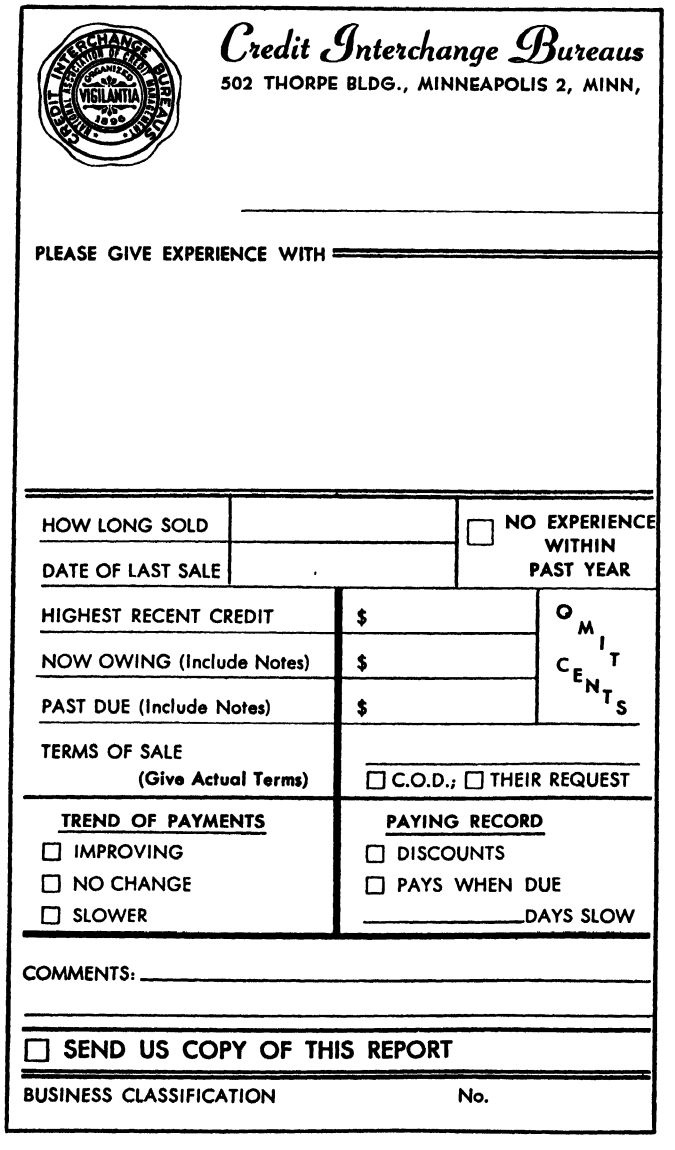
Each member is furnished a supply of inquiry forms (see Figure 26–1). These forms are used by members in requesting a credit report on active accounts or on new and reopened accounts. The inquiring member is required to submit his ledger experience with the subject each time he submits one of these forms. In addition a space is provided for the listing of all known sources of supply. Usually this space lists those business houses that were submitted as references by the prospective customer.

When a member makes an inquiry on a customer located in the same zone as the bureau receiving the inquiry, the files will disclose the names of creditors in the local market and the identity of other interested bureaus. The zone of operation bureau canvasses all creditors who are listed as selling to the customer. This is done by sending each known creditor the "member's reply form" illustrated in Figure 26–2. The local bureau also requests the same procedure be instituted in other interested markets. When the other markets have accumulated the ledger facts from interested creditors, these facts are forwarded to the bureau which originally initiated the clearance, where, together with its own local information, the credit interchange report is written. If, on the other hand, the subject of the clearance is located in another bureau's zone of operation, the bureau receiving the request automatically canvasses its local interested creditors for ledger facts, and at the same time forwards the inquiry to the subject's home zone from which a national clearance is initiated.

The local bureau is responsible for compiling the information and writing the credit interchange reports on all subjects in its territory. When an inquiry form is received by the bureau, the following actions are taken:

1. The most recent interchange report in the bureau's files is immediately forwarded to the member. Typically, any report older than 120 days is subject to revision and a canvass of the local markets and other zones is initiated. If this is the case, the inquiring member will also receive the preliminary and final reports noted below. On the other hand,

FIG. 26–2. Member's reply form.



Credit Interchange Bureaus
502 THORPE BLDG., MINNEAPOLIS 2, MINN,

PLEASE GIVE EXPERIENCE WITH _____

HOW LONG SOLD		☐ NO EXPERIENCE WITHIN PAST YEAR
DATE OF LAST SALE		
HIGHEST RECENT CREDIT	$	OMIT CENTS
NOW OWING (Include Notes)	$	
PAST DUE (Include Notes)	$	
TERMS OF SALE (Give Actual Terms)		☐ C.O.D.; ☐ THEIR REQUEST

TREND OF PAYMENTS	PAYING RECORD
☐ IMPROVING	☐ DISCOUNTS
☐ NO CHANGE	☐ PAYS WHEN DUE
☐ SLOWER	_____ DAYS SLOW

COMMENTS: _____

☐ SEND US COPY OF THIS REPORT

BUSINESS CLASSIFICATION No.

if the credit report on file is not subject to revision, and if it contains sufficiently fresh and adequate information to meet the creditor's requirements, the bureau will take no further action.

2. One or more *preliminary reports* are forwarded to the inquiring member. Preliminary reports contain revised and more current information from the local and nearby markets. Such reports are written as suf-

ficient information becomes available in the bureau as a result of their canvassing procedures.

3. Finally, the flow of information into the bureau from other zones of operation is completed and a *final report* is written. Copies of the final report are sent to the inquiring member as well as to each creditor who contributed ledger information to the bureau. As the final report becomes available, it represents an up-to-date summary of the buying and paying habits of the subject account with all creditors who registered an interest.

CONTENTS AND INTERPRETATION OF A CREDIT INTERCHANGE REPORT

An illustrative Credit Interchange Report is shown in Figure 26–3. It should be noted that unlike many other types of credit reports, the Credit Interchange Report offers no recommendations or opinions. Personal comments that are not based upon actual ledger experience are not included in the report. The report merely presents facts based on the actual ledger experiences of creditors and arranged in an orderly manner for rapid appraisal. The report contains a large amount of information for the credit executive who appraises it carefully and properly. Unfortunately, there are many instances when the only analysis made is a hurried glance at the paying record and comments columns. It should be recognized that the most intelligent appraisal of the Credit Interchange Report involves both the horizontal as well as the vertical analysis of the columns. Any appraisal which falls short of this technique results in faulty interpretation and the failure to uncover the true significance of the data.

Heading

The heading of the credit interchange report identifies the subject account by name, type of business in which it is engaged, its address, and the date the report was written.

Business Classification

This is the first column of the report and it shows *where* the customer buys and *what* types of merchandise he buys. Under each market designation is a code date, which reveals to the creditor the freshness of the information. For example the code 928 459 under Chicago denotes that Chicago contributors received requests from the bureau and supplied information on or before (928) which means, September 28. The last

FIG. 26–3. Credit Interchange Bureau Report.

FORM 7L 1-59

NATIONAL ASSOCIATION of CREDIT MANAGEMENT

Credit Interchange Report

Guarding the Nation's Profits

OFFICES IN PRINCIPAL CITIES

JOHN DOE
DOE MERCANTILE COMPANY

ANOKA, MINNESOTA
401 MAIN STREET
ANOKA COUNTY

OCTOBER 11, 1959

The accuracy of this Report is not guaranteed. Its contents are gathered in good faith from members and sent to you by this Bureau without liability for negligence procuring, collecting, communicating or failing to communicate the information so gathered

BUSINESS CLASSIFICATION	HOW LONG SOLD	DATE OF LAST SALE	HIGHEST RECENT CREDIT	NOW OWING (INCLUDING NOTES)	PAST DUE (INCLUDING NOTES)	TERMS OF SALE	PAYING RECORD: DISCOUNTS	PAYS WHEN DUE	DAYS SLOW	COMMENTS
MINNESOTA										
926-142										
#117 GENM						UNFILLED	ORDER	$310.00		
*236 GENM	yrs	7-59	2100	950	950	note 60			180	
*142 GENM	yrs	9-59	300	165	45	60		x		
138 GROC	1956	9-59	150	85				x		
*137 SHOE	1957	6-59	79	79	79	2-15-60			60	
*153 CLO	yrs	1-59	1350	150	150	60			180	
						in hands of attorney				
239 SHOE	1957	9-59	95	95		60		x		
215 RBR	1958	2-59	114					x		
*240 RBR	yrs	8-59	1000	340	325				60-90	
						UNFILLED	ORDER OF	$85.00		
165 RBR	2yrs	4-59	67			2-15-30			90	
277 SHOE	1959	7-59	284			2-15-60		x		
*320 FDP	3yrs	8-59	145	95	20	2-10-30		x	30	
*310 PPR	yrs	8-59	475	220	220	30		x	30-60	
323 CONF	yrs	3-59	104			30		x	·15	
*347 GROC	yrs	8-59	396	175	145	30			60-75	
453 CLO	yrs	8-59	313			REFUSED	IN 12-58		120	
*OMAHA & NEBR										
929-20										
418 GROC	yrs	6-59	193						60	
*140 GENM	8-59	9-59	750	750	243	60		no Pay	exp.	
264 HFGS	9-59	9-59	325	325		60		no Pay	exp.	
*532 ELEC	yrs	1-59	574	477	477	60			150	now cod
*CHICAGO										
928-459										
*B120 GENM	yrs	7-59	450	336	120	30			60	
B25 CLO						refused	on interchange report			
*ST. LOUIS										
929-413										
*730 SHOE	yrs	4-59	249	90	90	45			120	
*624 SHOE	new	5-59	375	325	225	30			90	checks ret
*CENTRAL IOWA										
928-24										
*178 GENM	yrs	6-59	165	165	165	2-10-30			60	
BU 5 MS				4822	3254					

portion of the code is a processing number and is of no significance to the credit analyst.

The proper interpretation of this column reveals the customer's buying practices. Is the customer buying in too many markets? Are these markets his normal sources of supply? Customers who buy in many

markets when fewer sources could be utilized to better advantage may indicate creditors' lack of confidence. Or, it may indicate a badly broken stock which can result when too many suppliers sell the same line to the same customer. In general, this column should give the credit executive a fair idea of the kind of business and some of the practices in which the risk is engaged. It is not too difficult to appraise the desirability of the risk's buying habits and also to estimate the proportion between total purchases of a line and the purchases made from the credit analyst's company.

How Long Sold

The column "How Long Sold" should be considered as a measure of confidence. When business dealings have continued satisfactorily over the years, it is much more reassuring than dealings of short duration. Credit risks that have recorded satisfactory experiences for many years are usually regarded highly in the credit and sales professions. In addition, the length of creditors experiences gives a clear indication of the reliability of the information to follow. If, however, an established customer suddenly opens new accounts and forsakes his old established sources of supply, it may mean that his credit is no longer acceptable. One of the early indications of financial difficulties may be the erratic seeking of new sources of supply, because of an account's inability to meet current obligations. This same technique may also mean that the risk has overbought in proportion to his ability to pay.

Date of Last Sale

Ledger information which does not disclose the "date of last sale" is valueless. Credit information not only must be adequate to make a rational decision, it also must be timely. Old information of a derogatory nature has little meaning because past credit weaknesses may have been overcome and the present-day payment record could well be satisfactory. Conversely, former satisfactory performance can easily be nullified by current difficulties which result in slow payment of obligations. Furthermore, this column should be compared with the "How Long Sold" column and the "Paying Record" column; the former to determine whether new sources are being sought by the risk, and the latter to study the trend of the account.

Highest Recent Credit

This column is another measure of the creditors' confidence in the subject. If the figures in this column are large relative to the payments being made on the account, it is an indication that creditors may have

an undue interest in the business. There are some other uses of these data which are particularly valuable to the credit executive. For example, the setting of a credit limit may be the average high credit accepted by other suppliers. From the sales viewpoint, it is a simple matter to estimate the proportion of any single line that is supplied by a particular creditor firm.

Now Owing

There is much value in comparing this column with financial statement data. Many credit executives regard the total of the figures in this column to be representative of the accounts payable figure in the customer's balance sheet. There is a strong possibility that this is a valid assumption provided, of course, both data are of the same date. Although the National Association of Credit Management does not claim that the reports reveal the total indebtedness of the subject, its representativeness can quickly be checked with the balance sheet of the same date. The association does warn its members that if the total of this column is greater than the amount shown on the balance sheet, a complete investigation of the subject should be undertaken. It is also desirable to compare the total amount owing as well as the individual amounts owed with reports over a period of time. This comparison will indicate the improvement or deterioration of the subject's affairs with his creditors. Comparison of this column should also be made with the "High Credit" column as this discloses whether he is currently heavily indebted to all sources of supply, or whether most of his accounts with creditors are in balance. The "Now Owing" figures should always be appraised with regard to seasonal variations and other conditions which may affect the activity of the business.

Past Due

Great care should be exercised in appraising the information shown in this column. Under most circumstances relatively large amounts in this column can be regarded as an early indicator of financial difficulties. It should however be checked against "Date of Last Sale" column and the "Paying Record" column so as to ascertain a clearer concept of the problem. A report that shows little indebtedness, on the other hand, might be an indication of credit refusal and hence must be checked against the "Paying Record" to clarify the condition. A single amount past due may be a legitimately disputed account rather than deterioration of the subject's paying habits, and such isolated amounts should be checked with the "Comments" column.

A large amount shown as "Past Due" should not immediately be appraised as an indication of an unfavorable trend. The total amount in this column should be analyzed relative to other things. Oftentimes a comparison of these data with the "Amount Owing," "Highest Credit," and "Comments" will disclose that the subject is overcoming a period of adversity.

Terms of Sale

It is necessary that credit executives be well acquainted with the terms and discounts which prevail in various industries. While C.O.D. and C.I.A. terms are sometimes indicative of a lack of confidence, they are also standard terms in some industries and cannot be regarded as restrictive. Restrictive terms may also be the result of the request of the subject and accordingly should be viewed as a favorable factor rather than as an unfavorable factor. The "Terms of Sale" should be compared with the "Paying Record" column so as to determine whether the subject is foregoing profitable cash discounts. This latter comparison may also help to explain some of the variations found in the report.

Paying Record

The "Paying Record" section of the report consists of three columns which are subtitled "Discounts," "Pays When Due," and "Days Slow." These columns are not to be regarded as having separate value to the over-all report but merely represent a summarization and explanation of facts shown in the other columns. An analysis of other columns will help to avoid erroneous assumptions which may be based on an average appraisal of these columns. In other words, the fact that a certain number of accounts are discounting, paying when due, or are slow is of little significance unless "Comments" and other facts are also evaluated at the same time.

Comments

This column of the report provides a space for information which can lend clarity to the ledger facts recorded in preceding columns. Oftentimes the trend of payments experienced by creditors will appear in this column. In general, data which show no change, improvement, slowness, and the like are valuable in determining the stability of the risk. Any report which shows a large number of unfilled orders in this column should be regarded with pessimism and a signal that further investigation might be advisable. When comments are particularly unfavorable, such as "collected by attorney" or "refused," an appraisal of the general

character of the report should be undertaken. Particularly, the date of the transaction involved should be determined so that unfavorable information of long standing is not regarded as current.

When to Use a Credit Interchange Report

The NACM recommends that a Credit Interchange Report be requested each time a new order is investigated, when an unusually large order is received from a customer, and, when a large number of direct inquiries are received on a customer. Likewise, a report should be requested on all slow-pay accounts, and when the creditor is anticipating special collection action against the debtor enterprise. Furthermore, the association recommends that creditors keep close watch on important customers as well as doubtful accounts by use of the *Automatic Revision Service.* This service gives the member a series of new, up-to-date reports at regular intervals designated by him. Such a series of reports permit the creditor to keep a close check on the paying habits of his customers and also determine whether the share of volume secured from good customers is in proper proportion.

APPRAISAL OF THE CREDIT INTERCHANGE SYSTEM

Much of the general worth of the Credit Interchange System is partially indicated by the fact that it is one of the most widely and frequently used sources of credit information. Strength in the system accrues from its operation by NACM which is one of the nation's largest, most respected, and influential trade associations. Each company represented in the association is either an interchange report user or a potential member of the system. The varied services of the association and the high esteem with which these services are regarded by members lend additional support to the strength and over-all value of the system.

Perhaps the system's greatest weakness stems from the fact that it is a co-operative venture, and hence, of necessity it depends upon its many members reacting in a like manner in originally supplying ledger information and in answering subsequent inquiries. For the maximum total effectiveness of the system each member must exercise promptness, thoroughness, and exert a high measure of fidelity. Additionally, each credit department member who answers inquiries and analyzes reports affects the quality of the system. Unless these same personnel are trained to understand the reports and the workings of the system, it cannot be presumed to be of maximum effectiveness. In those sections of the country where communications are easy, and where members of the system

are actively interested in using and promoting the interchange system, it seems to work well. In some sections, though, these qualities are not present and the system is unsatisfactory. Despite these weaknesses, a cooperative method of gathering ledger information is the most efficient method known to the industry. To overcome the shortage of trained credit department personnel, the association has developed educational programs and published a great deal of literature, portions of which are designed toward a clearer concept of the Credit Interchange system.

Other than what might be implied from a careful analysis of the Credit Interchange Report, it does not reveal information concerning either the subject's *history and business background,* nor the *character and responsibility of management.* These are but two of the six types of information needed by credit management to arrive at a sound credit decision as set forth in Chapter 23. From the preceding discussion it is obvious that the Credit Interchange Report reveals most comprehensively a customer's immediate *past and present payment record;* and, if the recorded data are properly analyzed a fair estimate of the customer's financial condition can be gained. Some credit executives regard the interchange report as supplemental to other types of reports for these reasons. With the system's specialization on a single type of credit information, one might raise the question as to "why is it a widely and frequently used source of credit information?"

Despite the apparent weakness of the interchange report to fulfill all of the needs of credit management, it should be emphasized that ledger information is regarded as one of the most important types of information used in the industry. Following the high importance of ledger information are the financial statement, the creditor's past experience, and then history and antecedents.[4] While credit management needs several types of credit information, there is considerable variation in the value attached to the several types and the frequency with which some kinds of data are needed. The superiority of the Credit Interchange Report stems from the frequency with which ledger data can change as contrasted with other types of information. Antecedents, method of operation, and financial statements do not change frequently, but only in the

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[4] A study conducted several years ago revealed the most valuable types of credit information and the order of importance sought by credit management to be: character, payment record, financial statement, past experience, and history and antecedents. While "character" was rated as first in value it is the least tangible quality credit management is concerned with. Some believe this quality overemphasized and impossible to measure. See Robert S. Hancock, *Sources of Credit Information* (Urbana, Ill., University of Illinois Bulletin, 1950). While this study was conducted in 1949 there is little reason to believe the order of importance of the types of credit information would be different today.

course of rather extended periods of time. It is the rapidity with which ledger data are observed to change which contributed to NACM's development of the interchange system. The oldest information which a member can receive from a completed credit interchange canvass is 120 days or less, whereas other agencies normally revise their reports only twice a year. Because ledger data change frequently each new Credit Interchange Report should assist the creditor in making proper and current revision of his customer's accounts. Finally, the interchange report is not intended to replace financial and operating statements. The best use of the interchange report is in conjunction with these statements. When this is done credit management has marshaled what many consider to be the most valuable data used in making a credit decision.

REVIEW AND DISCUSSION QUESTIONS

1. Compare and contrast the activities of the NACM with another trade association of which you are knowledgeable. Do you believe the widespread activities of the NACM and their emphasis on many phases of commercial credit work have contributed to the credit industry? In what ways?
2. Describe the method of operation of the National Credit Interchange system.
3. What is meant by "ledger experience." Does this type of information strike you as being significant to the work of credit analysis?
4. Analyze the Credit Interchange Report reproduced in Figure 26–3. Would you accept or reject this customer's order for $263 of men's shoes? Why?
5. Why is it important to *fully* analyze the interchange report and not arrive at a decision based on one or a few columns?
6. Why do members of the interchange system receive more than one report per request? What is the significance of each report?
7. List the major weaknesses in the system. The advantages and strong points.
8. Would you use other types of credit information to augment the interchange report? If so, what are other types? Why?
9. "A co-operative method of gathering ledger information is the most efficient method known." Discuss this statement.

CHAPTER 27

Financial Statements—Analysis and Interpretation

ONE OF THE most important sources of credit information available to the credit analyst is the financial statement. Generally speaking, when the term "financial statement" is used, it refers either to the balance sheet or to the profit and loss statement. In some instances, it also will apply to an analysis of surplus of a concern.

The balance sheet, of course, is a statement of the financial condition of a company as of a moment of time. In other words, it is a photograph of the concern showing the assets,[1] liabilities, and net worth as of the instant of time the "picture is taken." The profit and loss or operating statement, on the other hand, covers a period of time and reflects the sales, cost of goods sold, expenses, and net profit or loss during the interval covered.

REASONS FOR FINANCIAL STATEMENTS

In general, the credit manager needs financial statements for the same reason he needs other types of credit information—to arrive at a rational and sound credit decision. Without this type of data a credit decision would rest upon factors which do not reveal the customer's ability to pay the credit obligation. Because financial data most often reveals this capacity or probability, credit managers heavily rely on financial

[1] It is assumed that the reader will have had a course in the principles of accounting or practical experience covering the accounting field. If this is not the case, the reader is referred to any basic accounting text for definitions of accounting terms used in this and the succeeding chapter

statements to guide their decision-making processes. No other source, other than actual financial statements, can give the credit analyst a clear insight into the customer's financial condition and capacity or earning ability. Likewise financial statements reflect the integrity of the business' management which is charged with the decision-making segment of the concern.

The requests for financial statements have seen a tremendous growth in recent years, not only between the cash lender and business borrower but also between the seller of goods and buyer of goods. One of the reasons for this increasing demand for financial statement analysis and interpretation is the growing number of executives who are occupying positions on the credit management level, and who have been trained at universities and colleges in this technique of credit determination. Undoubtedly, even greater use of this source of credit information will be made in future years as some of these same individuals occupy an even greater number of decision-making positions.

As more firms and banks call for balance sheets and profit and loss statements from their prospective customers, these credit applicants have come to recognize the necessity of making a good showing in order to obtain on credit the merchandise or money desired. Business enterprises who trade on their credit have been forced to adopt accepted accounting practices and techniques, to keep organized and accurate books of record, and to employ the services of competent and recognized accountants who can certify as to the correctness of the information reported.

SOURCES OF STATEMENTS

The question now arises as to where the credit grantor can obtain financial statements reflecting the financial status of the prospective borrower of funds or buyer of goods.

Directly from Risk

One of the accepted sources is to ask the credit seeker directly to supply a balance sheet and/or a profit and loss statement. Some firms have adopted the policy not only of asking for a financial statement prior to the time of initial credit acceptance, but they also follow the practice of asking for interim and annual statements. Such a practice then becomes almost an automatic procedure on the part of the credit customer. Very often, a standardized form, similar to the one illustrated in Figure 23–1 (pp. 450–51), is prescribed and is furnished the customer for completion.

Commercial banks and accounting firms may also be regarded as a "direct" source of financial statements. Banks often supply the statements rendered to them by businesses for credit purposes, and in turn the commercial creditor can obtain the statement through the customer's bank. Both the bank and the commercial creditor use the statements for essentially the same purpose. Accounting firms that have certified to the correctness of the customer's accounting procedures, as well as prepared the financial statements, will on request supply statements to creditors.

Indirectly from Mercantile Credit Agencies

The reports furnished by Dun & Bradstreet, Inc. and by most of the special mercantile agencies generally contain financial statements that have been furnished to the agency by the prospective credit customer. These reports often contain financial information covering a period of three to five years, in order to show the financial trends occurring in the business operation. These agencies have made a concentrated attempt in recent years to gather financial statements on as many business firms investigated as possible, thus improving their coverage of the financial aspects of credit information to a subscriber of their services.

PURPOSES OF STATEMENT ANALYSIS

When a credit man approaches the analysis of financial statements, he has some specific goal in mind. The exact nature of his goal depends on the characteristics of the credit case at hand. For example, he may have what appears to be a one-time order to approve or disapprove; or, he anticipates the one-time order as a customer who might be a repeat buyer and the creditor-debtor relationship may exist over many years to come. Under the former situation he would spend less time evaluating the financial statements and arriving at a decision. If, however, the latter circumstance prevails much more time will be devoted to the financial analysis, and an attempt will be made to determine the probable continuing profitability of the customer. Fortunately, the content and structure of financial statements permit flexibility in their analysis and the precise nature of the analysis can be tailored to the nature of the credit risk.

In general, the analysis of financial statements can uncover three major factors. It can determine a firm's liquidity condition, its solvency condition, and its managerial efficiency. If the credit analyst is only concerned with determination of the liquidity condition of his credit case, then in all likelihood the customer is regarded in terms of a one-time

order. When, however, the credit risk appears to be one which will be continuing, the analyst will be more concerned with the long-run financial prospects of his customer. Hence liquidity, solvency, and managerial efficiency may have to be determined in order to arrive at a correct credit decision. The *liquidity* of a business is concerned with its ability to meet day-to-day current obligations. The *solvency* of a business determines the dependence on financial support from creditors as contrasted with the financial investment by its owners. *Managerial efficiency* as revealed by financial statement analysis determines the ability of the firm to operate profitably and successfully over a long period of time. Whether the analyst approaches the credit case to uncover all three financial conditions or only one or two of them is entirely dependent on the nature of the risk and what the analyst must know to arrive at an objective decision.

In analyzing financial statements, it must be realized that in any line of trade there are certain proportions of assets and liabilities which are more conducive to successful operation than are others. There also are certain proportions which are healthy in that they indicate an ability to meet maturing obligations. Thus the proportion of assets to liabilities should be such that the assets supplied by creditors are in no larger proportion than is indicated for safety, for continued operations, and for due division of the risks of the venture between creditor's capital and owner's capital. The debts also should be properly proportioned to the liquidity requirements. In a line of trade where most of the assets are highly liquid, a larger debt structure may be supported by these assets than would be true in a line of trade where a large proportion of the resources is invested in fixed or nonliquid form. There also is a proper proportioning of the assets and liabilities to assure continuation of the business, or what might be called to supply the safety factor. Too heavy a debt structure is not a sound financial policy with which to face a period of declining sales. On the other hand, a too-conservative borrowing policy may not act to the injury of creditors but may interfere with the profitable operation of the business.

The assets should be distributed in such a way that those which are acquired will result in profitable operations. For example, there is a common fault in many retail firms of having too large a proportion of the assets invested in buildings. This also may be true of a manufacturing venture; too large a proportion of its resources may be tied up in fixed form. This often interferes with the ability of the business to purchase its desired stock of material. With a merchant, it may interfere with his ability either to carry accounts receivable in sufficient amount to take

advantage of the sales potential sought by the offering of credit service or to stock an inventory sufficiently varied and selected so as to be attractive to his customers. Too large an investment of resources in a fixed form leads to the situation sometimes referred to as "frozen." The firm then may be good, but very slow, in meeting payments. Its resources are invested largely in assets which are not quickly converted into cash during the normal processes of business and in the event of emergency, are converted only at considerable sacrifice of value. In case of an emergency the firm may fail, despite the possession of large resources, because its inability to meet currently maturing liabilities may lead to so much impatience on the part of the creditors that failure will be precipitated by some drastic legal action.

The capital of the business should be in proper proportion to the needs—by this is meant the resources supplied by the investors, or owners, should be relative to the needs of the business. This may be both a matter of size and a matter of proportion. In connection with the matter of size, there should be sufficient owner capital supplied in each type of business to enable it to operate upon a scale which is conducive to success. If a business is started without sufficient capital to operate on an efficient scale, it will be hampered in competition and growth. Relative to the proportion concept, there should be a sufficient proportion of the capital supplied by outside creditors to distribute the risks properly between owned capital and borrowed capital. Certainly the proportion of the capital supplied by owners should not be so small that creditors are asked to take ownership risks in return for only creditor profits.

The trend, or direction-of-change, concept is slightly different. The credit analyst not only is faced with the question of the financial status of the firm today, but he also is concerned with where the firm has been and where it is going. These latter concepts are equally as significant as the current financial position. A firm that falls short of the ideal risk, but has been improving over a period of time, may be a better credit risk than the firm which is above the ideal, but which has been deteriorating over a period of years. The trend concept also recognizes that what should be thought of as the standard or ideal may change with business conditions. While deterioration may be shown, the fact that business conditions have been difficult would mean that a comparatively small deterioration may be more favorable than would slight improvement under more prosperous conditions.

In analyzing financial statements, the credit analyst should be alert to the success or failure of managerial efficiency in the conduct of the business. Certainly, managerial efficiency over a period of time will affect

the ability to pay even current debts. The credit analyst also may test whether the management has been efficient in conducting the business so as to meet new or unexpected conditions. Thus in a period of declining business, it may be seen whether the management has properly adjusted its asset structure to the new situation. In a period of business improvement, questions may be raised whether management has been guilty of expanding too rapidly, though not properly prepared to meet the change which will eventually come. Or whether in a period of improvement, it has strengthened the financial structure now that good times are here so as to be prepared for any future change.

The comparison of these various statement items should be a matter of appraising both the asset and liability structure and earning structure. It cannot be too strongly emphasized that it is the analysis of all the financial statements, not analysis of just the balance sheet, that is sought in order to make a complete, well-rounded analysis of these important business parts. The operating statement should be subjected to close scrutiny. In connection with managerial efficiency there are a number of specific devices for testing this. For example, the credit analyst may examine the gross profit which the firm earns. He may examine the percentage of particular expense items as compared to normal for that trade. He may see whether the advertising or selling expense of the credit applicant is too high; whether the firm is spending too much for rent; whether its administrative expense is unduly heavy. The finer classification of the expense items will permit some very exact and detailed examination of operations. Unfortunately, in credit analysis, the credit man is too often content with a balance sheet and sales figure. For this reason this technique of using the operating statement is not as common in credit work as its importance would otherwise warrant.

PRELIMINARY APPRAISAL OF FINANCIAL STATEMENTS

As the credit analyst commences his appraisal of financial statements, his first steps should be those which test the validity of the stated values. The financial statements present certain facts which, if good accounting practices are followed, the accountant will state as accurately as possible. The credit man, on the other hand, approaches the analysis as an outsider. Because of this, he is likely to be skeptical about some features of the statements, and hence will examine them critically. Oftentimes, he will try to determine whether the business' management has presented a financial statement which overstates financial condition. Some business concerns presenting statements will, for obvious reasons,

desire to have them appear as favorable as the circumstances permit. At times, even without an intention of dishonesty, there is an attempt to present facts in a light more favorable than the situation would justify.

Some of the various ways in which financial statements may be adjusted so as to present a more favorable appearance than the true circumstances warrant include window dressing, undue optimism, inability to reflect current facts, and actual falsification.

Window Dressing or "Putting Best Foot Forward"

This is not an attempt to actually falsify anything, but merely to present the various aspects in as favorable a light as it is possible to do. Knowing that the credit analyst will seek certain relationships in the statement as a test of goodness, the firm may attempt to manipulate its affairs immediately prior to statement time in such a fashion as to make these relationships highly favorable. For example, knowing that a good cash balance and a very liquid current position are considered desirable by the creditors, the firm may, for the month immediately preceding the year end, work strenuously to collect its accounts receivable and accumulate cash for statement purposes. Thus, at the year end, it may have a better-than-normal cash position. It also may defer certain spending which otherwise would take place, so as to avoid increasing liabilities or draining cash.

A further step in this direction may be taken by following the practice of continuing normal purchases but not entering the goods received in the asset account—inventory—or the corresponding accounts payable in the liability account—accounts payable. This is what might be described as poor accounting practice rather than falsification or deliberate dishonesty.

An effort may be made, just before the statements are prepared, to deposit in the bank a number of items which the firm may be uncertain as to whether they will be returned unpaid. This may include N.S.F. and other bad checks which have been held as collection items; it may even include some drafts or notes which have been previously presented and refused. With the co-operation of the bank, the firm may be able to deposit these and have them included for the last day of the fiscal period as cash in bank, although knowing that within a few days they may be returned unpaid, at which time these items will have to be charged back to the deposit account and again included on their books as unpaid items. There are differences of opinion as to whether this step is to be considered window dressing or actual falsification. Needless to say, it is hard to prove falsification in such cases.

Undue Optimism or "Reluctance to Face Unpleasant Realities"

As with window dressing, this is not usually considered a form of falsification. Instead, it is simply a reflection of a retail firm's natural optimism that certain items on the financial statement will in time return to the value at which they are now being carried. For example, certain inventory items may be carried at a much higher figure than the present market value, thus reflecting the reluctance of this firm to face the unpleasant reality that it has done a poor job of buying or selling or perhaps both.

Other items of a current nature, while not deliberately falsified may be treated with undue optimism. It is not at all uncommon, upon investigation, to find that deposits in a defunct bank are still carried as a current asset, or that securities that are not readily converted into cash are continued in a securities account, sometimes at a value considerably higher than their true market value. Because of the difference between the valuation placed upon some of these items by the prospective debtor and by the credit analyst, some credit men refuse to consider these miscellaneous items unless a very definite statement is given as to their true composition.

Inability to Reflect Current Facts

There is a tendency for the beginner in credit work to take the figures as shown in financial statements as definite and absolutely accurate. It should be clearly understood, for example, that the depreciated value of certain fixed assets may be quite accurate from an accounting point of view, but from a credit-determination standpoint the actual value of these fixed assets on the present-day market is much more useful and realistic. Not only does such reasoning apply to the fixed-asset item on the balance sheet, but it also has merit in setting a "true" value on accounts receivable (less reserve for bad debts) and on cash on hand (less commitments made but not always shown on the balance sheet).

Actual Falsification

As a matter of routine procedure, the credit analyst, when first analyzing a statement, should start with the question in his mind as to whether the statement does present any false conditions. The first thing to be done when handling a new statement should be to add the statement to make sure it is correctly totaled; to inspect it to see that it is dated and signed; and if possible, to see that the evidence of mailing is preserved. The statement that has round figures (clearly estimated items)

is, of course, on the face of it estimated rather than taken from the books and therefore should be viewed with suspicion. Notation to this condition should have been made in order to forestall any claims of falsification. The main point to emphasize is not that many false financial statements will be presented, but that a careful credit analyst will view every statement with the thought in mind that the first test to which it should be subjected is one for correctness and honesty in the presentation of statement facts. Obviously, nothing can be gained by analyzing a statement which has been falsified, or which has been doctored in such a fashion as to present a more favorable position than would be supported by the true conditions were they known.

A further exaggeration of statement items may be brought about by even more deliberately dishonest practices. We may consider, item by item, some of the practices of this type.

Cash. Starting with the cash account—if it is to be properly understood, this account should be divided into "Cash on Hand" and "Cash in Bank." It is possible to exaggerate the "Cash on Hand" item by including certain items in the cash drawer which are not actually cash. For example, the owner or members of the firm may follow the careless, and probably not approved, practice of taking cash out of the cash drawer and substituting their I.O.U.'s. For statement purposes these are clearly an exaggeration of the cash item, if they are included in "Cash on hand." As a matter of practice, firm members also may include as cash certain advances made to officers of the firm. They would justify this by saying that it is handled just as petty cash would be handled, and that when the expenses are presented these items will be charged to the proper expense account and, of course, taken out of cash. Temporarily, however, this method has the effect of exaggerating the cash item. Advances to salesmen for traveling expenses may be handled in this same fashion with, of course, resulting distortion of the statement values. The credit analyst, in order to check this situation, will note whether cash on hand is unusually large and, if so, be skeptical of it. He also will notice if there has been window dressing practiced in connection with the bank account by observing whether the balance at statement time is in agreement with the normal balance as indicated by the bank in the course of the investigation.

Accounts Receivable. This is another item which may be adjusted to show a more favorable situation than the true circumstances may warrant. It is possible to be unduly optimistic concerning the collectibility of certain receivables. Continuing to include in accounts receivable those items which are not likely to be collected, or which are very defi-

nitely going to become bad-debt losses, clearly exaggerates the value of this asset. Further falsification of this item may be practiced by arbitrarily including certain accounts which are not actually trade receivables, such as amounts due the business from officers and employees. While these are receivables, they are not receivables which will be collected in the ordinary course of business. Including them in the accounts receivables tends to present a more favorable situation than the true circumstances warrant, since this leads the analyst to think of them as current assets when they should be regarded as noncurrent assets and as not contributing to the true liquidity status of the firm.

More deliberate falsification also may be attempted by writing up fictious accounts receivable. Receivables may be set up with existing firms for imaginary transactions or for imaginary firms. This increases the asset falsely and also increases the sales. Often this device is adopted not only to deceive creditors, but to cover defalcations of employees. In the process of covering thefts, other assets may be falsified and nonexistent inventories created or other unreal assets placed on the books. The outside credit man can, by a careful analysis of the statements, often detect these frauds as soon or sooner than the owner.

Inventory. Merchandise is a very difficult item to evaluate properly. There are numerous opportunities for honest differences of opinion as to the actual value of the merchandise inventory. Try as one will, it is very difficult to get an inventory valuation which is agreed to by all people concerned. Under these circumstances it is readily apparent that a firm attempting to place a more favorable valuation upon the inventory than might be justified would have little difficulty in supporting this valuation on the basis of honest differences of opinion. While taking and valuing the inventory one can be optimistic or pessimistic. Which ever method is followed will necessarily change not only the assets shown, but also the profits for the period. Because of this effect on profits, not only may the credit analyst be deceived as to the true condition, but it also may be possible to change the tax which is to be paid by the firm in a particular year. In addition to this unduly optimistic valuation which may deceive the credit analyst, it is possible to falsify the statements more deliberately by including in the merchandise inventory certain goods, the invoices for which are not included in the liability item of accounts payable. This, of course, has a double effect, that of increasing the assets and decreasing the liabilities, thus making the statement even more favorable than would be the case were just one of these items changed.

Fixed Assets. The fixed assets may be even more difficult to value than the inventory. From a statement standpoint, the credit analyst naturally is desirous of having them properly shown on the statement at their book value and the depreciation reserve shown separately rather than deducted and only the net value given. For purposes of analysis, it is clearly desirable to know what depreciation policy is being followed by the firm and at least to see whether it is conservative and in line with good practice. Since this is another of those items which directly affect the profit and loss statement, the credit analyst also is anxious to test the profit shown by determining if it is on the basis of proper depreciation policies. Sometimes a check on the valuation placed upon the fixed assets may be made by comparing their valuation with the valuation and description given in an agency report or with that arising from the personal knowledge of the credit man.

Accounts Payable. In the previous discussion of the exaggeration of the inventory item, it was pointed out that the liability, accounts payable, may be correspondingly reduced by omitting the invoice as a liability although entering the merchandise received as an asset. A check upon the account-payable item may be readily supplied by comparing it with the total owing as revealed by a complete trade investigation. Another indication of possible minimization of the accounts payable may be supplied by a very unsatisfactory trade experience report, when compared with a much more favorable current position than is consistent with the payment record. Certainly the possession of a large claimed cash account and a rather liquid position would not be consistent with slowness in the trade, or with the existence of a small accounts-payable item. The comparison of accounts payable against purchases to get the turnover should indicate the period of payment; thus, twelve turns of accounts payable would roughly indicate payment in thirty days. With this turnover rate there should be a corresponding trade record of discount and pays when due. If the trade reports do not support the turnover rate, as shown by this calculation, it may indicate that the accounts payable on the statement have been reduced, or it may mean that careful avoidance of purchases just before statement time has resulted in an abnormal lowering of this item.

Other Payables. Notes payable may be checked against the bank letters to see whether the bank report of the notes payable is consistent with the amounts shown on the statement. The mortgages payable may, of course, be compared against the agency reports showing the mortgages which are matters of public record. If any of them has been

omitted from the statement, this should be revealed by comparison with the public record information.

Bonds can hardly be omitted because it is a matter of public knowledge that these are outstanding, and they should be very readily checked against this fact.

Up to this point it has been shown that a hint of possible exaggeration or falsification may be obtained at various points during the process of the analysis. Certain comparisons, or inconsistencies of certain facts with others, should be a warning to the analyst that he should look for some exaggeration or incorrectness in the statement. These indications will be further commented upon in the discussion of the methods of analysis.

The maximum benefit from falsification is, of course, obtained by a minimization of the liabilities. In changing a liability item, the falsification must be deliberate rather than a little undue optimism or exaggeration. The falsification of liabilities usually involves deliberate dishonesty, whereas the falsification of assets may be brought about in such a way that it is more difficult to prove deliberate falsification. For this reason firms may be more cautious about changing liabilities than they may be about exaggerating, or being unduly optimistic about the assets.

FINANCIAL STATEMENT LEGISLATION

Because the financial statement may be a vital factor in the decision of a firm to sell its goods on credit to a prospective credit seeker, it is imperative that safeguards be provided to prevent the furnishing of false and misleading information to creditors. For this reason, most of the states[2] and the federal government have enacted legislation which holds certain abuses of financial statements to be a misdemeanor subject to civil and criminal prosecution. A comparison of the state and federal requirements for prosecuting credit seekers who have submitted false financial statements is shown in Table 27–1. Although there has been no federal legislation expressly passed for the prosecution of makers of false financial statements, Section 215 of the United States Criminal Code is the basis of controlling those who would use the mails for transmitting false statements in order to obtain credit.

A study of Table 27–1 will reveal that the requirements for prosecution under the various state laws are very similar to those under the federal enactment pertaining to offenses against the postal service. Under each set of laws, the burden of proof rests upon the prosecution to

[2] These are generally known as "false pretense" statutes.

show that the financial statement was submitted in writing and was signed; that the maker of the statement knew that the statement was false (under most state laws it is sufficient to show that the maker "should" have known it was false); that the statement was made for credit purposes with the intent that it be relied upon in any credit decision; and that the false part of the statement misrepresented the facts to such a degree that the decision would have been otherwise if the true facts had been known.

It is at this point that the similarities cease, and the very important differences begin. In fact, these differences often are the deciding fac-

Table 27–1

PROSECUTION OF MAKERS OF FALSE FINANCIAL STATEMENTS
(State and Federal Laws)

Requirements	State Laws	Federal Law
In writing and signed	Must be proved	Must be proved
Made knowingly	Must be proved	Must be proved
For credit purposes	Must be proved	Must be proved
To be relied upon	Must be proved	Must be proved
Materially false	Must be proved	Must be proved
Fraudulent	Does not have to be proved	Must be proved
Use of mails	Does not have to be proved	Must be proved
Place of prosecution	County where statement made	Where statement made or received

tors as to which set of laws may be best for successful prosecution. The concept of fraud has been the subject of a great many court decisions and legal entanglements. Suffice it is to say here that many state laws do not require proof that property was actually obtained on the basis of a false financial statement. Proof that the facts were simply misrepresented has been sufficient for conviction under state laws. On the other hand, in the opinions expressed by some courts (including federal) fraud has been identified with the actual passage of goods as a result of a decision based upon a false and "fraudulent" financial statement. Here again the reader is cautioned to consult competent legal counsel in relation to the conditions prevailing in his situation.

A clearer-cut difference is found in the fact that use of the mails is a prerequisite for prosecution under the federal enactment, whereas this is not a condition under the various state laws. To aid the proof that the statement was transmitted through the mails, the self-mailing type of statement form has been developed (see Figure 27–1). The postmark on the back of the statement is thus proof that the mails had been used to deliver the form to the prospective creditor.

FIG. 27–1. Self-mailing type of financial statement form approved by the National Association of Credit Management.

Form 32

Date _____ 195__

FINANCIAL STATEMENT OF _____

At Close of Books on _____ 195__ Address _____

Kind of Business _____ City _____ State _____

ISSUED TO _____ { Name of firm asking for statement

[THIS FORM APPROVED AND PUBLISHED BY THE NATIONAL ASSOCIATION OF CREDIT MEN]

For the purpose of obtaining merchandise from you on credit, or for the extension of credit, we make the following statement in writing, intending that you should rely thereon respecting our exact financial condition on (date) _____ 19__

[PLEASE ANSWER ALL QUESTIONS WHEN NO FIGURES ARE INSERTED WRITE WORD NONE]

FOLD IN ON THIS LINE

FOLD IN ON THIS LINE

ASSETS	Dollars	Cents	LIABILITIES	Dollars	Cents
Cash (On Hand $_____) (In Bank $_____) Total			**Accounts Payable** for Merchandise, etc., Past Due		
Accounts Receivable			**Accounts Payable** for Merchandise, etc., not due		
(60 Days or More Past Due $_____) (Amt Sold or Pledged $_____)			**Acceptances and Notes Payable** for Merchandise		
Notes and Trade Acceptances Receivable			**Owing to Finance Companies, Banks, or Others**		
(Amt. Sold or Pledged $_____)			(Secured by $_____ of Accounts Pledged Assigned or Sold)		
Merchandise Inventory (Not on Consignment or Conditional Sale) at Cost or Market whichever is lower			(Secured by $_____ of Notes or Acceptances Pledged or Assigned)		
(Amount Pledged $_____)			(Secured by $_____ of Merchandise Inventory Pledged or Assigned)		
Other Current Assets (Describe)			**Notes to Banks** (without security)		
			Notes and Accounts Payable to Partners, Officers, Directors or Stockholders		
			Notes and Accounts Payable to Others		
			Interest, Accrued		
TOTAL CURRENT ASSETS			**Taxes**, Accrued		
Due from Affiliated or Subsidiary Concerns			**Unpaid City and/or State Sales Taxes**, Accrued		
Land (see reverse side for details)			**Debt Payable in Less Than One Year** ($_____ Secured by Mortgage on Land and Buildings $_____ secured by Chattel Mortgage or other Liens on _____ (Property))		
Buildings (at depreciated cost, see reverse side)			**Other Current Liabilities** (describe)		
Machinery (at cost less $_____ depreciation)			TOTAL CURRENT LIABILITIES		
Fixtures and Other Equipment (at cost less $_____ depreciation)			**Debt Payable After One Year** (secured by Mortgage on Land and Buildings)		
Notes and Accounts Due from Partners, Officers Directors Stockholders or others not Customers			**Debt Payable After One Year** (secured by Chattel Mortgage or other Liens on _____ (Property))		
Prepaid Expenses (insurance premiums, supplies, etc)			**Other Liabilities Not Current** (describe)		
Other Assets (describe)			TOTAL LIABILITIES		
			NET WORTH — If Corporation — Capital Stock — Preferred		
			NET WORTH — If Corporation — Capital Stock — Common		
			NET WORTH — If Corporation — Surplus Earned		
			NET WORTH — If Corporation — Surplus Unearned		
			NET WORTH — If Individual or partnership — Capital		
TOTAL ASSETS			TOTAL LIABILITIES AND NET WORTH		

STATEMENT OF PROFIT AND LOSS FOR YEAR ENDED _____

Sales (net)			**Gross Profit on Sales**			**Net Profit on Sales**		
Deduct Cost of Goods Sold			**Deduct Expenses**			**Less Income Tax**		
GROSS PROFIT ON SALES			**NET PROFIT ON SALES**			**NET INCOME**		

AMOUNT OF ANNUAL SALES FOR CASH $_____ **AMOUNT OF ANNUAL SALES ON CREDIT $**_____

IF PARTNERSHIP, NAME PARTNERS. IF CORPORATION, NAME OFFICERS (Give residence addresses also)

DETAILS OF LAND AND BUILDINGS

DESCRIPTION & LOCATION	TITLE IN NAME OF	Cost	Accumulated Depreciation	Depreciated Cost	Appraised Value	ENCUMBRANCES Amount	ENCUMBRANCES To Whom

INSURANCE PROTECTION CARRIED

Merchandise (Fire) $_____ **Buildings (Fire) $**_____ **Furniture, Equipment (Fire) $**_____

Employers' Liability $_____ **Fidelity Bonds $**_____ **Burglary $**_____

Life Insurance for Benefit of Business $_____ **Credit Insurance $**_____

Have You Had a Recent Insurance Analysis Made by a Competent Insurance Agent? _____

Name of Agent Making Analysis _____ **Address** _____

Is Any Insurance Assigned? _____ **If So, To Whom?** _____

(OVER)

FIG. 27–1—*Continued*

BUY PRINCIPALLY FROM THE FOLLOWING FIRMS

NAME	ADDRESS	AMOUNT OWING	
		Open Account	Notes, etc.

Are you a corporation co-partnership or individually owned?_____ Your terms of sale_____

How long have you been established?_____ If incorporated under the laws of what state?_____ When?_____

Contingent Liabilities on notes or trade acceptances discounted or sold (not stated above) $_____ All other contingent liabilities, including those as accommodation endorser, surety, guarantor, or for law suits, judgments etc $_____

Is it your regular practice to sell pledge or assign your accounts?_____ What amount of your accounts, notes and acceptances is sold, pledged, or assigned to banks? $_____ Finance companies? $_____ Others? $_____

Is any part of your assets (except accounts, notes, acceptances and merchandise) assigned or pledged as security for any debt, or is there any mortgage or other lien thereon?_____ If so, give details of assets assigned or pledged, and details of liabilities thus secured_____

_____ Actual date of last inventory_____

Does merchandise inventory shown in the foregoing statement represent the value of physical inventory?_____ If not, state basis used and date inventory was last reconciled and adjusted with stock_____

What amount of merchandise do you hold on consignment or conditional sale not included in assets? $_____

What amount of machinery or equipment is held under conditional sale? $_____ (Balance due $_____ at $_____ per month)

If machinery or equipment is under lease contract state amount of monthly payments $_____

If business premises are leased state term and annual rental_____

In whose name is title to business premises?_____

What books of account do you keep? (Give complete list)_____

Are your books of account audited?_____ If so, by whom?_____

Date of last audit_____ Do you have a credit department?_____

Names and addresses of your banks_____

The foregoing statement (both sides) has been carefully read by the undersigned (both the printed and written matter) and is to my knowledge in all respects complete, accurate and truthful It discloses to you the true state of my (our) financial condition on the _____ day of _____ 19____ Since that time there has been no material unfavorable change in my (our) financial condition and if any such change takes place I (we) will give you notice Until such notice is given you are to regard this as a continuing statement The figures submitted are not estimated They have been taken from my (our) books and physical inventory taken as on date shown

Name of Firm or Corporation_____

Date of Signing Statement_____ Street_____ City_____ State_____

Witness _____ Signed by_____
(Owner Partner or Officer of Corporation Must Sign)

Residence Address of Witness _____ Title_____

DO NOT WRITE BELOW THIS LINE

USE LETTER POSTAGE HERE

_____

_____

_____

FROM

USE LETTER OPENER HERE

A last point of difference is the place of prosecution. Under the various state laws, prosecution may be instituted only in the county in which the statement was made. On the other hand, prosecution under the federal law may be started either where the statement was made or where it was received.

The question may be raised at this point as to the true importance of these preventive laws. Because of the large burden of proof necessary under both federal and state laws, it is believed by many that the presence of these laws acts more as a deterrent of false-statement submission than it does as a basis of punishment for violations.

METHODS OF STATEMENT ANALYSIS

This chapter has been concerned with only one phase of financial statement interpretation. More often than not, the credit manager will have confidence in his credit customer and rely on the authenticity of the financial statement. After a rapid preliminary appraisal he may, in view of the requirements of the credit problem, proceed to determine the firm's liquidity, solvency, and trend. In general, there are four methods commonly in use which determine these factors. They are: (1) the simple-evaluation method; (2) the percentage-comparison method; (3) the where-got, where-gone analysis; and (4) the ratio-analysis method. In addition to these methods, some credit men also employ a preliminary scaling-down technique. This procedure is simply reducing by some predetermined percentage all the items appearing on the balance sheet before making any comparisons. This procedure is sometimes believed necessary so as to account for the "optimistic natures" of those people who prepare the financial statement. A discussion of the above four methods of statement analysis is the subject of the next chapter.

REVIEW AND DISCUSSION QUESTIONS

1. In addition to some of the factors mentioned in the text, what developments have added impetus to the rendition of financial statements by prospective debtors to creditors?
2. From what sources are financial statements usually available? Can you think of any advantages in the use of one source over another?
3. Assume a request to a prospective creditor for a financial statement is refused. How would you proceed to acquire the needed information? Would refusal of your request influence your credit decision? Discuss.

4. What are some of the specific goals that a credit analyst may have in mind when he gathers information for financial statement appraisal?
5. Do all credit problems require the same degree of financial analysis in order to arrive at a sound credit decision? Why or why not?
6. What is meant by the following terms:
   a) The liquidity position of a firm?
   b) The solvency condition of a firm?
   c) The managerial efficiency of a firm?
   Which of the above are more or less short-run considerations? Which are concerned with long-run considerations?
7. "Certain proportions of assets and liabilities are more conducive to successful operation of a firm than others." Discuss the implications of this statement.
8. How is it possible to determine evidence of:
   a) Window dressing?
   b) Undue optimism?
   c) Actual falsification?
   Is window dressing a crime punishable by law?
9. What are the more common techniques which are used to exaggerate or falsify the following:
   a) Cash account?
   b) Accounts receivable?
   c) Inventory account?
   d) Fixed assets?
   e) Accounts payable?
10. What points must be proven in order to secure conviction for falsification of a financial statement under the federal law?
11. In what respects do the state laws and the federal law differ in regard to making and issuing of false financial statements?
12. What purpose does the "self-mailing" type of financial statement of the NACM serve?

CHAPTER 28

Financial Statements—Analysis and Interpretation (cont.)

IN THE ANALYSIS of a financial statement, certain fundamental things are sought. One is balance or proportion. If a business is to be successful, the relationship of assets to liabilities must be healthy and sound. Also, the total assets must be invested in such a manner as to form an efficient business machine. Thus the inventory must be in the proper proportion to the sales; the receivables in the proper proportion to the sales and to the inventory; the investment in plant and equipment must be such that an excessive amount is not frozen in these forms, leaving too little with which to buy raw materials or pay labor; the liabilities must be proportional to the assets and to the owners' investment. This does not mean that there is only one proper proportion or balance for all kinds of business, or for the same business at all times, but rather that there is an ideal or best balance for each business at a particular time. It also means that there are certain disproportions which are dangerous and indicate definitely that trouble is in store for that business.

Another thing sought in the financial statement is the trend or direction of the business. The credit man naturally is interested in the present balance or proportion of the items in the statement, but he is even more interested in knowing what they are going to be in the future. For it must constantly be kept in mind that, although the credit decision is made in the present, the fruits of this decision will mature in the future. It is essential to know whether the applicant will be able to *pay in the future.* It is advisable then to interpret the financial statement in terms of the direction in which the business is moving. Is it moving toward a more correct, healthier proportion of assets, liabilities, sales,

and income; or is it moving toward a less correct, an unsound, or dangerous proportion? Perhaps the business has been in difficulty but is working its way out, in which case it may be a good risk. Perhaps it has been sound but is slipping into a dangerous condition, in which case it may be a poor risk. Perhaps, in the face of extremely adverse business conditions, it has managed to hold its own, in which case management has shown ability and the risk is good.

METHODS OF STATEMENT ANALYSIS

As pointed out at the close of the preceding chapter, there are at least four commonly accepted methods of analyzing financial statements in order to determine a firm's liquidity, solvency, and managerial efficiency. These are the simple-evaluation method, the percentage-comparison method, the where-got, where-gone analysis, and the ratio-analysis method. It is important to recognize that regardless of the method or methods used, the analyst must carefully conceive and understand the line of trade in which the maker of the statement operates, the location of the business, and the date of the statement in order to make his analysis within the proper framework.

Simple-Evaluation Method

This method is the one most closely dependent upon the analyst's experience and judgment. Here the credit manager analyzes the statement by a mere inspection of the dollar items shown. Often this is facilitated by arranging a spread or work sheet. After several statements have been received, the analyst then may have before him at a glance, the picture for the last three to five years. Such an arrangement for either the balance sheets or for the profit and loss statements permits a quick appraisal of the company and to the experienced eye affords an opportunity to spot any obvious changes in the operations of the business. The comparison of dollar items alone, however, is rather dangerous unless the analyst is unusually skilled. Certainly it is not the technique for the beginner. This technique is illustrated in Figure 28–1, which shows the consecutive annual balance sheet figures for one company.

Percentage-Comparison Method

To facilitate comparison, irrespective of the dollar items, the balance sheet may be computed so that each item in the statement is expressed as a percentage of the total assets, which would be the same thing as a percentage of the liabilities plus the net worth. Likewise in the profit

and loss statements, the net sales figure usually is taken as 100 per cent, and the other items are computed as a percentage of this total. This has been called the 100 per cent, or common-size method. When this technique is used, changes are more readily apparent than is the case when only the dollar figures are used. Increases in the dollar items actually may be decreased in the proportion, or vice versa, and this would not be readily apparent except to the very alert and experienced observer.

FIG. 28–1. Capital Supply Company.

	1st Year	2nd Year	3rd Year
Cash	$ 18,500	$ 18,250	$ 19,410
Notes receivable	6,250	5,075	8,960
Accounts receivable	37,425	43,112	31,177
Inventory	68,115	59,256	70,555
Total Current Assets	$130,290	$125,693	$130,102
Fixed Assets			
Buildings	27,000	26,100	25,200
Store equipment	4,850	5,200	5,690
Delivery equipment	3,120	3,830	3,412
Prepaid or deferred	1,140	1,953	1,210
Total Assets	$166,400	$162,776	$165,614
Accounts payable	$ 41,170	$ 39,735	$ 42,073
Notes payable	12,300	5,890	11,551
Accruals, interest, salaries, etc	860	1,430	716
Total Current Liabilities	$ 54,330	$ 47,055	$ 54,340
Long-Term Liability			
Mortgage payable	21,300	21,300	20,800
Net Worth			
Preferred stock	50,000	50,000	51,000
Common stock	29,500	29,500	29,800
Retained earnings	11,270	14,921	9,674
Total Liabilities and Capital	$166,400	$162,776	$165,614

Commonly the commercial credit analyst or the bank analyst will use a form similar to the one reproduced in Figure 28–2. This form, now in general use by creditors, provides for cumulative financial data covering a six-year span. Similar forms are also available for the comparison of interim statement information. In accordance with the techniques of this method, the actual financial data are rounded to even dollars, and the third column serves as the percentage column. Other than when this form is in use, it is kept in the customer's credit folder.

Where-Got, Where-Gone Method

Another method of indicating not only the direction of change, but also the exact amount of the change, is by making a where-got, where-

FIG. 28–2. Comparative statement form.

	Type / Date						
	ASSETS						
1	Cash						
2	Marketable Securities						
3	Notes Receivable - Trade						
4	Accounts Receivable - Trade						
5	Inventory						
6							
7							
8							
9							
10	Total Current Assets						
11							
12							
13	Cash Value Life Insurance						
14	Other Securities						
15	Plant - Net						
16	Machinery, Fix & Equipment-Net						
17							
18							
19	Prepaid Expenses						
20	Due from Officers or Empl						
21							
22							
23							
24	Intangibles						
25	Total Assets						
	LIABILITIES						
26							
27	Notes Payable - Banks						
28	Notes & TA's Payable-Trade						
29	Accounts Payable - Trade						
30	Income Taxes Payable						
31	Other Taxes & Misc Accrls						
32	Current Maturities						
33							
34							
35							
36							
37	Total Current Liabilities						
38							
39							
40							
41	Total Liabilities						
42	SURPLUS RESERVES						
	NET WORTH						
43	Preferred Stock						
44	Common Stock						
45	Capital Surplus						
46	Earned Surplus						
47							
48	Total Net Worth						
49	Less Intangibles						
50	Tangible Net Worth						
51	Working Capital						
52	Ratio C A To C L						
53	Sales						
54	Net Profit						
55	Depreciation						
56	Dividends						
57	Contingent Liabilities						

(OVER)

gone comparison. This technique depends upon the accounting truism, that an increase in an asset must be accompanied by a corresponding decrease in another asset, or an increase in a liability or net worth. Each of the statement items which has changed is listed as either being plus or

FIG. 28–2—*Continued*

OPERATING STATEMENT																				
1 Net Sales																				
2 Cost of Sales																				
3 Gross Profit																				
4 % to Sales																				
5 Selling Expense																				
6 % to Sales																				
7 General & Admin Expense																				
8 % to Sales																				
9 Net Profit from Operations																				
10 % to Sales																				
11 Other Income																				
12 Other Expense																				
13 Net Profit Before Taxes																				
14 % to Sales																				
15 Income Taxes																				
16 Net Profit																				
17 % to Sales																				
18 (memo) Depreciation Inc. Above																				
SURPLUS RECONCILIATION																				
Balance																				
Add																				
Sub-Total																				
Balance																				
RATIOS																				
Debt to Worth																				
Profit to Worth																				
Auditor																				
Prepared By																				

minus, and the sum of the pluses is canceled by the minuses. This is based upon the accounting equation of assets equals liabilities plus net worth. The advantage of this method is that not only are changes emphasized, but the policies of the business may be revealed by the increase or decrease in the particular statement items. It may be seen whether the company is increasing its liabilities in order to purchase additional plant, or in order to invest more in inventory, or for other purposes. Unsatisfactory dividend policies and unwise handling of surplus also may be revealed by the analysis of the where-got, where-gone type. Thus, if the business has continued to pay out dividends, although suffering losses, this fact will be readily apparent when such an analysis is made.

Ratio Analysis

Another, and perhaps the most publicized, method of statement interpretation is the "ratio analysis." One may ask the question, "Is a firm selling a million dollars worth of goods a year a success?" Obviously, to

reach a sound answer, more information is needed. A million dollar sales figure accompanied with a loss of $50,000 gives a much different picture than a firm reporting a $100,000 net profit (after taxes) on the same volume of sales.

Certain fundamental relationships of items in the statement are emphasized by stating them in the form of ratios. Interpretation of balanced relationships are easier and the trend of the business can be easily determined by noting the changes in these ratios. It is not to be thought that the ratios listed and commented upon here are the only ones to be used or even that they are, in all cases, the most significant. The ones presented are those which are most generally significant and are selected to illustrate the method, rather than to give final treatment to the subject of ratio analysis.

This balance or proportion of the various statement items may be compared to an ideal. In fact, a great part of ratio analysis is based upon this technique of taking the significant items and calculating them as a ratio; then comparing this ratio against what is called the standard, or ideal, ratio. Standard ratios may be computed by the statistical device of gathering large numbers of statements, selecting from them that group which might be called successful ventures, and making the average of this group the standard ratios against which the subject firm is tested.

Figures for the averages of trades and industries are available from various sources. One of the most comprehensive and current sources for this information is the material published by Roy A. Foulke, Vice-President of Dun & Bradstreet, Inc. Mr. Foulke has been one of the pioneers in ratio analysis, and his compilations were first used in a series of four articles appearing in the *Dun & Bradstreet Monthly Review,* starting in August, 1933. Mr. Foulke's development of the ratio-analysis concept since this beginning is outlined in the following quotation:

> In 1935 these various studies were brought up to date and with supplemental studies appeared as a brochure entitled *Behind the Scenes of Business.* The median ratio for 27 manufacturing lines of business, 15 wholesale lines, and 7 retail lines were included together with a three year average of each ratio for 1931–1933, a method which would smooth out any unusual yearly variations. In April, 1936, the first revised edition of *Behind the Scenes of Business* appeared with the median and a four year average of each ratio for 1931–1934 for 31 manufacturing lines, 16 wholesale lines, and 7 retail lines. In May, 1937, the second revised edition appeared with the median and a five year average of the medians for each ratio for 1931–1935 for 35 manufacturing lines, 18 wholesale lines, and 7 retail lines. In January, 1953, the third revised edition appeared with the median and a five year average of the medians for each ratio for 1947–1951 for the 70 lines of manufacturing, wholesaling, and retailing.

Since 1938 these "fourteen important ratios"[1] have been compiled annually and published in the same form as this current pamphlet. These studies have been undertaken and continued with the sole idea of providing factual information determined from a nation-wide sample of corporations in representative lines of industry and commerce to provide helpful current information of a factual type to managements of businesses, bankers, accountants, industrial engineers, credit men, and analysts. . . .[2]

Recognition should be given to the fact that the method of ratio analysis received its initial impetus from an article, "Study of Credit Barometrics," by Alexander Wall. This study, which was prepared at the request of the Federal Reserve Board, appeared in the March, 1919, issue of the *Federal Reserve Bulletin.* In addition, leadership in this field has been taken by the Robert Morris Associates, an organization of bankers who are interested in the analysis of financial statements and who have become active over the years in compiling financial ratios, based on financial statements furnished by the co-operating commercial banks, for the use of the bank members of the organization.

Rather than present a list of ratios and a discussion of how they are computed and what they mean, the following three-way classification will be used: ratios showing liquidity of the firm or its ability to meet debts as they come due, ratios showing solvency of the firm or the division of the risk between owners and debtors, and those showing trend and managerial efficiency of the firm. It will be noted that in several instances the same ratios appear under two classifications.

Liquidity Ratios. There are at least seven ratios that generally are considered significant in analyzing the ability of a firm to meet its debts. It should be recognized that many credit analysts do not attempt to compute and interpret all seven, but instead credit executives have developed their own "favorites" which they follow and on which they base their decisions. However, until one has developed the experienced background from which to pick his "favorites," it is well to understand what is involved in each of the seven.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}.$$

This ratio is called the current ratio and for many years was considered the most important of the ratios. It is computed by dividing the total current assets by the total current liabilities and shows the number of times

[1] See Figure 28–3 for the "fourteen important ratios" for 72 lines of business, published annually by Dun & Bradstreet, Inc.

[2] Roy A. Foulke, *The Genesis of the 14 Important Ratios* (New York: Dun & Bradstreet, Inc., 1955), pp. 41–42.

current assets exceed current liabilities. It is interpreted as indicating the ability of the business to meet its maturing obligations. As the obligations mature, they must be met from the cash item and an excess of current assets over current liabilities gives promise of having sufficient cash on hand to meet the business obligations without difficulty. The standard of excellence most commonly accepted is the proportion of 2 times the volume of current assets over current liabilities, popularly called the 2 to 1 ratio[3] and considered as the minimum of strength. This ratio is no longer considered of paramount significance because of the growing feeling that the composition of the current assets is more important than the amount by which they exceed the current liabilities. It also is to be noted that many businesses, knowing that the analyst will surely figure the current ratio, strive to make it favorable on their statements and thus artificially bring about a better showing than is justified. Although no longer thought of as being the most important of the ratios, it is still one which must be considered and one with which the analyst should be familiar.

$$\text{Acid-test ratio} = \frac{\text{Current assets less inventory}}{\text{Current liabilities}}.$$

This ratio is computed by dividing the total current assets less inventory by the total current liabilities. Inventory generally is the slowest of the current assets and when deducted from the total the remaining current assets are thought of as already converted or as being very readily converted into cash without shrinkage. The standard commonly adopted for this ratio as a minimum is 1 to 1, although variations are noted between various lines and during different economic conditions.

$$\text{Stock turnover} = \frac{\text{Net sales}}{\text{Inventory}}.$$

This ratio may be computed in at least two ways, if the data are available:

$$\text{Stock turnover} = \frac{\text{Net sales at retail}}{\text{Average inventory at retail}}.$$

$$\text{Stock turnover} = \frac{\text{Cost of goods sold}}{\text{Average inventory at cost}}.$$

There also is involved the consideration of what is meant by "average inventory." Some analysts interpret the term to mean the beginning in-

[3] This ideal proportion will vary from line of business to line of business and with the various phases of the business cycle.

FIG. 28–3. Fourteen important ratios in the retail, wholesale, and manufacturing trades prepared by Dun & Bradstreet (showing median and quartile ratios), 1958.

WHOLESALE

Line of Business (and Number of Businesses)	Current assets to current debt	Net profits on net sales	Net profits on tangible net worth	Net profits on net working capital	Net sales to tangible net worth	Net sales to net working capital	Collection period	Net sales to inventory	Fixed assets to tangible net worth	Current debt to tangible net worth	Total debt to tangible net worth	Inventory to net working capital	Current debt to inventory	Funded debts to net working capital
	Times	Per cent	Per cent	Per cent	Times	Times	Days	Times	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
Automobile Parts and Accessories (196)	4.45	3.40	10.56	12.90	4.56	6.05	32	6.7	6 3	21 8	49.2	67.3	39.2	8.7
	3.14	**1.93**	**6.26**	**8.61**	**3.25**	**4.07**	**38**	**4.7**	**13.5**	**38.7**	**66.4**	**84.6**	**56.0**	**18.9**
	2.21	0.73	2.88	3.98	2.34	3.22	49	3.6	27.3	62.9	100.4	108.1	88.8	38.4
Baked Goods (48)	2.58	5.02	19.36	75.00	5.10	19 64	9	35.8	62.5	21.9	41.9	39.6	103.1	34.1
	2.02	**2.50**	**11.71**	**44.78**	**4.08**	**14.06**	**12**	**23.5**	**71.8**	**29.4**	**54.6**	**58.6**	**174.6**	**82.1**
	1.43	0.74	2.92	11 63	3 50	11.35	15	20 5	95.3	44 6	80.1	89.6	239.4	180.0
Cigars, Cigarettes & Tobacco (76)	3.27	1.07	10 37	14 59	25.15	31 44	13	35.6	4.9	35.8	61.1	64.1	71.3	8.3
	2.11	**0.44**	**6.25**	**7.65**	**14.38**	**18.52**	**17**	**23.1**	**12.2**	**68.3**	**102.6**	**79.8**	**109.2**	**24.2**
	1.66	0.21	3.71	4.19	9 82	13 28	24	17.3	23 9	116.8	142 9	109.8	142.3	45.8
Confectionery (21)	4.76	4 62	16 13	22 21	9.58	19 24	20	25.0	4 8	10.6	24 1	50.1	65.3	2.7
	2.56	**1.48**	**9.30**	**11.67**	**7.92**	**10.43**	**23**	**16.6**	**12.9**	**26.7**	**47.7**	**70.4**	**83.8**	**18.0**
	1.81	0.40	3 29	4 55	4.33	6 37	32	7.8	33.2	64.6	94 6	95.6	114.5	60.5
Drugs & Drug Sundries (73)	3.32	2.54	12 43	16 01	8.85	9.34	22	8 6	6.1	37.7	48.6	68.6	55.1	10.0
	2.62	**1.78**	**9.49**	**12.13**	**5.45**	**6.62**	**33**	**7.5**	**15.3**	**53.8**	**64.9**	**89.7**	**69.4**	**15.9**
	1.97	1.00	7.61	8 37	3.73	4.62	45	6.4	28 8	86 5	105.7	102.7	102.3	28.5
Dry Goods (155)	6.30	2.05	8.89	11.81	6 26	7.09	38	7 2	1 7	16.6	44.0	50.9	34.9	10.3
	2.94	**0.67**	**3.14**	**3.90**	**4.21**	**5.29**	**54**	**6.1**	**4.9**	**43.4**	**65.8**	**69.5**	**69.4**	**14.8**
	2.03	0.06	0 21	0 27	2.79	3 59	65	4 6	11.4	83.0	98.4	100.3	118.1	26.7
Electrical Parts & Supplies (130)	4.00	1.79	8.51	11.19	6 58	7.64	38	9 6	5 6	27.7	45.9	60.0	55.3	8.1
	2.68	**1.05**	**3.60**	**6.35**	**4.56**	**6.06**	**44**	**6.3**	**10.9**	**45.2**	**87.0**	**75.8**	**82.6**	**18.8**
	1.94	0.31	0.76	0 85	3.01	3 64	57	4.3	23.3	80.1	122.6	95.8	132.8	27.9
Fruits & Produce, Fresh (51)	5.35	1.91	26.22	49.85	11.93	19.87	12	111 0	12.1	12.1	31.0	7.9	64.7	16.8
	3.30	**0.86**	**8.59**	**14.52**	**10.45**	**14.00**	**17**	**66.5**	**21.0**	**25.6**	**89.3**	**27.2**	**162.4**	**39.1**
	2.03	0.19	2.57	4.09	7.13	11.33	31	19.5	33.6	66 9	232.4	70.5	405.5	122.8
Furnishings, Men's (31)	7.00	9 04	19.55	26.07	5.71	4 87	28	7.8	1.3	11.5	33.7	33.9	32.0	6.4
	3.26	**1.65**	**7.31**	**7.81**	**2.59**	**3.16**	**49**	**5.9**	**2.5**	**42.5**	**79.6**	**55.7**	**71.3**	**20.6**
	2.28	0.12	0.35	0 36	1 93	2 33	77	4 1	6.1	74.9	142.6	74 9	135.6	52.3
Gasoline, Fuel Oil, and Lubricating Oil (42)	2 61	1 98	13 83	56.33	13 93	17 13	29	58.0	17 4	32 2	35 2	26.5	98 0	14 7
	2.01	**0.77**	**7.33**	**17.90**	**5.91**	**12.29**	**34**	**16.4**	**42.4**	**49.7**	**67.5**	**50.8**	**218.0**	**31.3**
	1.53	0 43	2.42	3 32	3 28	6 87	54	10 7	69 0	115 0	202 1	84.6	308 7	68.9
Groceries (253)	5 18	1 34	11.66	14 08	13.24	16.73	11	14 5	7.4	19 5	64.2	71.9	32.8	10 4
	3.03	**0.62**	**5.19**	**6.84**	**8.24**	**10.07**	**16**	**11.2**	**13.9**	**42.5**	**90.5**	**94.8**	**54.1**	**28.9**
	2.04	0.32	3.13	3.63	6.11	9.17	25	8.2	28.3	76.5	139.8	126.1	82.8	44.7

Hardware (191)	5.55	3.35	10.19	12.60	3.79	4 47	31	5.2	7.3	18.6	40.7	68.1	31 5	9.0
	3.50	**1.71**	**5.44**	**6.53**	**2.91**	**3.38**	**41**	**4.0**	**14.9**	**33.1**	**66.0**	**83.7**	**47.8**	**17.8**
	2.47	0 74	2.00	2.29	2 33	2 79	50	3 3	24.7	54.5	109 6	103.8	71.8	34.4
Hosiery and Underwear (38)	6 15	5.44	12 93	18 29	5.73	6 82	44	9 4	1.4	18 9	50.3	45.2	45 4	13 8
	3.36	**0.75**	**2.74**	**3.39**	**4.18**	**4.27**	**50**	**6.3**	**4.5**	**41.1**	**88.4**	**68.2**	**67.3**	**29.9**
	2 06	0.35†	1.45†	1.54†	2.34	2 35	76	3 8	17 7	75 4	108.8	97.8	95.6	54.1
Household Appliances, Electrical (101)	3.55	1 44	7.97	9 12	9 35	9 62	34	10 2	3 9	31 3	70.1	66.8	63.4	6.5
	2.17	**0.86**	**5.53**	**6.65**	**6.82**	**7.35**	**49**	**7.7**	**7.0**	**68.6**	**117.3**	**85.5**	**93.8**	**17.9**
	1.63	0.35	2 60	3.00	3 70	4.33	60	5 1	19 7	140 2	192.9	132.9	124.3	32.8
Iron & Steel Sheets, Strips, Bars and Plates (62)	5.03	3.00	8 16	10 88	3 52	4.53	29	6 0	9 6	19.3	38.2	74.7	33.2	8.8
	3.62	**1.78**	**5.50**	**6.91**	**2.69**	**3.62**	**39**	**3.9**	**24.9**	**28.0**	**56.0**	**91.8**	**45.1**	**20.2**
	2 64	1 04	3.13	4.54	1 81	2 93	47	3 4	39 1	49.9	74 0	106 1	68.1	34.5
Lumber (92)	5.33	2 80	7.84	9 41	7 71	7 82	34	9 0	5 3	15.7	48 3	40 0	34.7	8.0
	3.14	**1.04**	**4.57**	**5.42**	**4.15**	**4.89**	**44**	**5.4**	**12.0**	**33.2**	**72.3**	**68.3**	**77.3**	**20.8**
	1 84	0 34	1.81	2.36	2.22	3 06	54	4 5	21.9	73 6	131 6	100.0	132 7	47 0
Lumber & Building Materials (104)	7.05	2.58	8.71	17.22	6 83	12 08	26	8.9	8.7	13.0	36 7	47.9	31.3	7.6
	3.45	**1.24**	**5.10**	**6.31**	**4.52**	**5.72**	**40**	**5.6**	**19.9**	**27.1**	**66.5**	**73.9**	**59.0**	**21.3**
	2.18	0 71	2.40	2.80	2.33	2 60	61	4.1	35.8	70 2	108 6	91.5	124.3	42 2
Meat & Poultry (39)	3 92	0.87	12.92	19.80	20 97	40 13	9	71 1	16.3	24.3	43 4	31.5	90.5	36 8
	2.50	**0.44**	**5.00**	**8.36**	**11.83**	**26.84**	**11**	**46.8**	**34.1**	**39.1**	**78.6**	**40.8**	**134.0**	**51.5**
	1 74	0 07	1.66	3 11	8.99	16 41	14	29 8	53.4	109 2	160 6	87 2	207.6	69.6
Paints, Varnishes & Lacquers (31)	5.03	2 29	7 52	8.35	4 47	5.38	31	8.0	7 7	18 7	40 4	54 2	30 6	5 1
	3.37	**0.71**	**1.86**	**3.14**	**3.20**	**3.57**	**40**	**4.9**	**13.3**	**31.8**	**61.9**	**68.9**	**59.5**	**23.8**
	2.38	0.02†	0 07†	1.53†	1.85	2.71	59	3.5	31.1	54 2	104 3	90 9	87.3	29.6
Paper (133)	4.17	1.62	7.49	9.24	7.37	10 12	31	10 4	5 1	24 1	46 2	55 1	47 4	10 0
	2.83	**0.78**	**4.88**	**5.76**	**4.77**	**6.54**	**38**	**7.5**	**10.2**	**45.6**	**72.0**	**76.3**	**75.5**	**16.4**
	1.91	0.41	1.39	2 41	3.30	4 24	51	5.8	24 5	79 0	118 0	95 2	115 7	23 8
Plumbing & Heating Supplies (161)	7.11	2.65	7 24	9 44	4 13	5 17	39	7.5	7.2	13.8	40 8	58 2	32 0	3.6
	3.83	**1.06**	**4.02**	**4.61**	**3.24**	**4.02**	**49**	**5.2**	**15.2**	**29.7**	**66.7**	**74.1**	**51.9**	**14.9**
	2.33	0 42	1.54	1 77	2.33	3 00	63	4.2	23.9	63 6	106 6	102.1	86 6	28 3
Shoes, Men's, Women's & Children's (54)	3.75	0.98	3.83	4 38	8.73	9.49	41	9 3	1 4	27 7	52.8	42.3	63.5	12.4
	2.39	**0.56**	**2.25**	**2.42**	**4.00**	**4.82**	**58**	**6.9**	**3.8**	**63.0**	**110.6**	**61.2**	**103.6**	**25.8**
	1.66	0 03	0 07	0 08	2.87	3 36	76	6.7	10 6	122 1	201.7	99.7	169.3	37.4
Wines & Liquors (46)	2.98	1.15	11.11	16.82	10 33	18 03	21	12 9	4 5	36 5	86.2	61 8	73.0	7.1
	2.13	**0.94**	**5.93**	**8.26**	**7.76**	**9.46**	**41**	**9.9**	**14.0**	**69.8**	**121.2**	**84.3**	**109.4**	**17.2**
	1.50	0.33	3 10	4 37	5 37	7 11	54	6.0	28 5	121.3	204 4	152 3	158.3	40 6
Womenswear, Coats, Suits & Dresses (31)	3.26	2.44	11 47	18 48	6 23	7.74	31	18 1	1.9	27 5	43.8	28.0	84.1	22.0
	2.32	**0.48**	**2.17**	**2.72**	**4.88**	**5.53**	**57**	**6.7**	**7.6**	**56.3**	**100.6**	**45.6**	**152.9**	**36.3**
	1.85	0.52†	1.48†	2 70†	2 79	4 49	90	5.5	24.6	77.7	218.5	96 9	238.7	83.0

FIG. 28–3—*Continued*
MANUFACTURING

Line of Business (and Number of Businesses)	Current assets to current debt	Net profits on net sales	Net profits on tangible net worth	Net profits on net working capital	Net sales to tangible net worth	Net sales to net working capital	Collection period	Net sales to inventory	Fixed assets to tangible net worth	Current debt to tangible net worth	Total debt to tangible net worth	Inventory to net working capital	Current debt to inventory	Funded debts to net working capital
	Times	Per cent	Per cent	Per cent	Times	Times	Days	Times	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
Airplane Parts and Accessories (38)	2 53	6 02	18 57	30 44	6 02	10 20	36	8 1	28.0	42.9	67.7	71 6	94.5	13 7
	1.62	**2.60**	**12.10**	**19.91**	**4.37**	**7.09**	**43**	**6.4**	**40.6**	**75.7**	**105.0**	**118.2**	**113.7**	**56.1**
	1.36	1.14	4.75	7 45	3 01	3 86	56	4.3	69.4	129.2	200.7	170 8	166.1	97.1
Automobile Parts and Accessories (71)	4.01	4 15	10 36	19 85	3 20	5.91	34	7.1	29 4	18 6	29 9	47.2	56.0	7.4
	2.80	**2.53**	**6.18**	**12.29**	**2.02**	**3.85**	**42**	**5.9**	**43.7**	**29.5**	**45.8**	**77.7**	**83.9**	**30.8**
	2.07	0 32†	0 64†	0.96†	1 60	3.03	54	4 9	61 5	61 1	82.5	106.5	109.2	48.7
Bedsprings and Mattresses (63)	6.63	2.44	6.78	11 57	4.43	13 83	30	11.1	15.6	12 8	32 7	43 7	37.2	11.5
	4.03	**1.37**	**4.66**	**6.65**	**2.80**	**4.36**	**37**	**8.1**	**25.0**	**22.1**	**54.3**	**64.7**	**62.6**	**32.7**
	2.22	0.19†	0.77†	2 77†	2.61	3.87	55	5.0	36.9	49.0	130.6	92.4	102.8	50.1
Bolts, Screws, Nuts, and Nails (56)	6.35	4.45	7.94	15.80	3.25	5 92	31	9.2	39.4	14.7	31.7	48 5	43.4	27.1
	3.37	**2.12**	**4.04**	**10.57**	**2.24**	**3.55**	**35**	**5.5**	**55.4**	**21.1**	**48.5**	**69.9**	**67.1**	**36.7**
	2.27	2.70†	4 05†	6 20†	1.50	2.75	43	4.1	74.2	39 2	115 6	93 0	135.1	53.5
Breweries (38)	3 84	4 10	12.23	38 94	2 99	14 18	11	24 2	51 3	12 1	23.8	30 3	83 6	17.2
	2.71	**2.13**	**4.27**	**12.47**	**2.41**	**9.14**	**22**	**16.8**	**67.6**	**18.4**	**37.5**	**47.4**	**116.7**	**53.8**
	1.87	0 79†	2 82†	13 37†	1.84	5.96	37	13 1	82.7	27.7	66 1	74 5	197.1	122.5
Chemicals, Industrial (67)	3 49	5 68	11.71	30 66	3.16	7.67	33	11 4	32.1	18 1	46 3	43.9	71.2	25.5
	2.60	**3.75**	**8.88**	**18.03**	**2.06**	**4.69**	**39**	**7.5**	**55.0**	**31.2**	**59.0**	**63.8**	**102.7**	**53.2**
	1.81	2 21	5 08	9 27	1.43	3.08	47	5.9	83.8	47.6	88.1	99 0	153.4	104 6
Coats and Suits, Men's and Boys' (190)	4.30	1.74	6.62	7 43	5 63	6 69	26	9.2	3 0	26 9	52 7	43.6	53.2	8 5
	2.53	**0.70**	**2.81**	**4.36**	**4.04**	**4.88**	**53**	**6.8**	**6.6**	**57.8**	**84.9**	**73.8**	**82.7**	**17.5**
	1.89	0 01	0 04	0 21	2 59	3.08	75	4.9	16 7	107.3	152 9	98.7	145.5	26 6
Coats and Suits, Women's (81)	2 67	3 32	17 13	19 38	8.61	11 63	23	15 7	4 2	45.9	109 4	44.7	78.2	12.1
	1.84	**1.07**	**8.95**	**12.65**	**5.20**	**7.32**	**39**	**9.4**	**7.3**	**94.2**	**130.9**	**76.9**	**124.5**	**25.7**
	1.51	0.22	0.75	0 91	4.23	4 67	51	5 4	14.8	133.7	200 9	136 5	184.2	33.6
Confectionery (41)	4 34	3 04	12.48	23 99	6 10	15 08	19	16 2	32.4	15 2	32 5	46 5	43 7	9.5
	2.83	**2.40**	**7.95**	**16.40**	**2.96**	**6.36**	**26**	**10.7**	**39.8**	**23.6**	**48.5**	**70.7**	**68.9**	**24.1**
	1 99	1 10	3 03	9 85	2 27	5 23	43	6 9	61.0	47.4	65.1	93.6	105.4	41.8
Contractors, Building Construction (168)	2.40	2 55	16 32	23 45	9 52	13 23	*	*	8 4	46 5	66 5	*	*	7.2
	1.81	**1.46**	**9.48**	**15.18**	**6.52**	**8.84**	*	*	**20.0**	**75.2**	**82.9**	*	*	**17.9**
	1.41	0.54	2.63	5.56	4.30	6.42	*	*	37.5	145.7	197.6	*	*	**38.0**

Contractors, Electrical (49)	4.03	4.79	19.22	27.25	7 16	10.24	*	*	9.5	22.0	54.9	*	*	11.0
	2.80	**1.94**	**9.28**	**10.47**	**4.91**	**5.43**	*	*	**19.9**	**44.3**	**68.4**	*	*	**24.2**
	1.50	0.82	2 76	3 14	2.52	3.16	*	*	28.1	94 6	132.7	*	*	41.3
Cotton Cloth Mills (43)	7 90	2 93	4 41	11 33	3.40	7 08	24	5.4	35.5	8.5	26.4	61.3	21 8	18.8
	5.21	**1.69**	**2.59**	**4.70**	**1.73**	**3.90**	**38**	**4.5**	**47.4**	**13.7**	**35.0**	**78.5**	**47.3**	**27.1**
	2 29	0 47†	0 54†	2 61†	1.41	2.60	41	3.3	65.9	28.7	76.6	97.8	59.5	44.6
Cotton Goods, Converters, Non-Factored (38)	5 98	2.39	7 89	10 41	4 44	4.54	24	5.4	0.4	18.5	115.7	63.5	33.8	5.1
	2.43	**1.20**	**3.89**	**6.97**	**3.20**	**3.70**	**45**	**4.7**	**1.3**	**40.7**	**135.9**	**78.0**	**70.2**	**25.4**
	1 74	0 55	1 74	1 34	1 74	1.87	73	2 2	4.4	111.4	228.0	98.4	135.5	68.5
Dresses, Rayon, Silk, and Acetate (86)	2 98	0 72	8 71	16 73	14 96	24 60	28	22 5	4.2	39.5	39.5	33 3	95.0	5.8
	1.76	**0.26**	**2.92**	**3.35**	**11.22**	**14.60**	**34**	**14.8**	**9.0**	**90.2**	**112.2**	**76.1**	**166.9**	**39.9**
	1 43	0 05	0 54	0 62	7 52	8 39	48	10 2	15.6	172.1	323.5	119.7	273.8	71.6
Drugs (43)	4.58	13 27	21 89	37 67	2 54	4.20	36	7.6	24.8	16.6	35.0	44 0	52 8	10.1
	3.15	**10.53**	**17.09**	**32.63**	**2.01**	**3.15**	**44**	**5.8**	**37.4**	**27.5**	**51.7**	**54.6**	**76.7**	**19.4**
	2.36	4 32	9 64	13 11	1 33	2 26	63	4.7	47.7	39.4	84.3	80 1	117.8	35.3
Electrical Parts and Supplies (75)	4.25	5 48	13 45	22 35	3 15	6 10	31	6.5	22.5	16.6	36.6	55.7	43.1	13.1
	3.31	**3.09**	**8.11**	**10.46**	**2.48**	**3.76**	**41**	**4.7**	**34.7**	**30.2**	**65.0**	**77.8**	**62.8**	**30.4**
	2 01	1 57	3.06	4 95	1.71	2.67	49	3 6	52.8	50.9	109.1	97.2	93.7	59.1
Foundries (106)	5 65	4 66	10 25	17.50	3.20	5 43	29	12.0	34.9	12 4	29 5	32.4	47.0	16.3
	3.63	**2.33**	**3.69**	**8.63**	**2.20**	**4.05**	**36**	**7.2**	**47.3**	**20.1**	**40.6**	**48.9**	**75.8**	**26.2**
	2 47	0 04	0.07	0 34	1.60	2 87	46	5.3	63.3	32.8	52.6	77.9	130.1	39.3
Furniture (141)	5 08	3 07	9 25	13 92	3 72	5 70	43	8.6	16.7	15.6	47.7	44.1	42.7	8 7
	3.24	**1.79**	**5.63**	**8.90**	**2.78**	**4.27**	**48**	**6.2**	**29.8**	**28.8**	**54.8**	**68.2**	**67.4**	**26.9**
	1 94	0 50	0 77	2 53	2.22	2.80	58	4.6	47.7	55.4	96 3	108.3	103.9	45.5
Hardware and Tools (100)	5 27	4 89	11 22	17.29	2 91	4 96	33	6.9	25 6	14 8	36 2	49.2	37.6	15.5
	4.07	**3.23**	**6.98**	**11.00**	**2.03**	**3.42**	**42**	**4.6**	**37.0**	**23.5**	**52.0**	**67.6**	**58.6**	**34.8**
	2 51	0 81	1 54	5 11	1 64	2 60	49	3.4	56.5	35.0	86.2	92.3	92 1	57.7
Hosiery (71)	6 02	3 48	6 62	14 50	3 16	6 82	35	8.2	28 5	9.9	68 0	47.7	27.9	6.1
	3.52	**1.11**	**3.95**	**7.78**	**2.20**	**4.08**	**41**	**5.2**	**41.8**	**20.4**	**92.4**	**68.3**	**58.8**	**45.6**
	2 21	0 36	0 84	1 45	1.48	2 58	47	4 0	59 9	39 7	177.9	98 5	109 1	82.8
Lumber (74)	5 39	5 82	10.12	31 55	3 24	6 27	27	7.5	20 8	10.6	35.7	55 8	35.5	26.7·
	3.51	**3.30**	**7.67**	**13.71**	**2.29**	**3.67**	**38**	**5.9**	**37.0**	**18.9**	**56.4**	**75.3**	**55.8**	**51.4**
	2 06	1 14	2 37	5 19	1.10	2 73	47	4 0	59.5	47.8	80.8	107.0	91.2	90.0

FIG. 28–3—*Continued*

MANUFACTURING (Cont.)

Line of Business (and Number of Businesses)	Current assets to current debt	Net profits on net sales	Net profits on tangible net worth	Net profits on net working capital	Net sales to tangible net worth	Net sales to net working capital	Collection period	Net sales to inventory	Fixed assets to tangible net worth	Current debt to tangible net worth	Total debt to tangible net worth	Inventory to net working capital	Current debt to inventory	Funded debts to net working capital
	Times	Per cent	Per cent	Per cent	Times	Times	Days	Times	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
Machine Shops (145)	6 49	4 53	8 98	18 07	2.12	5.17	27	13 1	32.3	10 3	26 5	33.4	35 5	14.3
	3.93	**2.38**	**3.91**	**6.11**	**1.56**	**3.28**	**40**	**4.9**	**44.8**	**17.8**	**33.8**	**60.2**	**67.3**	**34.4**
	2.14	1.51†	1.66†	2.37†	1.30	2.10	52	3.3	63.1	33.1	57 9	84.4	135.9	54.8
Machinery, Industrial (358)	5.90	5 21	10 03	15 74	2 75	4 34	33	7.4	22.7	14 4	33.5	45.3	36.5	10.1
	3.68	**2.98**	**6.16**	**9.59**	**2.04**	**3.07**	**47**	**4.6**	**32.4**	**25.5**	**49.3**	**63.7**	**66.8**	**23.0**
	2 39	0 48	1.01	2 12	1 54	2 30	61	3.5	45 6	43.5	82 0	82.4	102 2	40.8
Meats and Provisions, Packers (68)	2 96	1.56	10 98	38 87	12 71	34.37	9	37 5	43 1	25.2	47.4	47.1	62.9	23.0
	1.99	**0.58**	**5.57**	**12.99**	**9.68**	**20.32**	**10**	**26.0**	**62.9**	**41.0**	**71.7**	**87.0**	**104.8**	**52.2**
	1.60	0 25	2 37	5.75	6.64	14 78	12	19 8	79 5	60 1	122 4	126.1	170.0	85.6
Metal Stampings (91)	5 26	3 86	9 21	16 58	2.75	6.30	27	8.7	27 4	12 5	39.4	41 9	45.5	9.6
	3.31	**1.54**	**4.44**	**8.64**	**2.33**	**3.78**	**37**	**6.8**	**42.3**	**22.5**	**59.1**	**60.6**	**69.9**	**34.1**
	2.24	1.63†	2 91†	5 52†	1 47	2 59	52	4 3	65 2	38 2	79.2	99.5	115 2	86.8
Outerwear, Knitted (68)	3.42	1.96	10 84	24.24	8.82	17.01	14	11.8	2 8	30 6	66.7	38.4	62 4	2.5
	2.20	**0.96**	**5.27**	**8.25**	**5.46**	**8.87**	**28**	**7.4**	**14.3**	**55.5**	**82.7**	**72.3**	**100.1**	**27.4**
	1 65	0 27	1 34	1.61	3.57	5.95	55	4 8	31.2	101.9	132 6	110.7	167.4	54.7
Overalls and Work Clothing (57)	5 75	3 06	9 73	13 09	4.14	5 88	30	6.2	9 2	16.7	47.9	64 2	31.4	12.5
	3.36	**2.01**	**5.88**	**7.14**	**3.40**	**3.95**	**38**	**4.4**	**15.7**	**31.4**	**73.0**	**80.5**	**50.8**	**22.8**
	2.39	0 78	2.85	3.74	2.19	2 95	48	4 0	25 9	57.8	91 2	109 9	82.0	28.8
Paints, Varnishes and Lacquers (137)	5.55	4 05	11 70	18.42	3 51	6 07	32	9.7	23 9	16 7	31.9	46 8	44.6	11.1
	3.55	**2.43**	**7.67**	**12.26**	**2.50**	**4.42**	**36**	**7.0**	**33.5**	**24.5**	**47.3**	**64.2**	**69.1**	**21.9**
	2.47	0.84	2.62	5.21	1.98	3.55	47	4.9	47.6	38.1	71.4	87.5	101.3	31.2

Paper (63)	3.91	7.64	10.31	30.50	1.89	5.73	26	8.3	56.7	14.0	32.8	54.6	57.5	36.5
	2.80	**5.75**	**7.75**	**22.22**	**1.57**	**4.17**	**33**	**6.1**	**76.7**	**19.6**	**46.8**	**73.5**	**74.0**	**66.4**
	2.23	3.77	5.42	14.83	1.07	3.24	37	4.8	93.5	30.1	66.4	89.6	108.2	109.7
Paper Boxes (65)	4 45	4 78	13 59	30 63	2.83	9 02	24	11 6	36.3	13.7	31 8	40.5	60.5	23.0
	2.75	**3.45**	**7.17**	**17.56**	**2.05**	**5.35**	**29**	**9.2**	**54.7**	**22.8**	**48.0**	**66.7**	**80.1**	**61.7**
	1 89	1.65	4.96	12 42	1 67	4.08	39	7.1	78 7	37 6	79.9	95.3	116.4	112.7
Petroleum, Integrated Operators (38)	2.95	10.30	10.84	47.18	2.54	7.51	35	9 8	70.7	14.1	29.1	49.9	94.3	29.5
	2.45	**6.16**	**8.22**	**35.62**	**1.18**	**4.95**	**41**	**8.2**	**90.1**	**19.0**	**47.1**	**62.7**	**117.2**	**96.6**
	1.90	3.78	5.75	14 92	1.06	4 27	49	7.5	114 9	26.8	78.4	83.1	151.9	199.3
Printers, Job (66)	3.69	4.22	10.71	29.47	3.82	10.77	32	**	44 0	20.8	32.2	**	**	14.8
	2.48	**1.70**	**5.12**	**14.85**	**2.49**	**7.05**	**41**	**	**59.3**	**28.0**	**45.3**	**	**	**43.2**
	1.63	0 07	0 24	1.57	1.93	4.38	54	**	81 4	51 3	71.7	**	**	81.4
Shirts, Underwear, and Pajamas, Men's (55)	3 14	2.77	10.69	12.87	6 29	9.28	29	7.6	2.1	31.6	47.1	62.2	47.7	13.6
	2.02	**1.42**	**6.00**	**6.35**	**4.38**	**5.91**	**41**	**4.9**	**6.1**	**77.0**	**105.6**	**102.9**	**86.1**	**19.8**
	1.59	0 34†	1.51†	3.72†	3 36	3.82	59	3.8	16.2	110.5	166.0	149.5	119.0	29.8
Shoes, Men's, Women's, and Children's (107)	3.42	3 54	12 60	15 35	4.83	5.49	38	7.5	11.0	32.2	50.2	57.8	54.4	8.1
	2.60	**2.24**	**7.48**	**7.85**	**3.32**	**3.97**	**55**	**4.8**	**17.7**	**49.4**	**65.5**	**74.3**	**82.6**	**23.5**
	1.73	1 16	4 31	5.02	2.53	2 88	65	3.8	25.7	103.2	127.3	115.8	129.3	38.0
Steel, Structural Fabricators (Sell on Short Terms) (96)	4 80	4 25	12 65	23.81	4.63	6 50	34	8 8	23 1	17.9	40.4	51.2	43.2	12.8
	3.00	**2.72**	**8.92**	**12.94**	**2.97**	**4.89**	**43**	**6.4**	**32.6**	**29.5**	**64.3**	**65.9**	**69.9**	**24.6**
	2 01	1.08	4 26	6.27	2 11	3.48	55	3.7	51 4	57.9	93.4	101 5	112.9	32.7
Stoves, Ranges, and Ovens (54)	5 68	3 62	11.60	17.99	3 66	5.37	36	6 9	17.1	14.5	24.7	52.1	40 4	11.5
	3.47	**2.06**	**5.52**	**8.44**	**2.87**	**4.27**	**47**	**5.3**	**29.6**	**27.2**	**42.4**	**66.6**	**59.6**	**17.4**
	2.38	0.39	1.57	2 58	1.96	2.78	58	3.7	40.9	44.2	59.8	100.4	100.5	38.6

†Loss.

**Building and construction contractors and electrical contractors do not have inventories in the credit sense of the term. They carry only such materials as lumber, bricks, tile, cement, structural steel, and building equipment to complete jobs on which they are working. Electrical contractors carry electrical equipment and supplies to complete particular jobs on which they are working. Concerns operating in these lines generally have no customary selling terms, each contract being a special job for which individual term are arranged.

–Job printers do not have inventories in the credit sense of the term. They carry only current supplies such as paper, ink, binding materials, and lead for type-setting.

FIG. 28–3—*Continued*

RETAIL

Line of Business (and Number of Businesses)	Current assets to current debt	Net profits on net sales	Net profits on tangible net worth	Net profits on net working capital	Net sales to tangible net worth	Net sales to net working capital	Collection period	Net sales to inventory	Fixed assets to tangible net worth	Current debt to tangible net worth	Total debt to tangible net worth	Inventory to net working capital	Current debt to inventory	Funded debts to net working capital
	Times	Per cent	Per cent	Per cent	Times	Times	Days	Times	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
Clothing, Men's and Boys' (163)	4.94	4.50	9.01	12.64	3.55	4.27	**	4.3	5.5	18.2	57.5	61.9	35.9	14.3
	2.87	**1.94**	**4.11**	**4.92**	**2.38**	**2.96**	**	**3.3**	**11.6**	**39.2**	**94.0**	**90.9**	**61.1**	**37.4**
	1.87	0.75	1.06	1.76	1.57	2.14	**	2.5	28.8	77.6	168.4	123.0	90.6	69 2
Clothing, Men's and Women's (87)	5.53	6.67	10.38	16.40	3.76	4.47	**	5.9	10.0	18.2	39 6	52 6	40.4	12.3
	3.35	**2.10**	**5.16**	**6.93**	**2.49**	**3.19**	**	**4.1**	**20.7**	**32.7**	**67.7**	**72.7**	**60.4**	**28.4**
	2 04	0.67	1.79	2.12	1.73	2.28	**	2.3	39.9	69.9	118 4	123.4	93.6	47.5
Department Stores (438)	5.67	3.15	9.12	13.32	3.92	5.12	**	7.3	13.0	14.5	42.4	47.0	39.6	14.9
	3.70	**1.91**	**5.27**	**6.93**	**2.88**	**3.82**	**	**5.8**	**24.5**	**26.8**	**60.7**	**63.7**	**61.3**	**34.2**
	2.40	0.32	1.05	1.24	2.26	3.09	**	4.6	45.5	49.8	91.6	91.8	90.3	51.9
Dry Goods (78)	14.73	12 66	19.38	30.03	4.10	5.90	**	5.0	5.7	6.1	47.3	62.1	14.4	16.2
	6.28	**2.17**	**7.23**	**9.65**	**2.41**	**3.05**	**	**3.7**	**15.0**	**16.2**	**51.5**	**75.8**	**32.6**	**41.0**
	2.99	0.65	2.46	2.80	1.87	2.49	**	3.0	31.0	39.6	108.0	112 6	50.8	56.8
Furnishings, Men's (44)	10.50	4 94	10.15	16.81	3.68	5.43	**	4.5	4.9	9.9	73.7	61.1	24.5	28.0
	3.51	**1.09**	**2.83**	**4.21**	**2.35**	**3.19**	**	**3.2**	**11.7**	**26.1**	**156.2**	**89.1**	**41.6**	**45.9**
	2.02	1.33†	3.23†	3.45†	1.42	1.86	**	2.5	30.4	64.8	218.5	145.5	76.2	65.9
Furniture, 50 per cent or more, installment (132)	5.74	2.87	5.69	7.11	3.11	3.78	94	5.6	4.8	19.1	46.3	29.7	56.3	8.1
	3.27	**0.95**	**2.06**	**2.59**	**1.92**	**2.30**	**148**	**4.5**	**13.4**	**42.5**	**83.6**	**44.2**	**101.0**	**22.2**
	1.90	1.01†	1 05†	1.86†	1.49	1 56	217	3.3	29.4	81.9	120.1	74.8	173.2	39.5
Groceries and Meats, Chain (54)	3.01	1.74	13.89	29.10	11.20	22.12	**	15.8	43.3	33.2	48.7	105.5	52.8	23.1
	2.21	**1.11**	**10.62**	**21.71**	**9.18**	**16.58**	**	**14.1**	**56.6**	**46.3**	**77.9**	**121.1**	**72.2**	**44.7**
	1.71	0.86	7.67	13.24	7.94	11.80	**	11.7	74.5	70.6	104.4	150.7	95.7	80.2
Groceries and Meats, Independent (44)	3.09	1 49	18.13	50.72	17.20	54.84	**	29.8	30.6	18.9	56.4	72.9	60.2	16.5
	1.89	**1.02**	**9.44**	**24.02**	**9.01**	**25.28**	**	**19.9**	**54.9**	**48.7**	**89.4**	**124.4**	**99.2**	**69.0**
	1.14	0.29	5.79	11.38	6.69	11.92	**	13.9	84.3	91.3	144.4	179.5	142.4	158.8
Hardware (40)	8.41	3.84	11.51	13.94	4.54	5.41	**	6.4	4.5	11 9	35.2	65.4	23.8	14.7
	3.18	**1.73**	**4.62**	**5.63**	**2.30**	**3.48**	**	**3.6**	**15.3**	**29.6**	**71.8**	**79.0**	**47.0**	**29.0**
	1.91	0.31	0.72	1.23	1.78	2.33	**	2.5	36.8	57.5	149.5	137.2	90.5	90.0
Lumber and Building Materials (142)	7.69	3.21	6.86	9.41	4.16	5.19	42	6.6	10.1	12.3	29.8	49.6	28.9	5.1
	3.66	**1.65**	**4.01**	**5.42**	**2.14**	**3.07**	**59**	**4.7**	**17.7**	**27.8**	**58.7**	**67.7**	**57.3**	**21.4**
	2.22	0.34	1.44	2.01	1.67	2.09	93	3.5	28.3	55.6	94.6	92.2	111.2	34.3
Shoes (78)	4.07	4.26	10.85	16.31	4.41	7.89	**	5.5	5.8	24.6	36.5	86.0	36.7	9.5
	2.84	**1.54**	**5.17**	**6.73**	**3.69**	**4.83**	**	**4.1**	**13.0**	**38.5**	**55.5**	**104.5**	**54.3**	**21.4**
	2.10	0.34	1.52	2.47	2.44	2.88	**	3.4	29 8	63.1	95.8	137.8	75.3	35.0
Women's Specialty Shops (193)	3.69	3.35	8.66	16.13	4.46	8.05	**	9.0	10.4	29.3	64.7	45.8	77.6	16.3
	2.26	**1.53**	**4.81**	**6.53**	**3.10**	**4.57**	**	**6.1**	**21.4**	**54.4**	**95.8**	**71.2**	**115.0**	**29.8**
	1.74	0.27	0.85	1.22	2.02	3.27	**	5.4	41.6	92.0	139.5	106.3	157.9	61.5

**Not computed; necessary information as to the division between cash sales and credit sales was available in too few cases to obtain an average collection period usable as a broad guide. †Loss.

ventory plus the ending inventory divided by two. Others will attempt to secure figures more often, such as the amount of inventory at the start of each month. Of course, the system of inventory control followed by a firm will determine its ability to supply such detailed information. In any respect, this ratio is designed to show the number of times a firm is able to convert its stock of goods into cash or receivables.

Comparison of the results of this ratio from year to year for the same company or for different companies for the same year will show the efficiency with which the subject company is utilizing its investment in inventory to generate sales. This is a very important indication of managerial efficiency and operating results. Declining efficiency, as shown by a declining ratio, forecasts slowness in converting assets into cash, decrease in sales volume, capital investment in less productive inventory, and declining profits. Slow turnover of inventory is indicative of excessive investment in old and slow-moving stock. This throws doubt on the value claimed for the current asset, inventory. It is, therefore, a test of the current position and may lead the analyst to doubt if the current position is actually as good as the face of the statement may indicate.

$$\text{Receivables turnover} = \frac{\text{Net sales}}{\text{Receivables}}.$$

This ratio is computed by dividing the net sales by the receivables. It shows the number of times during the fiscal period that the receivables are turned. This indicates the efficiency with which the receivables are being collected. Comparison of results for the subject company from year to year or for the subject company with other similar companies will show how the subject compares in respect to the efficiency of its conversion of receivables into cash. A slowing down of receivables, shown by a decline in the ratio, shows investment of capital in slow or uncollectible receivables. This, or course, hampers the firm's ability to meet obligations and ties up capital unnecessarily. Here also a more exact showing of conditions is obtained by dividing credit sales by receivables. This shows the true turnover of sales on credit and the average number of days it takes the firm to collect its sales on account. Thus, if the turnover is 6 times a year it collects in 60 days, if 12 times a year it collects in 30 days, and if 10 times a year, in 36 days. From these figures the analyst can appraise the soundness of the value claimed for accounts receivable in the current assets. It is therefore a means of testing the soundness of the current asset position.

$$\text{Sales to net working capital} = \frac{\text{Net sales}}{\text{Current assets less current liabilities}}.$$

This ratio, which is computed by dividing the net sales figure by the net working capital (current assets less current liabilities), shows the efficiency with which the net working capital is being utilized by the firm in producing the desired results—sales.

$$\text{Payables turnover} = \frac{\text{Purchases}}{\text{Accounts payable}}.$$

The payables turnover ratio is figured by dividing the accounts payable into the purchases. Interpreting this ratio over a period of years, the analyst is able to tell whether current liabilities are being paid more or less promptly than in prior periods. For example, a firm reporting purchases of $60,000 for a specified period (generally a year) and payables of $12,000 at the end of the period will have a ratio of 5 to 1. Translated into days (360 days divided by 5), this ratio reveals that this company is taking 72 days on the average to pay its accounts payable. This does not mean that some accounts will not be paid in less time than 72 days and some in a longer time, but it simply points out that if a seller is contemplating accepting the credit of this firm the average length of time it can expect to wait for its funds is 72 days.

$$\text{Net working capital represented by inventory} = \frac{\text{Inventory}}{\text{Current assets less current liabilities}}.$$

This ratio, which is not too well known and is not in general use, shows what proportion of net working capital is made up of inventory which may be too hard to sell. In interpreting this ratio, the analyst should recognize that it may be favorably influenced either by an exceptionally low level of current liabilities or by an excessively low level of merchandise relative to the other current assets.

Solvency Ratios. There are seven ratios generally accepted as capable of showing the solvency condition of a firm. In interpreting these ratios, the analyst is answering such questions as: "Is the net worth adequate?"; "Is the borrowing proper?"; or "Are the fixed assets fitted to the needs of the company, to the capital invested by the owners, and to the demands of outside creditors?" As with the liquidity ratios, the credit manager has his "favorites" which he generally computes and interprets and does not in most instances analyze all those that are listed and described in this section.

$$\text{Net worth to debt} = \frac{\text{Net worth}}{\text{Current debt plus funded debt}}.$$

The ratio of net worth to debt is computed by dividing the net worth by the total debt. It shows the number of times, or proportion of, capital invested by the owners in relation to investments by outside creditors. In other words, it indicates the proportional relationship which exists between the sum invested by the owners of the business (owners' equity) and the dollar value of money and/or goods secured on credit from outsiders. Obviously the owners should have an adequate equity in the business to protect the investments made by others. A rather general rule is that owners' capital should at the minimum be as great as the outside investments. This is a 1 to 1 ratio. This ratio is not altogether definite but varies with the nature of the business and other conditions. The thing to keep in mind is that as the proportion of owners' capital increases, the business is working into a safer position and the dependence on creditors is lessened. Some analysts also follow the practice of showing the net worth to current debt only. This is especially valuable when a considerable part of the debt is funded.

$$\text{Total assets to fixed assets} = \frac{\text{Total assets}}{\text{Fixed assets}}.$$

This ratio is computed by dividing the total assets by the fixed assets. It indicates the proportion of the total assets which are represented by fixed assets. It is of significance only in those lines of trade where fixed assets constitute an appreciable portion of the total assets. The danger to which many businesses are exposed is that they will allow too large a proportion of their assets to become "frozen" or nonliquid by being tied up in fixed assets which are not readily disposed of and which may not contribute to earnings. This tendency is revealed by a study of this ratio.

$$\text{Fixed assets to fixed debt} = \frac{\text{Fixed assets}}{\text{Fixed debt}}.$$

This ratio is computed by dividing the fixed assets by the fixed debt. The theory of the ratio is that the long-term debt is created to acquire the fixed assets and is frequently secured by the fixed assets. If this is the case, the comparison of these two items is of significance. It shows among other things the extent to which fixed assets are being carried by means of borrowings. This may indicate the safety margin of the loans, the prospects of renewing maturing debts, and the possibility of acquiring funds by making additional loans. Should the fixed debt be large relative to fixed assets it may be an indication of financial strain and a weakened condition. In some lines of business, however, the fixed

assets are so small in proportion to the total assets that this ratio has little significance and may be omitted.

$$\text{Net worth to fixed assets} = \frac{\text{Net worth}}{\text{Fixed assets}}.$$

This ratio, which is computed by dividing the net worth by the fixed assets, indicates the proportion of net worth or owners' equity tied up in plant, machinery, equipment, and other fixed properties. Whereas any relationship over 100 indicates the proportion of net worth provided for working capital, a low ratio here generally is interpreted as a danger signal that the owners have expanded more rapidly than warranted by normal growth.

$$\text{Sales to net worth} = \frac{\text{Net sales}}{\text{Net worth}}.$$

This ratio, which is computed by dividing the net sales by the net worth, shows the number of dollars in sales which are generated by the net worth of the owners. More efficient use of the owners' capital naturally results in a larger ratio. It should be noted that this ratio may become "too good." Thus inadequate investment on the part of the owners for the volume of business being attempted results in this ratio being abnormally high. This is known as overtrading. Inefficient use of owners' capital causes a low ratio. Either of these conditions is unsatisfactory, but overtrading is probably more dangerous than is undertrading. Inefficient use of owners' capital means that the capital is not being used as productively as it might be. This is likely to cause lower profits or inadequate returns. Attempting to do too much business on the capital invested means that the owners are straining the business. They are relying heavily on borrowed funds; they are able to maintain this pace because of very rapid turnover rates of inventory and receivables. Should something happen to slow down this rate of conversion of assets into cash, they quickly find themselves unable to pay debts as they mature. Slowing down in debt payment causes anxiety on the part of creditors and hesitancy to accept credit for additional amounts. This is doubly disastrous for a firm in this condition because the capital supplied by the owners is insufficient to give the creditors much margin of protection and the business is dependent upon continuance of the rate of operations for success. This ratio should be examined with the ratio of sales to inventory, sales to receivables, current ratio, and net worth to debt ratio. The combined review of all these ratios will suffice to reveal the condition. An attempt to do too large a volume of business on in-

sufficient capital may also be revealed by a comparison of sales to net working capital (current assets minus current liabilities).

$$\text{Sales to total assets} = \frac{\text{Net sales}}{\text{Total assets}}.$$

This ratio is computed by dividing the net sales by the total assets. It shows the number of dollars in sales which are generated by the total assets invested in the business. More efficient use of the assets results in more dollars of sales, while decreased efficiency in their use is shown by a falling ratio. This ratio may be more significant than the sales to inventory figure for manufacturing firms or other firms which carry only a small inventory but which have a heavy investment in fixed assets. For firms of this type a calculation of the sales to fixed asset ratio is sometimes made to supplement the information given by the other ratios.

$$\text{Sales to fixed assets} = \frac{\text{Net sales}}{\text{Fixed assets}}.$$

This ratio shows the dollars of net sales produced with each dollar of fixed assets. When this ratio is low, it may mean that the degree of plant utilization is relatively low or in other words that the concern is too large for the volume of business transacted.

Trends or Managerial Efficiency Ratios. The nine ratios included in this section are designed to answer such questions as: "How efficient is the firm in the use of its assets?"; "What is the ability of management to meet changing conditions?"; or "How adaptable and flexible is the firm?" Six of the ratios normally considered as revealing trend and managerial efficiency have been discussed previously. These are the stock turnover, the receivables turnover, the sales to net working capital, the sales to net worth, the sales to total assets, and the sales to fixed assets ratios. The other three ratios in this category involve net profit and are related to the net worth, total assets, and net sales of the firm.

$$\text{Net profit to net worth} = \frac{\text{Net profit}}{\text{Net worth}}.$$

This is computed as a percentage of net profit to net worth and shows the earnings made on the owners' capital. This amount is, of course, very important to owners and managers and is often considered as one of the most important of the results shown by the statements. It shows the ef-

ficiency of the over-all operations of the business and may be compared for the subject firm over a period of years or to other similar firms. Clearly the success of operations is here summarized. For purposes of comparison with other firms, however, it is not always the best figure to use. The profit on net worth earned by a particular firm is influenced both by its operations and by its financial policy. To illustrate: Firm A operates extensively on borrowed capital; it has $1,000,000 total assets employed and has $500,000 borrowed at an average interest charge of 6 per cent and $500,000 invested by the owners. In a particular year the total profits made before payment of interest are $80,000, and after $30,000 interest are $50,000, which is 10 per cent on the owners' capital and 5 per cent on the total assets invested in the business. Firm B operates almost exclusively on its own capital. It has $600,000 total assets employed and $50,000 borrowed at an average interest charge of 6 per cent and $550,000 invested by the owners. In a particular year the profits made before payment of interest are $53,000 and after $3,000 interest are $50,000 which is 9.1 per cent on the owners' capital and 8.3 per cent on the total assets invested in the business. Looking only at the rate of return on net worth, it would appear that Firm A was the more efficient, but Firm B is actually using the assets employed to better effect than is Firm A. The smaller return made to the stockholders in Firm B may be due to a more conservative policy in the use of other people's money rather than to a lack of managerial efficiency. Therefore to make the most exact comparison, both percentage of return on net worth and percentage of return on total assets should be computed.

$$\text{Net profit to total assets} = \frac{\text{Net profit}}{\text{Total assets}}.$$

This ratio is computed by dividing the net profit by the total assets. Thus, it is designed to show how efficiently the total assets are being used in producing dollars of profit. Used jointly with the ratio of net profit to net worth, as just discussed, it often will enable the analyst to interpret the true condition and future outlook of the firm more accurately.

$$\text{Net profit to net sales} = \frac{\text{Net profit}}{\text{Net sales}}.$$

This ratio, in indicating the efficiency of management, is computed by dividing the net profit by the net sales. It should be recognized that the policies followed by a firm will have a great effect on this ratio. Thus firms employing price-cutting techniques will tend to seek large to-

tal profits and high sales volume and will show a lower ratio than those firms that sell at a high markup and attain a lower volume of sales.

OTHER CONSIDERATIONS AND ILLUSTRATIVE USE OF RATIO ANALYSIS

Although other comparisons may be made and prove revealing, the ratios just discussed should be more than ample for most cases. The skilled analyst, of course, compares one ratio to other ratios. The object is to compare the condition of the business as a unit. Any one ratio emphasizes and concentrates attention upon highly significant and important details. The interpretation of these details becomes more significant as they are related to others and finally to the entire business unit. Also the skilled analyst looks for trends which indicate whether the business being examined is showing progress toward a sounder condition or retrogression toward a less-sound state of affairs.

An illustration of statement analysis with some comments on the significant relationships follows:

THE FASHION SHOP

(Retailer of Ladies' Ready-to-Wear)

	1958	%	*1959*	%
Cash	$ 10,483	6	$ 2,517	2
Receivables	14,977	9	22,657	15
Inventory	60,642	36	45,318	31
Total current	86,102	51	70,492	48
Fixed assets	82,439	49	74,026	51
Deferred charges			2,033	1
Total assets	$168,541	100	$146,551	100
Current liabilities	$ 25,872	15	$ 23,880	16
Fixed liabilities	38,000	23	30,000	21
Net worth	104,669	62	92,671	63
Total	$168,541	100	$146,551	100
Sales	$225,000		$151,688	
Net Profit	7,532		5,221	

RATIO ANALYSIS

	1958	*1959*
Current assets to current liabilities	3.33	2.95
Current assets less inventory to current liabilities (acid test)	.98	1.05
Net worth to debt	1.64	1.72
Sales to inventory	3.71	3.35
Sales to receivables	15.02	6.69
Sales to net worth	2.15	1.64
Per cent net profit to sales	3.35	3.44
Per cent net profit to total assets	4.47	3.56
Per cent net profit to net worth	7.20	5.63

These figures may be interpreted by the credit man as follows:

Both total assets and total liabilities have decreased. The inventory has decreased $15,000, and from 36 per cent of total assets to 31 per cent of total assets. This decline in inventory has, however, been nearly counteracted by the increase in receivables, so that current assets make up almost as large a part of total assets as before. The current assets to current liabilities ratio test shows that current assets are still considerably in excess of current liabilities, indicating that the firm is not in a dangerous condition in this respect.

The "acid-test" ratio indicates that, even with inventory omitted, the current assets are equal to the current liabilities. For this ratio the minimum for satisfactory conditions is often stated as 1 to 1. The net worth to debt ratio has improved. The interpretation of this ratio shows that owners are supplying $1.64 and $1.72 for each dollar they borrow from creditors. Despite the decline in net worth, this situation is improving because of the still greater decline in liabilities. It is believed by credit men that owners should have, as a general rule, a larger stake in the business than the creditors.

The sales to inventory ratio indicates the efficiency with which the management turns its investment in merchandise into sales. This firm has shown a declining efficiency in this respect, and many firms of this type have a sales to inventory ratio of at least 7 or 8 to 1.

The sales to receivables ratio is alarming. It has deteriorated sharply and shows that the management is not efficient in collecting. Not only has this ratio decreased greatly, but it has reached the point where it is evident that the firm has accepted credit unwisely. Much of this amount of receivables probably will never be collected.

The deterioration of both these ratios can be partially explained by the decrease in sales. It must be further said, however, that the firm did not adjust itself to this decline by reducing either its inventory or its receivables to bring them correctly in line with the lessened sales volume. This has kept it from turning these assets into cash and reducing its current liabilities accordingly. It has meant the sacrifice of cash and the loss of opportunities to take cash discounts.

The ratio of sales to net worth shows the efficiency in the use of an owner's capital. Too low a ratio here means the owner's capital is not being used efficiently; too high a ratio shows insufficient capital for the volume of business being attempted. In this case the ratio is too low and is getting worse. Partial explanation of the low ratio here is found in the large investment in fixed assets, which are not fully productive.

The three profit percentages are the most encouraging signs in this

situation. The net profit to sales appears better than it really is, because adequate reserves against losses on bad debts have not been set up. The net profit to total assets and to net worth, although not large, is satisfactory.

The credit man reviewing this situation finds some indication of satisfactory conditions and some of very unsatisfactory conditions. He has only the two statements. If he had one or two more, he could better determine the trend. But he must make a decision. He must determine whether the trend of sales is a result of national and local economic conditions and whether an improvement is to be expected in the near future. Or is this drastic drop a reflection of poor management? There are ample assets to protect creditors and there appears to be no immediate danger of failure. He might expect payments to be somewhat slow, but would feel safe in accepting a moderate amount of credit if he is able to resolve the declining sales figure.

The future prospects of the firm depend upon what steps the management takes to correct the unsatisfactory conditions. It should strive to reduce inventory by $5,000 and to reduce receivables by $10,000. In other words, the firm must stage a vigorous selling drive to clean out its surplus stock and at the same time must wage an effective campaign to collect from its customers who are delinquent in their paymants. The application of the $15,000 realized from these sources to paying off its own current liabilities would bring them down to manageable proportions and would make the firm liquid enough to take advantage of cash discounts. It also would bring about such a proportion of assets to liabilities that, when business conditions improved, it could increase its inventory and receivables to keep pace with increased sales. These increases could be managed on credit when accompanied by increased sales, but the wisdom of additional current debt is subject to considerable speculation.

CONCLUSIONS ON STATEMENT ANALYSIS

The methods we have discussed in the analysis and interpretation of financial statements are obviously not all of the acceptable ones. This does, however, introduce the subject to the beginning student. Other methods are available, and other factors should often be considered in order to make a sound appraisal and interpretation. The major thing to gain in making this appraisal and interpretation is the intelligent understanding of financial statement facts. Knowing what the facts on the financial statement really mean, the credit man can relate these facts to

other significant types of information and thus have the knowledge given him by reading the statement more meaningful and significant.

REVIEW AND DISCUSSION QUESTIONS

1. List four commonly accepted methods available to credit managers for analysis of financial statements. Explain the essential features of each method.
2. Should the credit analyst using the simple-evaluation method of analysis have individual qualifications different than the user of the ratio-analysis method?
3. What is the advantage of the percentage-comparison method over the simple-evaluation method?
4. Describe the background, development, and reasoning behind the ratio-analysis approach to financial statements.
5. Examine the tables of ratios reproduced from a Dun & Bradstreet publication in Figure 28–3. Would you use these ratios as standards against which you measure credit customers' ratios? Explain your answer.
6. List five or six liquidity ratios. Explain what each ratio reveals.
7. Explain the significance of the following ratios:
   a) Net worth/current debt + funded debt.
   b) Total assets/fixed assets.
   c) Fixed assets/fixed debt.
   d) Net worth/fixed assets.
   e) Net sales/net worth.
   f) Net sales/total assets.
   g) Net sales/fixed assets.
   Explain for each of the above how changes in the resulting ratio affect the solvency of the business concern.
8. Is it possible to accurately determine the managerial efficiency of a business firm by using ratio analysis? If so, what ratios are used? What is their significance?
9. Study the illustration titled "The Fashion Shop" on pp. 559. Assume you have received an initial order amounting to $1200. The order is to be made up of women's coats and dresses.
   a) On the basis of the analysis accompanying the illustration would you accept or reject this order? Why or why not?
   b) Would you want additional information on this case? What type of information would be particularly helpful?
   c) If you have rejected the order, would you accept it on C.O.D. terms? Explain your decision.

CHAPTER 29

Analysis of and Decision in Commercial Credit and Setting of Credit Lines

IN THE PRECEDING several chapters the discussion has centered upon the sources of information that are available to the credit analyst. The basic purpose of these data is clearly to assist the credit manager in making a better analysis of the credit risk and in reaching a sounder decision. In other words, will *profitable sales* and *continuing sales* be the result of the acceptance of the order? A discussion of the role of analysis and decision making in commercial credit transactions and the setting of credit lines form the basis for the subject matter of this chapter.

CORE OF THE COMMERCIAL CREDIT TASK

As previously stated in Chapter 22, many functions are performed in the operation of a commercial credit department. Orders are received, investigations are instituted, credit files are opened, accounts are controlled, credit records are maintained, customers are billed, collections are pressed, and adjustments are made. However, as in consumer credit, the really critical core of the commercial credit task is arriving at credit decisions. When credit decisions are formed on the basis of accurate information, properly evaluated, and carefully analyzed, they will reflect sounder and more rational judgments. Decisions, though, cannot always be free from error—no prediction of the future can always be correct —but they will be right in a sufficient proportion of cases to conform to the credit policies and objectives previously established.

Establishment of a "House Standard"

In order for a credit manager to accomplish the objectives desired by top management of his firm, it is desirable for management to furnish its credit manager a clearly defined and understood statement of what is desired of his department. Once this is accomplished, the credit manager is then in a better position to establish what might be called a "house standard," or a guide by which he may judge the pertinent qualities of credit risks seeking to purchase from his firm. In determining such a house standard, the credit manager is *influenced by various* external or uncontrollable factors such as competition, general business conditions, and characteristics of the local market.[1] Certain controllable factors also influence the establishment of this guide. These include profit margin of the seller, type of product, seasonal aspects of the product, use of special terms and special arrangements for marginal and submarginal customers, influence of collection policies and procedures, personality of the credit manager, and other managerial influences. It should be emphasized that as these factors vary from time to time so does the house standard by which the credit manager judges whether to accept or reject customer orders. Some of the factors have more weight at certain times than other factors, but no one factor or set of factors is always dominating and all-conclusive.

External Factors. The credit manager, in deciding whether an order is worthy of approval or subject to rejection, must determine the degree of risk connected with the account and then compare this risk to the level he has decided he is willing to accept. In establishing this level, the credit manager must consider what his competition is doing in the way of lenient or strict credit, type of credit terms, and lenient or strict collections. Regardless of the desires of a company to dictate its own house standard, consideration must be given to the "other fellow" who is eagerly seeking the customer's order.

Attention also must be directed to general business conditions. When the economy is at a high level of activity and the demand for a company's products exceeds its present capacity to produce the necessary supply, the credit manager of the company will have an entirely different philosophy of credit acceptance and rejection as compared to that normally found in periods of reduced business activity and troubled times in moving the company's products. Likewise, firms selling in localized areas will be influenced by local business conditions and may face prob-

[1] Adapted from William J. Shultz and Hedwig Reinhart, *Credit and Collection Management* (2nd ed., New York: Prentice-Hall, Inc., 1954), chap. xi.

lems in disposing of its products, while the over-all economy may be moving in the so-called prosperity phase of the business cycle. Such situations may be pointed up by the phrase, "It's a recession when the other fellow's products aren't selling, but it's a depression when our products aren't selling."

Controllable Factors. Although his firm has little or no control over the external factors just discussed, there are other factors which also will influence a house standard and which are largely controllable within the framework of company policies. Thus, the type of product sold, its seasonal or nonseasonal characteristics, the profit margin of the seller—all of these factors will have an influence upon the level of credit acceptance of a company. Generally speaking, the wider a company's profit margin on its sales, the poorer the class of credit risks which it can afford to sell. It is not to be inferred, however, that all firms operating with a high profit picture will sell to poor risks. Such firms simply can *afford* to do so, if they decide such a policy is feasible and consistent with other aims.

It is not always necessary to disapprove orders from marginal and submarginal customers, but there are certain arrangements that might be made and that might still permit acceptance of the order at the level of the established house standard. One arrangement is to place "slow-pay" customers on a trade acceptance basis. Such a procedure is aptly described in the following quotation:

> Where trade reports indicate that a customer, new or old, is substantially late in payments to a goodly proportion of his suppliers, and analysis of his financial statements shows that, while he is fundamentally sound, his operating capital position is weak and he simply cannot avoid lateness in many of his payments, it is generally optimistic self-delusion for a credit manager to hope that his concern will be a favored one and consistently receive prompt payments. His realistic objective should be, not to obtain prompt payment, but to obtain certain payment in an extended period not longer than, or possibly slightly shorter than, that for other suppliers. This can often be achieved by arranging suitable trade acceptance terms with the customer.[2]

Other arrangements with customers who are acceptable only as qualified credit risks include the use of cash terms (generally means payment within ten days of the invoice date), C.O.D. terms (cash on delivery), or "split-shipment" terms (part of the goods shipped on cash before delivery and part on regular terms).

The type of collection policy a firm decides to follow is often a determining factor in the level of acceptance that the credit manager may

[2] *Ibid.*, pp. 260–61.

establish.[3] If a firm has a very strict collection procedure, the chances are that the house standard of acceptance level is low or lenient. This is simply saying that the following combinations are found most often:

Strict acceptance—lenient collection
Lenient acceptance—strict collection.

Another factor of importance to be considered is the personality and "sales-ability" of the credit manager. Some individuals have the talent to say "no" to a customer and at the same time maintain his good will to such an extent that the transaction still is completed either on a cash basis or on credit terms much more strict than those normally prevailing.

Once all these factors are carefully weighed and analyzed, the credit manager then has some guide by which he may judge the credit worthiness of the orders being received.

Automatic and Nonautomatic Initial Orders

A distinction should be drawn between initial orders and follow-up orders. It is particularly essential, whenever possible, that the first order from a new customer be processed as quickly and expeditiously as possible without lengthy and extensive investigation. Here is the first contact between buyer and seller; here is the forming of the initial impression that can often mean the difference between a long-range series of follow-up orders and a one-time, one-order customer. Some firms also follow the practice of considering "old" customers who have not bought during the preceding year the same as "new" customers.

Automatic Initial Orders. In order to expedite the processing of initial orders, blanket approval may be given to all first orders below a certain specified amount. This maximum guide undoubtedly will be influenced by the type of product involved, the nature of the company operation, the over-all credit policy, general market conditions, competitive credit terms, and prior experience in collecting small credit accounts approved under such a blanket policy. It must be realized, however, that blanket approval should not stop with simply approval, but that a follow-up procedure is a vital necessity for future successful operation. This point is clearly illustrated in the following quotation:

Follow-up work is an important requirement of a blanket approval system. Since the first small order may be a trial shipment which will lead to larger orders, the system should provide for the sales department to supply an estimate of each customer's credit requirements and, if possible, an appraisal of his credit

[3] Of course, the type of credit acceptance policy adopted in turn influences the decision as to the type of collection policy to follow. In fact, this is the more normal cause-and-effect sequence.

worthiness and importance as an outlet. With that information the credit department is in a position to set up any necessary credit controls or to plan its investigation, thus expediting the processing of future orders. In many cases, no credit investigation at all will be required, if the customer's continuing needs will be within the minimum amount for which referral is required. If this is true, and payment performance is good, the cost of credit investigation is eliminated entirely.[4]

Some concerns follow the policy of appraising initial orders on the basis of ratings given by mercantile credit agencies, such as Dun & Bradstreet and the various specialized agencies. The maximum amount[5] of the first order will be specified by the company for each Dun & Bradstreet credit rating, for example, and if the initial order of a customer (with a certain credit rating) falls below that maximum, approval becomes automatic. Of course, each company using such a technique will establish its own first order limits to meet its own needs and to conform to its own policies.

Nonautomatic Initial Orders. If the company has not established procedures such as blanket and agency-rating approvals, the question then arises as to how to handle these nonautomatic initial orders. One suggestion offered is that the decision as to the disposition of the first order may be based on answers to the following questions:

1. Is the dollar value of the order large enough to warrant the cost of investigation?
2. Is the potential for future sales such that the account should be cultivated, or is it immaterial what the reaction may be to a request to do business on other than regular credit terms?
3. Does company policy dictate trying to establish credit terms for *all* customers for the public relations benefit which might result?

Should it be decided to investigate, a further decision must be made as to how extensive the investigation should be. Where present and expected sales potential justifies an intensive and direct investigation, the credit department should seek all available information regarding historic and forecast data, reputation and ability of principals, marketability and competitive forces related to products, and so on.[6]

Credit Decisions as a Routine Operation

The first order has been approved, the complete credit investigation has been made, and every hope now is that the relationship with the customer will prove to be a long and fruitful one, resulting in a series of

[4] *Credit Management Handbook,* A Publication of the National Association of Credit Men (Homewood, Ill.: Richard D. Irwin, Inc., 1958), p. 275.

[5] This amount will be changed from time to time, depending upon all the factors affecting company policy.

[6] *Ibid.,* pp. 276–77.

profitable transactions. The next question arises as to how the subsequent requests for credit may be handled in the most expeditious manner to serve the needs of the customers and at the same time to incur the least possible expense to the company. The credit manager generally is too involved with more pressing matters to have to give the final approval to every order received. Thus, it is necessary that some procedure be established through which the credit manager may delegate authority for credit approval while at the same time retaining the degree of control necessary to protect his department from an excessive bad-debt situation. Such a procedure should act to free the credit manager for really important decisions and to place routine where it rightly belongs in the departmental operation. The most common method used today to accomplish this delegation of authority is the technique of credit lines or credit limits.

CREDIT LINES

The two terms, "credit lines" and "credit limits," often are used interchangeably. Historically, the term "credit limit" has been in use for a longer length of time than the term "credit line." This is more true in the commercial credit field than in the commercial bank credit field in which the term "credit line" or "line of credit" has always been common terminology.

Some commercial credit managers give a little different interpretation to the two terms. Thus in some companies credit lines are looked at as the maximum amount of credit they are willing to accept from a customer. Used in this manner, the credit line becomes the credit limit.

It appears that the most realistic approach to the use of these terms is to recognize that in most instances a firm will use this figure, indicating the amount of credit to be approved, as a "warning signal" or as a "red flag." It does not mean that orders exceeding this limit will be automatically refused, but the figure simply acts as a guide to force a further analysis of the account and another decision as to whether to accept or reject the larger order.

Advantages

As previously mentioned, the use of such credit lines is designed to increase the efficiency of the credit department. If handled properly, they should save the time of the credit manager for really important decisions, should permit delegation of authority but still allow for retention of control of the accounts, and should place routine tasks in the

hands of subordinate personnel. In addition, the use of credit lines forces over-all consideration of the entire account and not merely on a transaction by transaction basis. This should in turn lead to better decisions than a single-order technique would. Likewise, such an arrangement should protect the buyer from himself, in that it acts as a check on the reckless buyer who for the moment may be unduly optimistic and desirous of buying in amounts greatly in excess of his needs.

Limitations

While the use of credit lines is not universally accepted in all commercial credit transactions, it is believed that somewhere in the neighborhood of ⅔ to ¾ of such credit approvals involve the use of some type of credit-line control. Unfortunately, the adoption of such a practice carries with it certain problems and limitations.

The firm that establishes a line of credit for a customer and then makes no attempt to keep it up-to-date, immediately defeats the basic premise on which the use of credit lines is predicated. While it is recognized that such revisions are time-consuming and costly, the lines established will not reflect the current ability of the customer to pay for the goods and services purchased unless some system of periodic review is installed.

Another limitation involved is that approval of orders within the credit line established will be performed generally by clerical personnel and not by the credit manager himself. Thus in certain instances the credit manager may lose contact with the account and not develop the full potential of future business.

Methods of Setting Credit Lines

Perhaps the credit department will never be in a better position to establish a credit line for a customer than at the moment when the credit investigation is completed. Generally at this time more careful examination of the credit data, more complete analysis of the account, and more thought as to whether to accept future orders will be taking place than at any other moment in the life of the account. It stands to reason, therefore, that the credit manager is in the best position at this time to establish the line of credit which he believes safe to allow the customer on future orders. The question then arises—just how does the credit manager go about setting credit lines? There are no scientifically and mathematically accurate methods to accomplish this task. In fact, credit managers generally report that they follow certain techniques but that they are not sure that they are the best methods possible.

Some six methods are found in use to accomplish this task: (1) allow as much as the customer wishes as long as he pays as agreed; (2) allow as much as the other creditors are allowing the customer; (3) allow a small dollar volume of purchases and raise gradually as the customer proves he is a good risk; (4) allow purchases based upon a time interval; (5) basis of facts (divide the number of creditors of the customer into net worth, current assets, net working capital, and inventory; use of an agency rating); and (6) requirements (or pseudoscientific) method.

As Much as the Customer Wishes. Some firms follow the practice of allowing the customer as much credit as he wishes, just as long as the customer pays as agreed. Such an arrangement stresses the "increasing sales volume" function of the credit department and does not create any real problems for the credit manager unless—at any moment when the indebtedness of a customer is high he decides he cannot or will not pay as agreed. As long as payment is prompt and automatic, this method is a highly desirable one. On the other hand, some observers believe that this method of setting credit lines should not even be considered a method, since no definite line is established but it is entirely flexible depending upon the wishes and actions of the customer.

As Much as Other Creditors Are Allowing. This method is based upon the premise that a firm can discover the amount of credit that its competitors are allowing the customer in question. While definite and exact figures may be hard to obtain, a firm often is able to acquire approximations through direct interchange of such information and from data appearing in the "HC" or "HRC" columns of Dun & Bradstreet and Credit Interchange Bureau reports. It should be recognized, of course, that the "highest recent credit" figure may represent an amount of credit between a seller and its customer in excess of what the seller believes the limit should be. In certain cases, extenuating circumstances such as a desire not to offend a long-time customer may cause the "HRC" to be more than it ever should have been.

If this method is adopted, the question also should be asked "How did the competitors decide on what the credit line should be?" In other words, is this simply a case of "the blind leading the blind"? Unfortunately, there is usually no good and dependable answer to this question, and many firms decide to rely upon their own analysis and interpretation of the credit information in setting the credit line, using their competitors' experiences only as a guide in some instances or completely ignoring them in other cases.

A Small Dollar Amount, Raised Gradually as the Customer Proves to Be a Good Risk. Another very common and practical pro-

cedure is to start with a low credit line and raise with experience. Customers may be started with a low limit, or enough to take care of their first purchase. As experience with the account accumulates, as they prove their ability to pay larger amounts, the limit is raised to take care of their purchases. If the experience is unsatisfactory and they do not prove capable of taking care of the purchases they have made, the limit is held so as to restrain their purchases or it even may be lowered.

Based upon a Time Interval. Some credit departments attempt to limit an account to a certain period of time; that is, a month's purchases, a week's purchases, or some definite time. For example, a line of credit of $5,000 per month would mean that during any one-month period, a credit department clerk could approve without any referral to the credit manager orders totaling $5,000, regardless of the total amount outstanding and owing.

Credit lines stated in this way are particularly useful in companies which process orders at a number of locations but maintain more centralized accounts receivable. Lines for a specific time period provide control with a minimum of referral to a central office and of record keeping at the order-processing point. In assigning such credit lines, the credit man should bear in mind that, since even prompt payment for all invoices billed during the designated period would not necessarily be received during that period, the total credit exposure will often be larger than the amount of the line. Adequate controls must be established to prevent extension of excessive credit to delinquent accounts.[7]

Basis of Facts. This method is based upon certain financial information or facts, such as net worth, current assets, net working capital, and inventory. These data are then related to the number of creditors the customer may have, by dividing the number of creditors into the financial figures chosen by the credit manager. For example, if a firm has a net worth figure of $100,000 and the number of its creditors is 10, then the line of credit may be established[8] at $10,000. Likewise, if this firm has an inventory figure of $80,000, the credit line would be $8,000.

Whereas the financial figures of net worth, current assets, net working capital, and inventory generally are readily available from financial statement information, more of a problem is involved in reaching an accurate estimate of the number of creditors. One method of obtaining this information is simply to ask the customer for a list of the names (and probably addresses) of his creditors. Sometimes, however, this list is dis-

[7] *Ibid.*, p. 279.

[8] Generally, a line of credit is not established on the basis of a single computation. Several of these methods may be averaged to arrive at the final credit line chosen.

covered to be incomplete, either intentionally or unintentionally. As a check, some firms also follow the practice of obtaining a Dun & Bradstreet report which shows a column of "Owe," for the customer in question. A similar column of "Now Owing" appears in the Credit Interchange Bureau reports. Generally these reports do not contain all of the creditors either, and some adjustment must be made to arrive at a fairly accurate estimate of customer count. One method of adjustment is illustrated as follows:

> XYZ Retail Store is seeking to buy goods from the ABC Manufacturer. This is the initial order. XYZ furnishes a balance sheet which shows accounts payable of $10,000. ABC receives an interchange bureau report that lists 8 creditors of XYZ with an indebtedness of $8,000. Thus if 8 creditors account for $8,000 worth of debt, the $10,000 accounts payable total is probably owed to 10 creditors.

It should be recognized that such a computation or estimate is "rough," and no claim should be made that it is 100 or even 90 per cent accurate. Critics of this method may point out that one creditor may account for half of the accounts receivable and that any system of proportions based on such a situation would be more misleading than helpful. Any user of this method should consider his estimate of the number of creditors simply as a guide, and it is recommended that these basis-of-facts methods be supplemented with some of the other techniques described.

The last basis-of-facts method to be described does not involve financial facts that appear on a customer's balance sheet, but it utilizes mercantile agency ratings. Beckman and Bartels describe this as follows:

> A somewhat similar method is the one in which mercantile agency ratings are used as a basis for assigning credit limits, either as absolute amounts based on certain rating brackets or as a per cent of the capital rating. When the latter is used, the rule normally followed is to allow a credit limit amounting to 10 per cent of the higher capital rating figure if the account is rated in the first or second general credit grade ("high" or "good" in Dun & Bradstreet's reference books) and 10 per cent of the lower capital rating figure if the account's general rating is in the third or fourth grade ("fair" or "limited" in Dun & Bradstreet's). Especially is this true of concerns carrying credit insurance. In such instances the common practice is to follow the limits of coverage indicated in the policy opposite each rating of whatever agency has been chosen for the purpose. . . .[9]

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[9] T. N. Beckman and R. Bartels, *Credits and Collections in Theory and Practice* (6th ed.; New York: McGraw-Hill Book Co., Inc, 1955), p. 564. Reference to credit insurance in this quotation is a little premature, as credit insurance is the subject matter of the following Chapter 30.

Requirements (Pseudoscientific) Method. This method usually involves five basic steps in computing a line of credit. These steps are as follows:

1. Secure the total annual volume of sales of the customer. This figure often may be obtained directly from the firm seeking to buy goods on credit, from financial statements if these are prepared for the use of creditors or are published to conform to the various security-issuance regulations, or from educated guesses of the sales activity of the firm in question.
2. Find out what part of these sales is in the line of business covered by you, the seller of the goods. Often this type of information is difficult to obtain with accuracy, unless the customer is willing to co-operate in furnishing it. Otherwise, a "guessestimate" may have to prevail.
3. Decide what proportion of this business you, the seller, can hope to secure. Perhaps this is the weakest link or step in this method, as this figure *has* to be an estimate Often there is wide variation between what volume the seller actually is furnishing the customer and what he hopes or thinks he will be selling. The accuracy with which this third step is carried out will be a determining factor in the accuracy of the credit limit itself.
4. Determine how many days you will allow the customer in your net credit period This step is necessary, because a customer generally does not buy only once a year but probably will place an order for goods, pay for them, place another order, and so forth. The line of credit usually will relate to the total amount of indebtedness that a firm plans to accept from a customer as of any one time, not a yearly accumulation of orders placed by the customer.
5. Adjust the retail credit limit thus far determined to reflect the cost value of the order. This step, of course, is necessary because the customer's cost price is the seller's selling price This last step requires that the seller be familiar with the customer's gross margin of profit on which he (the customer) handles the line of goods involved

For purposes of illustration, dollar figures are substituted for the preceding description and the five steps are followed through mathematically:

1. Customer's annual sales are $50,000.
2. Proportion in the seller's line is $10,000
3. Proportion the seller hopes to obtain is ¼ or $2,500.
4. Terms of sale are net 60 which means the goods should turn six times a year; $2,500 ÷ 6 equals approximately $416
5. Gross margin of the customer is 30 per cent. Thus, the limit of the seller may be estimated as between $290 and $300.

Caution is urged in the use of this pseudoscientific method. It should be viewed as it really is—an estimate, and most credit managers who use such a procedure supplement it with one or several of the other methods previously outlined.

To Inform or Not to Inform Customers

There are different schools of thought as to whether the customer should be advised of his credit limit, as soon as it is established. Some executives are in favor of notification and claim that such action permits the seller to discuss the entire credit picture with the customer and to offer suggestions as to how to improve the credit standing, if there is need for improvement. Likewise, the customer is not held in the dark as to what amount of credit he can rely on from the seller.

On the other hand, some observers point out that the notification may cause the customer to restrict his buying to the dollar amount of credit line established, thus strictly interpreting the word "line" to mean an inflexible limit. This damage to good will and to expanding sales volume causes some executives to view a credit line only as an instrument of internal control.

There is a similar difference of opinion as to whether the seller's salesmen should be informed of these limits on their customers. Unfortunately, there is no one correct answer to either of these problems. Under certain circumstances, both the customer and the salesman will know when the credit limit has been reached. When an account has reached its limit no further orders will be approved (or at least orders won't be shipped) until payments are forthcoming which reduce the balance below the limit. This condition can exist even though the customer may not have any amount due on outstanding receivables at the time the new order is requested.

REVIEW OF DECISIONS

Business conditions change. The credit standing of customers changes. The outlook of sellers changes. In fact, in credit operations change of many varieties is a certainty, and the successful credit manager recognizes that the decisions he has made and the credit lines he has set must be regularly reviewed to bring them up-to-date. Otherwise, increasing sales volume, cutting down bad-debt losses, reducing the costs of credit administration, and efficiently managing the investment in receivables will not be accomplished.

Unfortunately, despite all the safeguards of analyzing credit information from a number of sources, making careful and complete credit decisions, setting realistic lines of credit, and constantly reviewing all these steps—still every dollar of credit accepted is not repaid on time and in some instances is never repaid. For this reason, the next three

chapters are devoted to a discussion of commercial credit insurance and collection policies and practices.

REVIEW AND DISCUSSION QUESTIONS

1. What is meant by the term "house standard"? How do various external factors influence a commercial creditor's house standard?
2. In what ways do the controllable factors affect the creditor's house standard?
3. Is the concept of a line or limit of credit inherent in commercial credit transactions? Discuss.
4. Is it desirable as well as prudent business policy to provide a system for automatic approval of initial orders? How can this be done without assuming great risk?
5. Are credit lines most often regarded as inflexible devices, or should they be flexible to changing conditions affecting the customer? Discuss fully.
6. What are the advantages of developing a system of credit lines? What are the limitations?
7. List and describe the operating details of four methods of setting lines of credit. Which ones appear more logical and objective to you?
8. What data, and what sources, provide the information needed to intelligently set limits on a customer's credit buying?
9. In what way may a customer and the company's salesman become aware of the credit line even though the amount of the line has not passed to them?

CHAPTER 30

Commercial Credit Insurance

THE ORDER has been received, the account has been investigated through the accumulation of credit information from credit-reporting agencies, the decision has been made to accept or reject the order, a credit line has been determined to guide future orders. Now if all accounts paid as agreed, there would be no necessity of worrying about the collection of accounts receivable. But unfortunately, every account does not pay as agreed, and as a result it is necessary for a firm that has a credit policy also to have a collection policy. One phase of the collection policy of many firms is the decision to share part of the risk of noncollection with an insurance company. Such an activity is known as commercial credit insurance and is the subject of discussion in this chapter.[1]

It should be pointed out that commercial credit insurance is confined to manufacturers, jobbers, wholesalers, etc., and is not available to firms selling goods and services or loaning money to the ultimate consumer. Transactions involving the ultimate consumer are sometimes covered by what is commonly known as "credit life insurance" or "consumer credit insurance." As previously described in Chapter 16, this type of risk sharing is predicated on the death of the consumer. Commercial credit insurance is an entirely different field of activity than that of the consumer credit insurance field.

PURPOSE OF COMMERCIAL CREDIT INSURANCE

In Chapter 1, credit was defined as a medium of exchange of limited acceptance. It was further spelled out that credit was of limited accept-

[1] In this chapter, emphasis will be placed upon credit insurance as part of the collection policy of a firm. Discussion will be directed more toward the purpose, the advantages, and disadvantages of this type of protection rather than to all the possible provisions of the insurance policies themselves.

ance because of two elements—time and risk. Thus in every credit transaction there is an element of risk, and the credit manager must decide whether to bear this risk alone or whether to share it with someone else. As previously discussed, the firm that factors its accounts receivable has decided to let another institution bear the task of credit acceptance and credit collection without recourse. For this service the firm pays a fee to the factor. Credit insurance is another method of sharing this risk with others, this time with an insurance institution rather than with a financial institution as in factoring. For a charge, the risk accompanying the credit transaction is shared with a specialist, just as fire, theft, storm, and public liability dangers are passed on to other types of insuring companies.

It is the unusual loss that is insured against, as credit insurance does not protect the insured against the normal (or primary) loss experienced by a particular business firm. The more frequent and important causes of abnormal bad-debt losses are as follows:

1 Loss resulting from insolvency of one or more large customers whose accounts constitute a disproportionate fraction of the selling firm's total receivables
2. Loss resulting from insolvency of a substantial proportion of a firm's customers, all engaged in a particular line of business which is affected by some unusual event, that is, a technological development, a protracted strike, a raw material shortage.
3. Loss resulting from insolvency of a substantial proportion of a firm's customers located in an area affected by some unusual regional event, that is, a flood, a crop failure, a protracted strike in an industry which economically dominates the region.
4. Loss resulting from customer insolvencies in excess of the "normal" as a result of a general business depression.
5. Loss resulting from inability to move obsolete inventory.[2]

With most firms the extent of this unusual or abnormal loss is dependent upon many factors. These include: the highest credit accepted from any one customer, the type of business in which the seller is engaged, the product or products sold (type, stability, diversification, seasonality, obsolescence), the quality and "freshness" of inventories, the geographical location of and competition in the buyer's markets, money supply in the economy, price level fluctuations, phase of the business cycle, labor conditions, and so forth. It will be noted that some of these factors are within the control of the seller; others are entirely outside the control area and dependent upon external circumstances.

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[2] Joseph T. Trapp, *Credit Insurance, A Factor In Bank Lending* (Baltimore, Md.: American Credit Indemnity Co of New York, 1953), pp. 44–45.

ADVANTAGES OF COMMERCIAL CREDIT INSURANCE

In his decision to share the risk of an account receivable with an insurance company writing commercial credit insurance, the credit manager must weigh the possible advantages that may accrue to his company. These have been summarized by one observer in the following quotation:

> . . . It guarantees that portion of working capital represented by insured accounts receivable. It provides a basis for extending credit, inasmuch as it establishes an endorsement naming the lending institution beneficiary under the policy. It backs the creditman's judgment and provides him with a yardstick on which to rely when approving questionable credits. The proper application of Credit Insurance should create a balance between volume of sales and profits. The creditman's objective is to approve the greatest possible volume of sales without incurring undue loss and the salesman's goal is to sell as much as possible. It is then only natural that by creating a proper balance between sales and bad debt losses, this type of insurance should create harmony between the credit department and the sales staff. By providing specific limits as to the amount of credit which the insurer will guarantee to various customers, there is established an automatic system of credit approval under which the sales force can operate almost independent of the credit department. This makes for greater efficiency.[3]

Balance between Sales and Profits

Advocates of commercial credit insurance point out that a user can have a clear idea in advance of what his costs will be in the form of excessive or abnormal credit losses during the coming year. By combining his normal losses with the premium cost paid for credit insurance, the credit manager will be able to come up with a fairly accurate estimate of this expense item. If its system of expense control is working properly and other expense items are subject to accurate prediction, a firm can then arrive at a fairly good approximation of anticipated profits. This use of credit insurance is dependent upon the type of policy that is written, as some policies do not cover all possible losses on all classes of risks. A further discussion of this and other limitations is covered in the section that briefly describes the basic features of credit insurance.

Credit insurance also works on the "sales side" of the credit manager's operations. Some credit managers believe that the purchase of credit insurance has the effect of making them more careful in credit acceptance, in that they have to maintain a strict control over all changes in agency ratings of customers. This is necessary to stay within the provisions of the credit insurance policy. At the same time, others argue

[3] *Ibid.*, p. 42.

that the opposite effect is the result. By shifting extraordinary losses to the insurance company, the insured can afford to take greater risks in credit acceptance and thus can increase his sales volume. Since any increased losses are covered by the insurance company and any increased profits are retained by the insured firm, credit insurance may work for freer credit acceptance on the part of some companies.

Improvement in Collections

It is recognized that the longer an account remains unpaid the more difficult it is to collect. Since many of the commercial credit insurance policies carry a compulsory or optional collection provision, the insured firm either is required or may voluntarily submit accounts that have not paid within the specified net period. The insurance company usually asks that these delinquent accounts be turned over within 90 days after the end of the credit period. Vigorous collection action generally is taken by the insurance company, thus increasing the chances of early collection and of greater return to the creditor company. The psychological impact of collection by a third party—and when the third party is an insurance company—cannot be overlooked.

Improvement in Borrowing Capacity

Most firms find themselves from time to time in the position of having to borrow from a financing source to carry on their operations. Some of these loans are unsecured; some involve the assignment of accounts receivable as collateral to the loan. Credit insurance may act as an aid in the discounting of these accounts receivable with a bank or finance company. "With the danger of excessive loss for a borrower's accounts eliminated, the lending institution can afford to be more generous in its judgment of the discount acceptability of such accounts. Apart from the special purpose of accounts receivable financing, a supplier who carries credit insurance on some of his accounts is generally considered a better loan risk by a bank."[4]

DISADVANTAGES OF COMMERCIAL CREDIT INSURANCE

Some credit executives believe that the weaknesses connected with commercial credit insurance overshadow any benefits that might be obtained from its use. Some even go so far as to say that there is no legitimate place or need for credit insurance in the activities of an efficient

[4] William J. Shultz and Hedwig Reinhardt, *Credit and Collection Management* (2nd ed.; New York: Prentice-Hall, Inc., 1954), p. 503.

and well-run credit department. Some of the most important disadvantages generally listed are cost, false sense of security, restrictions in placing accounts for collection, limiting features of the provisions of the policies, and need for credit insurance as opposed to other types of insurance.

Cost

As in all insurance, premium payments on credit insurance are an expense item for a business concern. Although it is recognized that credit insurance is designed to cover the abnormal or unusual credit loss, some firms have found that recovery from such accounts is frequently less than the premium cost over a number of years. In the instances in which this is true, premiums paid for credit insurance can exceed the return from claims made on the insurance company. Of course, it cannot be overlooked that the company was enjoying *protection* from excess loss during the period under comparison and in one sense was fortunate in the fact that its bad debts stayed within the range normally expected. A somewhat similar situation may be cited in the case of the individual who buys health and accident insurance and who is fortunate enough to stay entirely well for five years. He may reason that the cost of the insurance was just another expense for him and that he would have been ahead at the end of the five-year period if he had not taken out the insurance. His reasoning would be much different, however, if a month's hospital stay had been required during the first year the policy was in effect. Even though no claim was made against the commercial credit insurance (or the health and accident insurance), it must be remembered that *protection* was obtained for the premium paid.

False Sense of Security

Another important objection which has been raised against commercial credit insurance is the tendency that it may cause in some credit managers' to rely more upon insurance protection than upon their own deliberate judgments. This disadvantage is well described in the following quotation:

> The mercantile credit agency ratings upon which credit insurance is so largely based are a valuable guide to the credit risk status of customers, but only a guide. They are not a substitute for detailed inquiry and careful analysis. Yet, if an account can be covered by insurance up to the maximum for its risk class, a credit manager may be tempted to reduce his labor by arbitrarily using such coverage as the account's credit limit. He then blindly approves all orders within the credit limit, and just as blindly refuses to check orders in excess of the limit. Such blind approval of all orders within the covered amount tends to increase the volume of

bad debts sustained by the seller and so prevents him from obtaining a lower normal loss deduction on his experience rating. Also, by increasing the adjustments that must be made by the insurance companies, it results in higher premium rates than would otherwise be necessary. Categorical refusal to check orders above the policy maximum may often result in the turning down of good business and possibly in the eventual loss of good customers.[5]

Credit insurance thus may cause the credit manager to have a false sense of security in knowing that excessive bad-debt losses are covered, to have less incentive to make a good showing as evidenced by greater sales with lower bad-debt losses, and to exercise a freer hand in credit acceptance in order to receive a pecuniary return from the credit insurance policies purchased.

Collection Restrictions

Under most of the policies being written, accounts that have gone unpaid must be turned over to the insurance company within a stipulated time period. This requirement precludes a credit department from exploring all friendly means of collection in an effort to recover the entire amount or an acceptable and fair reduced amount (composition settlement as discussed in Chapter 32) from the debtor firm. Often circumstances prevent a firm from paying within the specified credit period, and a carefully worked out arrangement between seller and buyer may result in complete recovery of the indebtedness and in maintenance of good will. The requirement that past-due accounts be automatically transferred to the insurance company tends to prevent the possibility of the credit department salvaging the overdue customer.

Limiting Policy Features

It will be remembered that credit insurance does not cover all losses. The normal (or primary) bad-debt losses must be borne by the creditor, and there is some criticism levied at the method of computing this primary loss. "It will be observed that in determining the primary loss the insurance company computes all losses, including those which are not normally allowable under the policy because of inferior ratings and other stipulations of the agreement, notwithstanding the fact that the losses of these accounts constitute an important or even major part of the aggregate losses."[6]

Another questionable feature of the credit insurance policies is that

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[5] *Ibid.*, pp. 503–4.

[6] Theodore N. Beckman and Robert Bartels, *Credits and Collections in Theory and Practice* (6th ed.; New York: McGraw-Hill Book Co., Inc., 1955), p. 555.

the insurable risk of any one customer is predicated entirely upon ratings of Dun & Bradstreet and of special mercantile agencies. To base credit decisions entirely upon agency ratings fails to give due weight to all the other credit information that normally is available to the credit analyst. While the required limitation is justifiable from the insurance company's point of view, at the same time such a restriction seems to infringe upon the necessity of the credit manager's weighing all the factors involved and of analyzing pertinent sources of information before arriving at a decision.

Credit versus Other Types of Insurance

Simply to say that a firm needs to protect its accounts receivable by insurance because it protects its inventory, building, and equipment against fire or "acts of God" fails to recognize the differences in the two needs. The company that has all of its inventory and equipment in one building faces the threat that a fire, flood, tornado, or windstorm could completely wipe out these assets in a short period of time. To protect against this calamity, insurance generally is carried. There are companies, of course, whose plants are so widely scattered and whose danger of financial ruin because of fires and "acts of God" is so remote that they have decided to provide their own form of insurance through some system of reserves.

The chances that the accounts receivable of a firm will be wiped out in a single disaster are very remote. Even though the receivables are concentrated industry-wide or geographically, it is hard to imagine a firm losing the major portion of its accounts in any one year. Nevertheless, protection against excessive loss in a number of individual large accounts still has proved desirable in the activities of many firms.

BASIC FEATURES OF COMMERCIAL CREDIT INSURANCE

Commercial credit insurance is written by two companies, the American Credit Indemnity Company of New York (organized in 1893) and the London Guarantee and Accident Company, Ltd. (organized in 1869). Whereas other companies have attempted to operate successfully in this area of insurance, these two have survived the competition and are now the recognized leaders in this field.

As previously pointed out, commercial credit insurance is primarily for the protection of manufacturers, jobbers, wholesalers, and certain types of service organizations (such as advertising agencies).

In the usual commercial credit insurance policy, there are two de-

ductibles, coinsurance and primary loss. The amount of coinsurance (an arrangement by which an insured firm bears a specified percentage of its total losses on all insured accounts) is deducted from the invoiced price of the merchandise shipped. This usually amounts to approximately 10 to 20 per cent, although in special instances the amount may vary or even be waived. This amount usually is higher on losses from customers who are not rated in the first or second credit appraisal category of recognized mercantile agencies or who carry no credit appraisal at all.

In addition to coinsurance, there is a primary loss which is agreed upon between the insurance company and the insured as a percentage of the insured's covered sales, with a definite minimum spelled out in the policy. This primary loss percentage varies with the risk covered, the size of the sales volume, and the insured's actual loss experience. If the applicant's loss experience is less than the national average for that line of business, it generally is recognized that he is a better risk and the amount of his primary loss is reduced. This latter practice is known as merit rating.

A good description of the most common types of policies written is given in the following quotation:

> There are two broad types of policies offered. Either could be used by an average business, depending upon the purpose to be served. One is known as Back Coverage. These guarantee to reimburse the policy holder for losses occurring during the policy term. They pick up the outstanding balances owed by debtors, when the policy starts, and carry them into coverage. The first year policy picks up current accounts only (those not past due when the policy starts). Each renewal policy goes back for a full twelve months and picks up balances owing, whether past due or not. Insolvent accounts must be placed with the insuring company. Past due accounts may or may not be handed to the company for collection—this is an optional privilege.
>
> The other type of policy offered is known as Forward Coverage. It guarantees to reimburse the policy holder for losses occurring on shipments made in a twelve-month period. The policy starts fresh each time. No outstanding balances are picked up at the outset of coverage. When the twelve month Shipment Period has ended, that policy continues in effect until the terms of sale have run their course and an additional time allowed for the payment of the bills. This could be for a period as long as seven months after the Shipment Period. The rule followed is to add three months to the longest terms of sale, in order to fix the end of the Policy Term. This type requires the Compulsory filing of all accounts within the policy term.[7]

The companies writing commercial credit insurance attempt to make the coverage of their policies flexible and as automatic as possible.

[7] J. L. McCauley, *Credit Insurance, A Profit Stabilizer* (Baltimore, Md.: American Credit Indemnity Co. of N.Y., 1958), pp. 13–14.

The Executive Vice-President of the American Credit Indemnity Company of New York has written on this automatic feature as follows:

Coverage is made as automatic as possible. The usual policy has a Table of Ratings and Coverage for the better risks. These ratings are those assigned by a mercantile agency. The agency most frequently used is Dun & Bradstreet, Inc. The rating at date of shipment governs the amount of coverage on a particular account. If the credit lines are too large to apply directly to a rating, then the accounts are named in the policy This Table of Ratings and Coverage includes all accounts rated first and second at date of shipment. These are the ones covered for 90% of the invoiced price.

In addition to the Table, there is almost always an endorsement added, providing coverage on all other accounts. In arriving at the amount of coverage, it is usual procedure to make an analysis of the prospect's needs. An average may be arrived at—such as $2,000 per account. If that be the figure, then "across the board" coverage of $2,000 would be set up. Those accounts not covered by this single limit of coverage are named in the policy for the larger amount. This latter is called "Extraordinary Coverage." The open single limit applying to each account is known as "L Coverage." These are the accounts covered for 80% of the invoiced price.[8]

As previously noted, policies may be written with or without a provision for the insurance company to handle all phases of the collection of past-due accounts. When the policy is written on an optional collection basis, the insured firm may turn over any past-due account for collection, no fees being charged on accounts collected within 15 days. In the policy there is listed an agreed-upon schedule of fees, usually based upon Commercial Law League rates. In those instances involving a compulsory collection arrangement, accounts must be turned over to the insurance company as soon as they are past due for a specified period of time. Policies also may be written with no collection provision. In these cases, the insurance company does not become liable until a debtor becomes insolvent, as defined in the policies and as described in the following quotation:

Insolvency under a credit policy does not necessarily require bankruptcy or legal insolvency. This condition usually includes absconding, death or insanity of a debtor, bulk transfer of stock in trade, general offer of compromise to creditors, appointment of a receiver, taking over of the debtor's business by a committee of creditors, levy on stock under attachment or execution, recording of a chattel mortgage on a debtor's stock and assignment for benefit of creditors, in addition to voluntary or involuntary bankruptcy proceedings and proceedings for relief in a bankruptcy court. In addition, where the policy agrees to handle past due accounts and where the account is filed within the stipulated number of days, such accounts are claims against the policy the day they are filed.[9]

[8] *Ibid.*, pp. 5–6.

[9] *Agent's and Buyer's Guide—1959 Edition* (Cincinnati: National Underwriter Company, 1959), pp 90–91.

In concluding, it should be emphasized that the insurance company should never be considered as a replacement for the credit department and the credit manager of a firm. Commercial credit insurance is not intended to make the credit executive careless in credit acceptance, but its primary purpose is to protect against the unexpected and unpreventable accidental losses which occur at times despite the precautions and safeguards taken by the insuring concern.

REVIEW AND DISCUSSION QUESTIONS

1. What are the advantages of insuring against credit losses?
2. Can the firm with credit insurance accept those credit risks which would be rejected if insurance was not carried?
3. Are collections stimulated by virtue of credit insurance coverage?
4. In what ways are the following considered disadvantages to credit insurance
   a) Premium costs?
   b) False sense of security?
   c) Collection restrictions?
5. Distinguish between "back coverage" and "forward coverage" provided for in the two types of policies offered.
6. "Credit insurance can be regarded as a substitute for the credit department and the credit manager." Discuss.

CHAPTER 31

Implementation of Commercial Credit Management through Collection Policies

THE HISTORY OF the treatment of debtors reveals that in earlier times failure to pay debts was dealt with very severely. Death, slavery, division of the body into proportionate parts, cutting off of the ear, exposure in the pillory, and imprisonment were some of the penalties imposed at various times in the world's history. Gradually the realization arose that injury to the person of the debtor did not secure the desired payment and thus benefited the creditors but little. Also the development of civilization brought about a recoil from the more barbarous practices of the past. Accordingly the desire to deal more sympathetically with distressed debtors began to manifest itself.

As with collection of consumer accounts (see Chapter 16), collections in commercial transactions are an inherent part of any credit operation. It should be recognized that as its ultimate accomplishment any collection system to be successful must get the money. This objective becomes less obvious and much more difficult to attain, when the additional requirements of retention of good will, rehabilitation of the debtor, promptness of payment, and economical operation are added. If promptness is made the major objective, it may be attained by handling all collections immediately. However, the methods selected and used may be very costly and may simultaneously lose good will. On the other hand if retention of good will is made the major objective, the appeals and techniques used will be very gentle, even delicate, and collections will tend to be slow in starting.

Thus, the purpose of a commercial collection system generally is two-fold: maximization of collections and minimization of loss of future trade. Which segment of the purpose is emphasized the greater depends upon the aims and policies of the individual creditor firm concerned.

FACTORS AFFECTING COLLECTION POLICY

In its decision as to what type of collection policy to adopt, a firm should recognize that there are many factors which will have an influence on policy determination. While by no means do the following comprise a complete list, at the same time it generally is recognized that classification of debtors, capital, competition, type of business and type of goods, profit margins, credit policy followed, and type of records used are among the most important and most influential factors. A brief discussion of each of these factors follows.

Classification of Debtors

Collection work would be less involved, time-consuming, and headache-producing if there were some magic formula by which each debtor firm could be immediately and accurately classified as to the reason for nonpayment of its account and as to the collection method or methods which would be most effective in securing payment for the amount past-due. Some firms have developed over the years a classification of debtors somewhat similar to the following:

1. Debtor misunderstood terms.
2. Careless or inefficient customer.
3. Small amount involved and customer therefore ignores.
4. Slow by habit and by nature
5. Poor business management.
6. Temporarily out of funds but good.
7. Could pay but must be forced.
8. Terms chiseler.
9. A fraud [1]

Thus, the creditor may classify a past-due debtor into one or more of these categories and from previous experience with similar customers can have a predetermined collection policy to follow in his efforts to collect the amount due.

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[1] Adapted from. Watrous H. Irons and Douglas H. Bellemore, *Commercial Credit and Collection Practice* (2nd ed.; New York: Ronald Press Co., 1957), pp. 376–80, and Richard P. Ettinger and David E. Golieb, *Credits and Collections* (3rd ed.; New York· Prentice-Hall, Inc, 1949), pp. 233–35.

Debtor Misunderstood Terms. When this is the true situation, the solution is simple. A clarification of what the credit terms exactly are and of what is expected of the debtor should result in prompt payment. The word "should" is chosen because other reasons may be the true causes for nonpayment, and a professed misunderstanding of the terms involved may be merely an excuse. At the same time, however, misunderstandings do occur and care must be taken to handle such cases in a manner that will maintain a maximum amount of good will. Firms have at times discovered that certain salesmen, in an effort to make sales, have assured their customers that they can pay "whenever they wish to pay." This lack of co-ordination between sales and credit can make for customer ill will and requires a reselling job on the customer when the true terms are spelled out for him.

Careless or Inefficient Customer. Again here is the customer from whom collection should not be a major problem. Pressed with the vast variety of other problems and cares, this businessman has just overlooked making payment. This may be caused by an inefficient system of keeping track as to when bills are due or may be the result of the fact that the debtor is just careless or even forgetful. In most cases, a simple reminder that the amount is due and immediately payable will bring in payment with no loss of customer good will.

Small Amount Involved and Customer Therefore Ignores. There is the feeling on the part of some accounts payable personnel—fortunately a small number—that if the indebtedness is a small amount to ignore it for the time being and to wait until the account becomes larger and to write just one check to cover the entire amount. In such cases there is no attempt on the part of the debtor firm to escape payment; it is simply a delaying action and results in "future" payment to the creditor. In addition to the nuisance and trouble involved in having to start the collection procedure, there is always the problem that what is small to one person may not be considered small to another. Thus, often there arises differences of opinion on this point.

Slow by Habit and by Nature. Some firms—and their accounts payable personnel—are notoriously slow in making payment. Collections are attained but only after various types of collection devices have been used and various degrees of persuasion have been applied. The firm that sells this type of customer and knows beforehand that the customer is this type should carefully analyze the gross margin on any sale and compare it with the expenses involved in making the sale. Such expenses tend to be high because of the cost of having to invoke certain steps in the collection process used. Even at the risk of losing a customer, the

executive to whom the collection task is assigned should adopt a strict policy toward the firm that is slow by habit and by nature. Such firms have a poor conception of what responsibility actually is, and generally are undesirable and unprofitable accounts.

Poor Business Management. Firms falling into this category perhaps account for the largest number of difficulties for the collection manager. Often the operators of these concerns are honest and optimistic but overbuy. Because of poor business management they find that they are not in a position to meet the terms to which they agreed. Whether to follow a strict or a lenient collection policy will be determined largely by the creditor's decision as to whether there is any hope that this poor business manager will ever learn to conduct his activities in a profitable manner. Thus, can he be salvaged and made into a good customer? If the answer is "no," the relationship should be short and terminated quickly.

Temporarily Out of Funds but Good. This type of customer is aptly described in the following quotation:

> The best solution to the type of collection problem posed by this debtor is an amicable adjustment or extension of the credit period. The cause of the delinquency usually is beyond the debtor's control. It may be due to illness, temporary or seasonal unemployment in the area, local business conditions, or any one of many other developments. But, in any event, there should be no reflection on the debtor's integrity, inasmuch as his delinquency is not an attempt to avoid payment. However, this fact should not deter the collection department from taking action promptly for the debtor must not be allowed to feel that his obligation can be neglected, otherwise the wheel (a creditor) that squeaks the loudest may get the oil. The lax creditors will get paid last. Above all, the seller should investigate and satisfy himself that the buyer is giving him honest reasons and not just trumped-up excuses. Furthermore, after arrangements have been made which are mutually satisfactory, the creditor should insist that the debtor carry out the terms of the agreement to the limit of his ability. Finally, this may be a case of the debtor being actually short of working capital. In this instance, the seller should help the customer to understand this condition and tactfully advise him in ways of improving his working capital position.[2]

Could Pay but Must Be Forced. This type of customer is somewhat similar to the "slow by habit and by nature." However, in dealing with this group more persuasion and even threats must be used to obtain payment. It is here that certain debtors are classified as being the type who must be "forced" to pay their debts. Most of the time unless they are pursued vigorously, payment is unduly delayed or may never take place. Credit standing means very little to this type of customer

[2] Irons and Bellemore, *op. cit.*, p. 378.

who has become accustomed to severe collection methods. For this reason, the collection department in its dealings with these chronic delinquents should force the issue immediately and strongly, at the very moment when the account becomes past-due. Less severe actions will prove of little value, with no return for the expense involved.

Terms Chiseler. There are at least two types of chiselers who might be included in this classification. One is the type who regularly deducts cash discounts even though payment is made after expiration of the cash discount period. Firms vary as to their policies in such a situation. The question is raised whether it is best to return the check and request full payment or whether to accept the check and bill the customer for the balance owing. Whichever procedure is followed, the action taken should be accompanied by a clear, concise statement that credit terms are being violated. How strong and threatening the statement should be will depend largely upon how profitable the customer is to the debtor firm and how much his future business is desired.

Another problem facing collection personnel is the customer who makes only a partial payment, sends a postdated check with deductions for cash discounts, or who dates the check back in order that the date is within the discount period. The chronic offender who operates in this manner should be told "the facts of credit" much more emphatically than the first-time offender who may have been simply careless.

A Fraud. This dishonest debtor should not be shown any consideration, nor should any concerted effort be made to retain his good will or possible future business. Just as soon as the creditor firm is convinced that the debtor is dishonest and is engaged in fraudulent actions, the account should be turned over to an attorney or possibly to a collection agency, with instructions to take legal action against the debtor. Time is of the essence in dealing with such offenders, and there is little reason to go through all the steps normally followed in a collection process.

Capital

The discussion that appeared under this topic in Chapter 16 applies equally well to commercial credit transactions and is repeated here. One of the most important factors is the amount of capital owned or available to the firm involved. Regardless of how liberal a collection policy a creditor may wish to follow, if he is operating within a limited capital structure, he is forced in most instances to adopt a "strict" collection policy in order to keep himself in a position to meet the demands of his own creditors. Most business firms are not blessed with an overabundance of work-

ing capital and are forced to depend upon the turnover of their goods to provide the funds needed. But a mere turnover of goods is not enough, if these goods are sold on credit as they usually are in commercial transactions. One step is added to the process and that is completion of the credit transaction by receipt of cash payment. How quickly this last step must be completed is predicated upon how badly the firm is in need of capital. Thus capital availability and need play a vital role in determining just what type of collection policy a firm must adopt, despite the fact that a somewhat different policy might be more feasible in view of some of the other factors involved.

Competition

The business firm of today does not function in a vacuum, nor in the pure air of "no-competition." Rather, the firm attempting to sell its goods and services finds that the actions taken by its competitors are highly influential upon the policies it establishes. And one of the policies influenced is the collection policy. Thus if an active competitor is "selling" its lenient credit and collection policy, a firm cannot simply ignore this policy and indiscriminately follow a very strict credit and collection policy of its own. That is, the firm cannot do this if it wishes to obtain its share of the business. Thus in the decision as to the type of collection policy to establish and to follow, serious consideration must be given to competition as an important factor in policy determination.

Type of Business and Type of Goods

Collection methods and practices tend to vary with the type of business and method of operation of the selling firm and with the type of goods sold. As in consumer credit, it is obvious that the greater the perishability of the product, the greater the need for prompt payment of the account, and thus the stricter the collection policy to be followed.

Profit Margin

With any established collection policy, the ultimate aim of the creditor firm is to collect the amount due and still have a net profit left after all the expenses are deducted from the gross margin. Thus how wide this gross margin is has an important influence upon the collection policy followed. A good discussion of the importance of the profit margin in collection policy determination is found in Beckman and Bartels' *Credits and Collections in Theory and Practice:*

> The profitableness of the line of business in which a creditor is engaged, is another consideration in planning a collection system. In general, the wider the

margin of profit on which a vendor operates, the more lenient may be his collection policy and the less urgent his collection efforts. A vendor operating on narrow margins cannot allow delinquencies to continue for very long or engage in prolonged and costly collection activities. Both the risk and cost involved in diverse collection systems must be related to the profit margin on which the creditor operates, and care must be taken that amounts collected are not exceeded by the cost of collection.

A creditor must consider also the profitableness of a particular debtor's business to him, as well as his general margin of profit, in planning a collection system. Some portions of a vendor's business are more profitable than others. Some lines, for example, are handled on lower than average margins; some customers order small quantities frequently whereas others place large orders at longer intervals; some sales are made only with high selling cost; some deliveries are more costly than others because of distances involved; some customers are also more bothersome than others, increasing a vendor's costs through numerous returns, complaints, and service demands. A collection system, therefore, in being well adapted to the situation in which it must operate, is based upon adequate consideration of these factors.[3]

Credit Policy Followed

The credit policy that has been established and that is followed by a firm has an important influence upon the type of collection policy that is adopted. The chances are that the firm following a liberal credit approach will have a strict collection policy; one with a strict credit approach, a liberal collection procedure. To be liberal in both phases is an invitation to trouble; to be strict in both is to neglect the "increasing sales" aspect of credit activities. It should be recognized by the creditor firm that as long as its customers regard credit solely as a service rather than a mutual privilege, then its collection problems may be troublesome. When the customer begins to think of credit primarily as a joint business transaction, the collection problems of the creditor tend to become simpler; sentimentality lessens; the creditor is not as reluctant to insist upon payment for fear of incurring the ill will of his customers. Terms once established between debtor and creditor must be respected. Slow-paying customers not only cost additional money for collection efforts, but they also often become reluctant to return to the scene of their buying activities until their previous indebtedness is cleared.

Types of Records

While it is not possible to set up a record system that will fit all businesses, at the same time it is important to recognize that the type of

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[3] T. N Beckman and R. Bartels, *Credits and Collections in Theory and Practice* (6th ed.; New York: McGraw-Hill Book Co., Inc., 1955), p. 422.

record keeping that is in use will have a direct effect upon the collection system introduced and the efficiency with which it is operated. Each business concern should carefully study its own requirements and in turn adopt a system that will meet its own needs. It is recommended that the credit and collection manager carefully consider the numerous systems and equipment offered by the office-equipment supply houses. These systems and equipment are being revised, modified, and improved constantly, with the aim of providing faster availability of information on which to take the necessary actions to effect collections. But before any decision is made as to the system to introduce and to use, the credit and collection manager should remind himself that the system that *meets the needs* of his business at the *lowest relative cost* is the system for him to adopt.

One of the essential features of an effective collection procedure is the promptness with which the first "reminder" notice is furnished. If this is not received by the debtor until an extended length of time after the due date has passed, the tendency is for the debtor to feel that he is dealing with an inefficient and indifferent creditor. As a result, collections may drop accordingly. Thus the system used should provide information daily on those accounts which are overdue. And this means every account that is overdue!

The number of accounts involved will be a determining factor in the type of follow-up system to be used. Among the systems in use for watching accounts, the following are in general use and are described briefly in the subsequent sections: (1) the customer's ledger sheet or card; (2) maturity lists; (3) the collection tickler system; and (4) the duplicate invoice system.[4]

Customer's Ledger Sheet or Card.[5] The basic information source as to the condition of any account receivable is the ledger sheet or card of the customer. The problem then arises as to best way for the credit manager to discover those accounts that are not paying on time and to locate this information as quickly and as cheaply as possible. For the small concern with relatively few accounts, the problem is not a serious one as the credit manager generally is in such close association with the ledger cards that he himself will inspect the ledgers at regular intervals,

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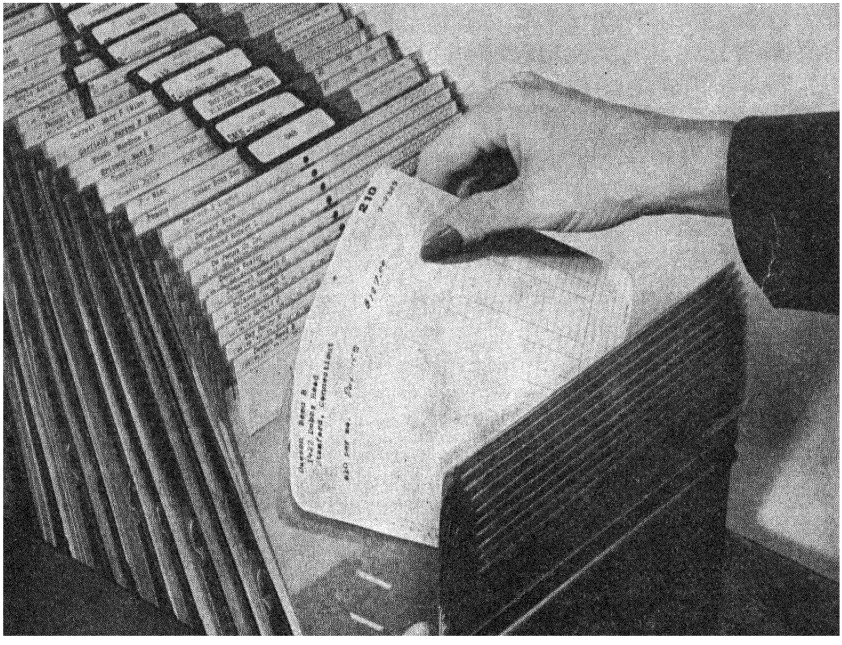
[4] For a more detailed discussion of these four systems, the reader is referred to Albert F. Chapin, *Credit and Collection Principles and Practices* (6th ed.; New York: McGraw-Hill Book Co., Inc., 1953), pp. 421–26.

[5] These ledger cards may be held in some sort of visible index panel or may be of the punched-card variety in which knotched holes in the margins of the card aid in sorting out the past-due accounts. Examples of the Remington Rand "Kolect-a-Matic" system and of the McBee "Keysort" ledger cards are shown in Figures 31–1 and 31–2.

will in turn note any delinquencies, and will take the necessary action to commence the collection procedure.

Unfortunately, this simplicity of action with no duplication of work or records is limited to the very small business concern. As the firm increases in size, so does the number of ledger sheets or cards. The resultant situation is one in which the credit and collection manager may

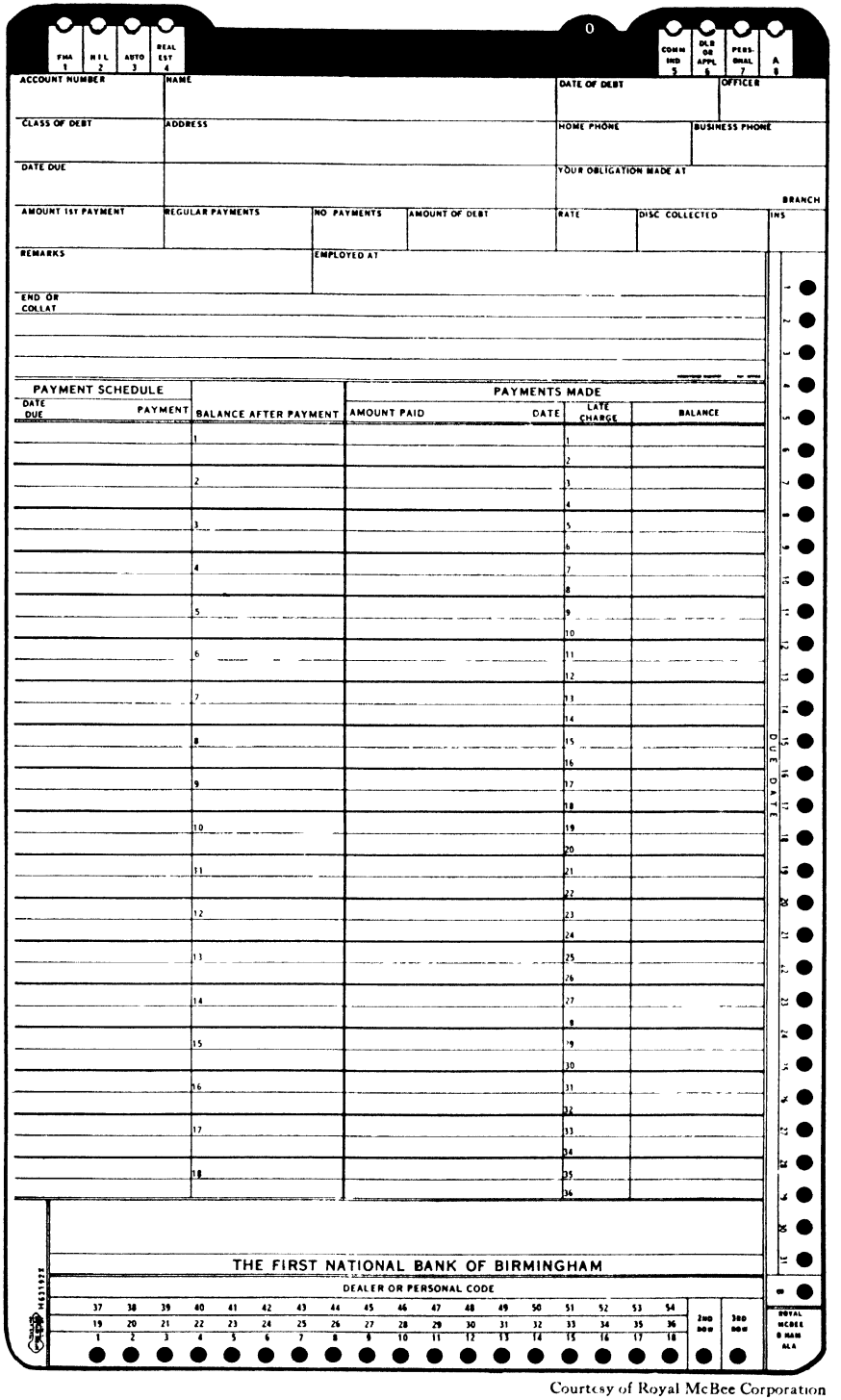
FIG. 31–1 Remington Rand "Kolect-a-Matic" system.



find that his check of the ledgers has become irregular and unfortunately haphazard. Collection procedures are not started with the regularity they formerly did when the concern was smaller. The use of the ledgers may become an involved question of timing between the bookkeeping department and the credit and collection department. The activities of the credit and collection manager may become so involved that he does not feel that his time is best spent seeking out the few nonpayers from the hundreds of on-time payers. Obviously, some other action becomes necessary if collections are to be carried out on an efficient basis.

Maturity Lists. "Under this plan the ledger clerks at stated intervals list under their maturity dates the accounts which will mature between the present and the next listing date. Remittances as they are

FIG. 31–2. Royal McBee Keysort file card.



Courtesy of Royal McBee Corporation

received are checked against the record and daily lists of delinquencies referred to the credit department."[6]

This type of procedure is thus one calculated to enable the person charged with collections in a firm with a fairly large number of credit accounts to keep track of the delinquencies. The detailed work of the procedure is removed from the actual activities of the credit and collection manager. Duplication of work and records is necessary, however, in this procedure.

Collection Tickler System. Another system designed to take some of the detail work off the credit department is the so-called collection tickler. In this system the accounting department generally is charged with the task of setting up a file of individual cards which usually contain the name and address of the delinquent firm plus any other pertinent facts including a description of the collection action thus far taken. Using 31 divisions, the accounting clerk then files the cards under the date that the department desires to take the next collection action. Such a procedure leaves nothing to chance, and as long as the ledger clerks competently perform their filing tasks and as long as no past-due accounts are overlooked or lost, all overdue accounts receivable turn up automatically for the next desired collection action and are handled systematically in accordance with the predetermined procedure.

Duplicate Invoice System. "This method combines some of the features of the card tickler and the maturity list. It is like the former except the invoice is substituted for the card, and like the latter in that it provides a file record of all accounts becoming due from day to day."[7] It should be noted that in this method duplication of records—in this instance, duplication of invoices—is necessary. This technique of follow-up must be carefully watched in those instances in which customers are making frequent purchases. With invoices coming due on a series of dates, the person charged with the responsibility of collections would not want to take the same action on each date but undoubtedly would delay the action until all of the invoices clustered around one date had matured and would then institute one collection effort.

PRELIMINARY STEPS IN ESTABLISHING A COMMERCIAL COLLECTION SYSTEM

The reader is referred to the discussion on "A General Collection System" which appears in Chapter 16. While the material in that

[6] *Ibid.*, p. 425.

[7] *Ibid.*

chapter is slanted toward collection problems and procedures in consumer credit transactions, many of the comments have applicability to commercial credit procedures and practices. At the risk of being repetitive, the following comments are taken from that chapter.

Promptness and regularity of payment must be built into any system because of the following conditions:

1. A lax collection policy often indicates an incompetent management. This in turn can reflect upon the purchaser's attitude toward the products sold by the firm.
2. Experience has shown that there is a definite correlation between the length of time debts are unpaid and the volume of resulting bad-debt losses.
3. Slow collections tend to result in the loss of future sales to these customers because of their reluctance to attempt to buy from creditors whom they have owed for some period of time. Of course, these creditors may show even a stronger reluctance to sell such customers.
4. Failure to enforce the collection activity tends to aid the imprudent purchaser. Thus, the foolhardy buyer may plunge headlong into unwise buying, knowing that the collection system of the selling firm will permit him an excessively long time before drastic legal action is taken, if it is ever taken at all.[8]

In order to bring about promptness and regularity of payment, the following preliminary steps in establishing a sound commercial collection system are suggested:

1. Determination of the length of time for the collection process to run.
2. Selection of appropriate types of collection devices or actions to use.
3. Decision as to the number of actions to be taken.
4. Arrangement of the actions in logical sequence.
5. Schedule of the actions at appropriate intervals.

In the preliminary planning of the collection procedure to follow, the person charged with the responsibility of collecting accounts receivable will have to decide just how long the entire collection process should run. Such a decision generally is controlled by circumstances other than the desires of the collection manager. For example, all the factors (debtor classification, capital, competition, type of business, type of goods sold, profit margin, credit policy, and type of records) previously discussed will have an important bearing upon how long any collection process is to be allowed to run.

Equally important—or possibly even more important—is the selection of the appropriate types of collection devices or actions to take. In the following chapter (Chapter 32) these actions are separated into

[8] End of Chapter 16 comments (pp. 327–28).

three categories and are discussed in some detail. The three categories are: (1) actions between a single creditor and a single debtor; (2) actions between a group of creditors and a single debtor; and (3) third-party actions between creditor(s) and debtor. The first grouping includes such actions as invoices, statements, reminders, telephone calls, telegrams, personal calls, personal letters, notes, drafts, trade acceptances, attorneys, collection agencies, replevin, extensions, and collection by suit. The second grouping includes extension agreements, composition settlements, assignment, bankruptcy, and arrangements. And the third grouping is involved primarily with the Adjustment Bureaus of the National Association of Credit Management.

The third step in establishing a sound commercial credit system involves the decision as to the number of these actions to be taken. In other words, after the decision is made to use collection letters, for example, just how many of these letters will be included in any collection procedure? Undoubtedly, the more lenient the policy, the larger the number of such actions that will be included.

Step four involves the arrangement of these actions in some logical sequence. Since collection efforts have the twofold objective of obtaining the money and of retaining the good will, most collection managers bear in mind that generally a successful collection system will use the milder methods first, to be followed by the more intense actions arranged in order of their severity. Exceptions to this arrangement are to be found in those instances in which the debtor was a marginal risk to begin with and the collection manager knows that the milder methods would be a waste of time and money on such firms.

The last step is the determination of the frequency with which the collection actions are to be used, or the interval of time that should be allowed between each action taken. A lenient collection policy calls not only for a relatively large number of collection actions but also a comparatively long lapse of time between the different measures. In all instances, however, the time interval should become shorter as the stage of delinquency advances.

REVIEW AND DISCUSSION QUESTIONS

1. What are the major objectives of the collection policies adopted by a credit manager?
2. List six of the nine major classifications of debtors, and discuss why each is so classified.
3. Which of those listed in question 2 account for a major proportion of slow accounts?

4. Does the credit manager have opportunities to advise and hence aid a debtor in overcoming a relatively bad collection situation? If so, under what circumstances and by what procedures?
5. How does the amount of the capital influence his collection policy? What is likely to happen if the creditor consistently fails to guard the investment he has in accounts receivables?
6. How do the type of business and the type of goods sold influence credit and collection policies and practices?
7. What factors should the credit manager consider in selecting a record-keeping system for the credit and collection departments? What should these systems provide in the way of "watching" devices?
8. What is a collection tickler system? How does it operate?
9. What are the usual repercussions of a lax and ineffective collection policy?

CHAPTER 32

Implementation of Commercial Credit Management through Collection Practices

ONE OF THE preliminary steps in establishing an effective commercial collection system is to select the most appropriate types of collection devices and actions that will maximize collections and yet minimize loss of trade. While the actual choice of the particular action or actions to take in the collection of any commercial account is largely a matter of judgment and experience, it is vital that the person charged with the responsibility of collections have an understanding of the benefits and the pitfalls of each of the collection devices at his disposal. In some of the more complicated and legally involved techniques, the assistance of a capable attorney specializing in this area will be well worth the money expended for his services. Some companies do, however, encourage their credit managers to study law and hence become proficient in the legal phases of collections.

No attempt has been made in this chapter, or for that matter in the entire book, to cover in detail all the legal ramifications and technicalities that are connected with some of the more involved collection devices. In actual operation, the collection manager must be familiar with the fact that such actions are available, but he undoubtedly will rely heavily upon the legal knowledge of the company attorney or one consulted for this purpose. It is with this idea in mind that the most common collection devices available to the commercial credit and collection manager are discussed in the following sections.

DEVICES AVAILABLE

As shown earlier, collection actions may be divided into three categories: (1) actions between a single creditor and a single debtor; (2) actions between a group of creditors and a single debtor; and (3) third-party action between a creditor or a group of creditors and a debtor. Generally the action between a single creditor and a single debtor occurs before any effort is made to use either one of the other two types. Whether group action or third-party action occurs next in the order of sequence, because single-party action has not been successful, is dependent upon the circumstances surrounding the particular debtor-firm account.

Single Creditor and Single Debtor

The actions taken between a single creditor and a single debtor are practically the same whether collection procedures are being discussed from the point of view of consumer credit or that of commercial credit. These devices which generally are well known to both debtor and creditor include the following:

Invoices
Statements
Reminders
Telephone calls
Telegrams
Personal calls
Personal letters
Notes, drafts, and trade acceptances
Assignment of accounts receivable
Attorneys
Collection agencies (part of the debtor company and separate organizations)
Replevin (repossession of merchandise)
Extension agreement
Suit

For a discussion of these devices,[1] the reader is referred to Chapter 16. Mention should be made at this point, however, that the use of notes, drafts, and trade acceptances is common only in commercial credit transactions.

In those instances in which the debtor firm does not meet its obligations on its indebtedness, the creditor may ask that a promissory note be

[1] While the discussion of these devices in Chapter 16 is slanted toward consumer credit, the basic description of such actions applies equally well to commercial credit transactions.

signed. This usually takes place only after a predetermined extension has been worked out and a definite date of repayment can be shown on the note. In addition to the stated repayment date, an interest charge may be agreed upon by the parties concerned.

In other instances, a sight draft may be used. Although the sight draft has declined in popularity in recent years, its most common use today is in connection with C.O.D. shipments. In brief, the creditor prepares the draft which in effect requests the customer's bank to seek payment of the account. Perhaps moral pressure is the greatest asset of the draft, in that the debtor desires to maintain good working relations with his bank and to have his banker think highly of his awareness of credit responsibility.

The trade acceptance, likewise, is drawn up in connection with the shipment of goods from seller to buyer. The manufacturer prepares the trade acceptance at the time of shipment. Upon receiving the form, the customer indicates his "acceptance" of the indebtedness by signing and dating the agreement and designates the bank at which he will make payment on the noted date. The manufacturer may hold the acceptance until the time of collection and then send it to the bank as a collection item or he may choose to discount the acceptance with his bank prior to the payment date.

Another action often taken by a single creditor is to assign the early stages of the collection procedure to salesmen. Just as they are frequently used to do a nominal amount of investigative work on their customers, they also are called upon to effect collections. Salesmen who call on smaller companies are in a good position to take collection action. It is in the smaller companies that we find relatively simple organizational structures and easy access to the responsible parties. In fact, the salesman can often discuss the collection problem with the proprietor or partner himself. Furthermore, their closeness to the actual business scene and their observations and reasoning as to why a customer is delinquent may be particularly helpful to the collection department in plotting future actions. Past-due and seriously delinquent accounts obviously result in a rejection of future orders written by salesmen; hence their concern for promptness as well as effectiveness in the collection procedures is vital to their welfare.

Also worthy of note, is the fact that the commercial credit managers play an active part in the commercial collection procedures. This is in direct contrast to the part played by consumer credit managers. The dollar amounts involved are often large, the opportunities to rehabilitate a customer are sometimes present, and the fact that commercial credit

managers deal with relatively few accounts explain the reason for their activity in collections.

Group of Creditors and Single Debtor

The most common types of action taken by a group of creditors against a single debtor are:

Extension agreement[2]
Composition settlement
Assignment
Bankruptcy
Arrangements—Chapter XI of Bankruptcy Act

Extension Agreement. An extension agreement is essentially a moratorium, under which the debtor proposes to pay his creditors in full at some future date. This agreement is binding only upon those creditors who sign it, and no creditor is compelled to do so. For this reason, if the larger creditors desire to grant an extension to a debtor but some of the smaller creditors are not in agreement, these smaller creditors sometimes are paid in full by the other creditors to prevent their filing of involuntary bankruptcy proceedings.

Before an extension is granted, however, credit managers have learned to be careful in estimating the extent of the debtor's difficulties. This situation is emphasized in the following quotation:

> . . . A debtor may be *solvent* but *not liquid* (unable to pay his debts as they mature), or he may be *insolvent* (his liabilities exceeding his assets). From experience, credit men learn to distinguish between a business which can be salvaged and rehabilitated financially and one in which liquidation for the benefit of creditors, in or out of bankruptcy, is necessary. They also learn to recognize the dishonest debtor, who, although he could be rehabilitated, should instead be liquidated and punished by denial of discharge from his obligations, or even by prosecution. If possible, the dishonest debtor should be prevented from re-establishing a business and repeating the same offenses.[3]

Composition Settlement. This settlement, either with or without an extension of time, is a contractual arrangement under which the creditors signing the agreement offer to accept less than the full amount of their indebtedness and in turn agree to discharge the debtor of any future obligation to make full settlement of the claims.

Again, care should be taken to grant such settlements only to the

[2] It will be noted that an extension agreement may be a single-creditor action or a group-creditor action.

[3] *Credit Management Handbook.* A publication of the National Association of Credit Men (Homewood, Ill.: Richard D. Irwin, Inc., 1958), p. 328.

debtor whose financial position, although serious, is such that he probably could operate profitably in the future if relieved of his excessive debt burden in the present. Also, evidence of fraud should be sufficient to cause any composition settlement to be set aside and the offender to be prosecuted to the limit.

Assignment.[4] When an extension is not warranted and a composition settlement cannot be agreed upon, then "friendly" liquidation of the concern and settlement of the indebtedness may come about through assignment proceedings.

Assignment for the benefit of creditors is generally considered a voluntary, out-of-court action taken by a debtor who usually is insolvent (liabilities exceeding assets). The debtor transfers in trust some or all of his assets to a third party, an assignee, in order that these assets or proceeds from their sale may be applied to payment of his debts. Such an assignment may be made either under common law or under state law, as every state has some form of law that spells out the provisions for an assignment.

At first glance it may appear that assignment prevents all the ills of bankruptcy (described in the subsequent section). Advocates of this method point out that it is fast, relatively inexpensive, free from court restraints, private, and provides more money for distribution to the creditors. On the other hand, critics of the plan point out that assignment constitutes an act of bankruptcy, that the debtor cannot be examined under oath, that recovery of preferential payments is not provided for, that the debtor is not freed of his remaining indebtedness without the consent of the creditors, that there is a lack of uniformity in state laws concerning the procedure,[5] and that there is little or no direct supervision over the assignee in estate administration.

Bankruptcy. The creditor has several duties and responsibilities relative to the action which he must take in connection with bankruptcy cases. The credit man handling bankruptcy matters should be familiar enough with the law to know the rights of his firm and to take the proper steps to protect these rights.

His most important responsibility arises out of the fact that he often has it within his power to decide whether or not to place a debtor in bankruptcy or to attempt other means of working out of a bad situation. For creditors to hasten to place every difficult collection into bankruptcy means the overburdening of the bankruptcy courts with unnecessary

[4] Assignment as used here is entirely different than assignment of accounts receivable.

[5] This constitutes a problem when there are creditors in several states involved with the delinquent debtor.

cases and the liquidation through bankruptcy of many cases which could more economically and advantageously be liquidated by other means. He then should consider carefully whether or not all other possible means of collecting the debt have been canvassed before consenting to being a party to a petition in bankruptcy.

Another consideration is the attitude of the debtor. If the debtor is attempting to give preference to certain favored creditors or if he is dissipating the estate by conveyances, transferances, or concealment of property with the intent to hinder, delay, or defraud creditors, there is no choice but to put the estate into bankruptcy so as to protect all creditors and to secure a fair and equitable distribution of the assets. If, however, the debtor is trying to be fair and is doing everything possible to assist in the protection of the interests of the creditors, there is every reason for the intelligent creditor to help the debtor avoid the stigma of bankruptcy and to find some better way to work out his difficulties.

When these efforts fail or appear inexpedient, bankruptcy is the only alternative.

Bankruptcy Legislation in the United States. The Constitution of the United States provides in Aricle I, Section 8, that: "The Congress shall have power . . . to establish . . . uniform laws on the subject of bankruptcies throughout the United States."

The grant of this power to the federal government was not subject to much discussion either in the Constitutional Convention or in the various ratifying conventions. The power was not immediately exercised by Congress, and the first United States Bankruptcy Act was not passed until 1800. This act was repealed in 1803. A second passed in 1841 was repealed in 1843. A third passed in 1867 lasted until 1878. The present act was passed in 1898 and has continued in force until the present time. While amendments to the Act have been numerous, it was in 1938 that the most thorough revision was made. In fact, the law today often is referred to as the Bankruptcy Act of 1938, or as the Chandler Act.

General Purposes of Bankruptcy Legislation. The general purposes of legislation dealing with the relationship of debtors to their creditors have been threefold.

The first and earliest purpose was to provide the creditors with some means whereby they might legally possess themselves of the property of the debtor and equitably distribute it among the claimants. In addition to possession of the property of the debtor, creditors frequently were given control of the person of the debtor to assist further the enforcement of payment from a recalcitrant or unwilling debtor. Some of the

more severe penalties of the early legislation on debts had as their underlying motive the belief that severity in treatment of the debtor would stir his relatives to renewed efforts to satisfy the debts or perhaps would dissuade the debtor from attempts to defraud his creditors.

Later, creditors realized that control of the person of the debtor served no useful purpose. Therefore, the later acts of bankruptcy have attempted to provide merely for an equitable distribution of the property of the debtor among the various creditors and control of the person of the debtor has been relinquished. Provisions for the distribution of property were found necessary to avoid the inequitable division of the debtor's estate which might result from permitting the debtor to continue his full right to pay whomever he chooses after he becomes insolvent. In other words, it prevented the debtor from making preferential payments. It also was necessary to prevent the estate from being apportioned exclusively to the more diligent creditors. To appreciate this necessity, it is only necessary to remember that the condition of insolvency means that the debtor's equity in the estate is entirely extinguished. Under these conditions the entire estate should be used to satisfy the claims of creditors and thus may be said to belong to the creditors rather than to the debtor. Bankruptcy legislation provides a means whereby this property may be prorated among the creditors equitably and economically.

The second purpose was the relief of the debtor from further demands after his confession of inability to satisfy claims against him. The development of more humane notions of the relations of man to man have resulted in fuller realization of the folly of continuing to oppress the debtor by requiring him to continue the struggle to pay debts which are beyond his capacity. It is but common humanity to permit him to be freed from an impossible burden and not be made continually to pay the penalty for past mistakes. This relief from the legal necessity of paying debts is secured by the surrender of the entire estate. This does not necessarily relieve the debtor from the moral obligation, for he may still feel himself morally compelled to repay the unsatisfied debts when he has recovered his fortune. The protection of the law, however, relieves him from the necessity of paying debts which are beyond his capacity.

The third purpose recognized that society has an interest in the rehabilitation of the debtor. As long as he is oppressed by the results of past mistakes, the debtor is lost to society as a useful active producer. Every effort he makes to rehabilitate himself may be defeated by the pressure of creditors, and he is forced to become a drone or burden upon

society. Furthermore, the fear of the consequences of debt would inhibit the ambitious man and stifle his initiative. Thus economic development would be slower. Therefore, it is to the interest of society to permit the debtor to recover and to provide an equitable process of so doing. This must not be permitted to go to the other extreme of unduly favoring debtors. When relief from debts is too easy and readily available, the fear of loss inhibits creditors from lending and also slows down social and economic development.[6] Thus the social good requires that legislative control should be exercised in such a manner as to provide full and equitable protection of the rights of creditors and also relief of debtors from impossible burdens, but such control should not make it possible for fraudulent debtors to shield themselves from the consequences of their acts.

In general the bankruptcy legislation in the United States has attempted to strike a balance between the interests of debtors and creditors, while maintaining the social interest at a maximum. At times various changes designed to favor one group or the other have been embodied in amendments proposed to Congress. Associations of creditors have frequently agitated for "reforms" which would afford them more protection or prevent certain "abuses," while associations of debtors have sought "reforms" which would provide them with more certain or readily available "relief." Debtors' agitation has been most vehement and most successful during times of depression and has been responsible for many of the acts and amendments passed at these times.

What Is Bankruptcy? A dictionary definition of bankruptcy is: "Bankruptcy—state of being bankrupt; insolvency. Bankrupt—one who cannot pay his debts. Insolvent—to break in trade; to render insolvent."

This differs from the legal definition. According to the legal definition, in addition to the condition of insolvency there must also be some legal and public recognition of the condition coupled with some specific act or acts on the part of the debtor or creditor or both. Nor can every firm avail itself of the provisions of the bankruptcy act and become legally bankrupt.

Kinds of Bankruptcy. Bankruptcy may be either voluntary or involuntary. As the names imply, voluntary bankruptcy comes about through the conscious desire and initiative of the debtor. Involuntary bankruptcy is brought about through the conscious desire and initiative of the creditor(s).

[6] Evidence of this may be found in the failure of credit to function in certain "backward" countries whose legislation unduly favors debtors.

What Firms May Become Bankrupt? Perhaps the easiest way to answer this question is to list those types or classes of firms that may not voluntarily petition themselves into bankruptcy or may not be forced into it. These are: municipalities, railroads, insurance companies, banking corporations, and building and loan associations.

The Acts of Bankruptcy. The law sets forth six acts, one of which must have been committed within four months of the filing of the petition. These acts, as set forth in Chapter III, Section 3, are:

1. Concealed, removed, or permitted to be concealed or removed any part of his property, with intent to hinder, delay, or defraud his creditors or any of them, or made or suffered a transfer of any of his property, fraudulent under the provisions of section 67 or 70 of this Act (which deal with Liens and Fraudulent Transfers and Title to Property, respectively); or
2. Made or suffered a preferential transfer, as defined in subdivision (a) of section 60 of this Act (which deals with Preferred Creditors); or
3. Suffered or permitted, while insolvent, any creditor to obtain a lien upon any of his property through legal proceedings or distraint and not having vacated or discharged such lien within 30 days from the date thereof or at least 5 days before the date set for any sale or other disposition of such property; or
4. Made a general assignment for the benefit of his creditors; or
5. While insolvent or unable to pay his debts as they mature, procured, permitted, or suffered voluntarily or involuntarily the appointment of a receiver or trustee to take charge of his property; or
6. Admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt.

Regular Bankruptcy Procedure. It should be recognized that bankruptcy proceedings may take many forms and may become exceedingly complicated and legalistic in nature. However, for the purposes of this text, a brief description of only the so-called regular or ordinary bankruptcy procedure will be given. For the more complicated procedures, the guidance of a qualified bankruptcy lawyer is a must. The steps generally taken in the ordinary bankruptcy procedure then are as follows:

1. The bankruptcy petition is filed with the Federal District Court for the district in which the alleged bankrupt is located. It will be noted that bankruptcy is a federal action.

2. A receiver is appointed to preserve the insolvent estate. The office of receiver is a temporary office which is used only when it is necessary to have someone appointed to take charge of the debtor's property until the election of a tustee. He is appointed only when it is necessary for someone to be in charge to prevent waste or loss during this intervening period. He is supposed, so far as possible, to conserve the property and not to convert it into money. Selling property will take place only when

it may be necessary to prevent waste or loss. A receiver is appointed when the creditors request such an action.

3. If proceedings are contested, a jury trial will be held and the debtor will be examined under oath; the court will decide whether the firm is to be adjudged a bankrupt; and if so, the case will be referred to a referee in bankruptcy for legal administration of the case. The referee thus becomes the representative of the court in all subsequent actions. The duties of the debtor are numerous. For example, he is required to comply with all lawful orders of the court, to examine the correctness of proofs of claims filed against his estate, to execute and deliver such papers as ordered by the court, to prepare and file a schedule of his property and a list of his creditors, and to submit to an examination relative to the conduct of the business and the cause of his bankruptcy.

4. The referee then notifies the creditors of the adjudication.

5. The creditors then are asked to file proof of their claims.

6. The first meeting of the creditors is held, at which time the election of the trustee occurs; the bankrupt is examined; and allowance of claims occurs. The trustee, who represents the creditors and who replaces the receiver, henceforth administers the estate and keeps a record of all his activities and makes reports to the referee who is representing the court.

7. The trustee, acting in accordance with the instructions and subject to the review of the court, proceeds to convert the estate into money. He takes the same legal position as was formerly occupied by the bankrupt and has the same rights to sue upon the debts due the estate and can dispose of the assets owned by the estate.

8. From the proceeds of the estate, disbursements (called dividends) are made to the creditors in accordance with the provisions of the act; a final accounting is filed by the trustee with the referee. It is the duty of the trustee to attempt to void any preferences which are voidable and to recover the property for the benefit of the creditors. The order of payment and the priority given certain debts are as follows:

a) Actual and necessary costs of preserving the estate subsequent to filing the petition.
b) Filing fees paid by creditors in involuntary cases and reasonable expenses of recovering transferred and concealed property.
c) Costs of administration.
d) Wages (due employees) earned within three months of the commencement of proceedings, not to exceed $600 to each claimant.
e) Reasonable expenses incurred by creditors in opposing the confirmation of an arrangement.
f) All taxes legally due.

g) Debts owed to any person who by the laws of the states or the United States is entitled to priority. Since the trustee's title is only the title previously held by the bankrupt, any valid lien against the property continues and must be paid before the trustee can dispose of the property free of encumbrances. Should a sale of the property fail to pay the entire debt, the secured creditor then becomes a general creditor for the amount of the deficit.

h) Unsecured general creditors.

9. The final meeting of the creditors then is held; the final report is submitted to the court; and the bankrupt is granted his discharge of the indebtedness remaining. It must be recognized, however, that certain debts are not discharged by bankruptcy action. Debts which are not affected by a discharge are as follows: (*a*) taxes levied by the United States, any state, county, district, or municipality; (*b*) liabilities for obtaining property by false pretenses, or for malicious injuries to the person or property of another, or for alimony due or to become due, or for maintenance or support of wife or child, or for seduction of an unmarried female, or for breach of promise of marriage accompanied by seduction, or for criminal conversation; (*c*) claims not scheduled in time for proof and allowance unless the creditor had notice or actual knowledge of the proceedings; (*d*) debts created by a bankrupt's fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity; (*e*) wages earned within three months of commencement of proceedings; (*f*) moneys of an employee received or retained by employer to secure faithful performance of the terms of a contract of employment; and (*g*) all debts incurred after the petition has been filed.

Responsibilities of Credit Managers. When becoming a party to an involuntary petition or when receiving notice of the filing of either a voluntary or an involuntary petition, the credit manager must immediately take steps to protect the interests of his firm. These necessary steps are:

1. Stop all further credit. Mark all records to indicate that credit lines are suspended.
2. Recover as much as can be recovered. Hold up or stop payment on all checks and other remittances going forward to the bankrupt. Issue stoppage orders on goods in transit. Stop work on all goods in process or on order. File suit to recover goods already in the debtor's possession whenever there is legal ground for so doing. Seize and hold all of the debtor's property which is in your possession or which can be placed in your possession lawfully.
3. Start foreclosure proceedings on all secured claims or take possession of all collateral or other property against which you have a lien claim, attempting to reduce this claim to possession wherever possible.

4. File proof of claim with the referee.
5. Attend creditors' meeting; co-operate in the election of a capable trustee; and see, so far as it is in your power, that the estate comes under the influence of a reputable lawyer.
6. Whenever there is the slightest suspicion of fraud, assist other creditors by contributing to an investigation fund to expose further evidence of fraud. Postpone the examination of the bankrupt until such time as the investigation is completed.
7. Assist in the examination of the bankrupt and help other creditors to set aside voidable preferences or conveyances where they are present in the case.
8. Resist the final discharge whenever there are any grounds for opposing the discharge, and if grounds are present, assist in the criminal prosecution of the bankrupt.

Certain of these duties of the credit man are necessary to recover as much from the estate of the bankrupt as is possible. Others of them will pay dividends only over the long run. At times intelligent interest and co-operation in the correction of abuses seems a thankless and profitless task. It is, however, part of the social responsibility which membership in society imposes upon each citizen.

Arrangements—Chapter XI of the Bankruptcy Act. Often a debtor can overcome many of the difficulties encountered in voluntary bankruptcy settlements by utilizing the arrangements proceedings set forth in Chapter XI of the Bankruptcy Act. An arrangement is defined as "any plan of a debtor for the settlement, satisfaction, or extension of the time of payment of his unsecured debts, upon any terms." Arrangements proceedings usually are started under one of three sets of circumstances, all involving a debtor who is hopeful of being rehabilitated rather than liquidated but who is financially distressed:

1. If negotiations for an out-of-court settlement break down because of inability to secure the consent of important creditors, perhaps the next best step is for the debtor to file a petition under Chapter XI.
2. The debtor may decide not to undertake an out-of-court settlement, and may proceed at once to file under Chapter XI.
3. If an involuntary petition in bankruptcy has been filed against a debtor, he can avoid this by filing a petition under Chapter XI.

Proceedings under Chapter XI are voluntary only. No *creditor may force a debtor into Chapter XI; the proceedings may be instituted by the debtor alone.* An individual, partnership, or corporation may file a petition. The arrangement will modify the rights of *unsecured* creditors only, although others may be indirectly affected.[7]

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[7] *Credit Management Handbook, op cit.*, pp. 334–35.

In looking at Chapter XI proceedings, it is important to remember that they apply only to unsecured obligations of the debtor. When secured claims are outstanding, such as mortgages, conditional sales, or assigned accounts receivable, they may be unaffected by the proceedings under Chapter XI. On the other hand, the debtor is free to arrange privately with the secured creditors for the settlement of their claims. The court, however, usually will require that priority claims, such as taxes, rent, wages, and administrative costs, are covered before approving any arrangement plan for the unsecured creditors.

Before leaving this section on group creditor action, mention should be made of the bulk sales laws. While not strictly a collection device, these state laws generally provide that prior to the sale of a business "in bulk"[8] the seller must give the buyer a sworn list of creditors (name, address, and amount owing), an inventory of the business must be taken, and the creditors must be notified either in person or by registered mail that such a sale is scheduled to take place. Obviously, these laws are designed to prevent debtors from selling out at so many cents on the dollar and leaving the creditors in a precarious position in trying to collect the full amount due them.

Third-Party Actions

Recognizing the need to speed up the processes of collection, especially in those cases of insolvent and embarrassed debtors, many industries have organized some form of adjustment bureau or agency to aid their members, particularly those in the larger market centers, in dealing with their overdue accounts. The National Association of Credit Management has been an outstanding leader in the development and widespread use of such an effort, through the establishment of local Adjustment Bureaus within its own organization. How these bureaus function is aptly described in the following quotation:

> All activities of the Adjustment Bureaus of the National Association of Credit Men may be divided into four parts. The first function consists in personal investigations made by representatives of the bureau upon request of a member of the National Association of Credit Men. These representatives investigate the debtor's condition and adjust the account. A second function is that of effecting friendly adjustments, including service in a fiduciary capacity in any action of any character except bankruptcies. These adjustments are made in behalf of two or more creditors and for the common good of all. Bureaus are also equipped to serve in a fiduciary capacity during bankruptcy proceedings. Bureau representatives attend all hearings and otherwise investigate all bankruptcy cases,

[8] What is meant by "in bulk" varies from state to state, depending upon the provisions of the law in each state.

irrespective of whether or not a representative of the bureau is elected receiver or trustee. Finally, most of the bureaus are equipped to handle collections in their respective zones or to forward them for collection to other bureaus and attorneys.[9]

BETTER COLLECTIONS—IS THERE A SOLUTION?

Just as the conditions that lead to collections are due to a number of causes, so the remedy or solution cannot be found in any one change in procedure or any one device.

Part of the remedy may be found in greater care on the part of creditors to accept credit only from those debtors who have good credit to tender and only in such amounts as is justified by the debtors' conditions. This would require of the creditors a more complete and careful investigation and a more penetrating and acute analysis of the results of the investigation.

Part of the remedy may be found in greater care on the part of debtors in the offering of their credit. Credit should be regarded by the debtor as something of which he has but a limited stock. He should husband his stock carefully and replenish it frequently. He should recognize that acceptance of cedit should not be granted indiscriminately and therefore should be cautious to keep his reputation such that he can tender good credit and be sure of its acceptance.

Part of the remedy may be found in revision of the bankruptcy act itself in such a way as to make it more difficult for fraudulent debtors to avail themselves of its provisions. More investigation should be made before granting of discharges. Creditors should take more interest in the protection of their rights under the act and to avoid the paying of undue tribute to unscrupulous attorneys and other parasites and bankruptcy rings.

REVIEW AND DISCUSSION QUESTIONS

1. What are the devices available to a single creditor to effect collections? Which of these would you regard as routine devices? Which have at least some aspect of pressure?
2. Are company salesmen of any value in making collections? If so, in what particular way and under what circumstances?
3. Why do commercial credit managers take an active part in collections, whereas many consumer credit managers do not?

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[9] T N. Beckman and R. Bartels, *Credits and Collections in Theory and Practice* (6th ed.; New York: McGraw-Hill Book Co., Inc., 1955), p. 492.

4. Explain the essential characteristics of the following:
   a) Extension agreement.
   b) Composition settlement.
   c) Assignment for the benefit of creditors.
5. How does early bankruptcy legislation differ from the later acts?
6. "Society has an interest in the rehabilitation of the commercial debtor." Discuss the validity and implications of this statement.
7. What elements comprise the legal definition of bankruptcy?
8. May any commercial enterprise declare itself bankrupt?
9. What are the acts of bankruptcy? Of what significance are they?
10. What are the duties of the receiver in bankruptcy? What is the purpose of the first meeting of creditors? The duties of the trustee?
11. Do some costs and creditors' claims have preference over other claims against the proceeds of the bankrupt estate? What are the priority debts?
12. List the debts not discharged by bankruptcy action.
13. Explain the actions, and the reasons for them, that a commercial credit manager should take when notified that a sizable account is bankrupt.
14. Discuss the provisions of Chapter XI of the Bankruptcy Act. Do you regard the arrangements provided for as commercially desirable? Why or why not?

CHAPTER 33

Measuring Efficiency and Control of Commercial Credit Decisions

PREVIOUSLY IN Chapter 17, the subject "Testing the Success of Credit Operations" was discussed. While the material in this earlier chapter was directed primarily toward testing the success of the credit department of a retail, service, or financial organization serving the ultimate consumer, most of the discussion applies equally well to the problem of how to measure the efficiency and control of commercial credit decisions. For this reason, most of the material that appeared earlier will not be repeated here. Instead, the reader is asked to review the discussion in this earlier chapter and to note the significant differences on this topic between consumer credit and commercial credit, as pointed out in this chapter.

The problem of being able to appraise the performance of a commercial credit department is aptly described in the following quotation:

> The particular combination of measures used by any one company will be influenced, of course, by the peculiarities of the company's own credit situation—for example, the number and types of customer accounts handled and the size and internal organization of the credit department. Differences of this kind account for the adoption and use of widely different groups of measures by business firms. At a more general level, however, it is possible to describe the minimum requirements which any combination of measures must satisfy if it is to be used as a basis for judging the credit department's over-all performance.
>
> The credit department's objectives have been loosely described as the maximizing of sales and the minimizing of costs which the department controls—bad debt losses, the cost of carrying an investment in accounts receivable, and the department's own operating expenses. These objectives thus call attention to the main variables in the problem of judging effectiveness, any reasonably

complete combination of measures must provide at least some information on each of the variables.[1]

There is no agreement among commercial credit executives as to "the" best method or technique of judging how efficiently a credit department is operated. This lack of agreement is accounted for partially by variations in size of companies, in credit policies adopted, and in company organization, as well as by the fact that no one statistical measure which attempts to show the results of credit and collection operations is itself an actual measurement of how *effectively* these activities are performed. The person who has the responsibility of judging performance must have some predetermined standard to use as a basis of comparison. It is evident that if this standard has been erroneously set or has not been adjusted to reflect changing conditions the judgment will undoubtedly be wrong from an over-all profit and loss point of view. Thus the establishment of proper standards or targets is a prerequisite to proper judgment of performance.

As commercial executives well know, it is easier to voice the need for correct and proper standards than it is to establish them in actual operations. One of the main reasons for this problem is the lack in many organizations of a meaningful, reasonably precise definition of the objectives desired by top management. Until such a definition of objectives is furnished the credit manager or is developed by the credit manager and approved by top management, it is difficult to clarify and to answer the question of how results are to measured and appraised.

In almost all instances, a business organization attempts to judge the effectiveness of its component parts by how much does this part (department, etc.) contribute to the net profit of the operation. Especially in the case of the credit department is this end result very difficult to isolate and measure. As a result, efficiency is more often judged—when it is judged—on the basis of certain figures which are assumed to be correlated closely with the credit department's contribution to the goals previously established by top management—when such goals have been spelled out.

As pointed out in previous chapters, these goals or objectives of the credit department are often broadly[2] defined as (1) maximizing sales, (2) minimizing bad-debt losses, (3) minimizing the cost of carrying an investment in accounts receivable, and (4) minimizing the credit

[1] *Credit Management Handbook.* A Publication of the National Association of Credit Men (Homewood, Ill.: Richard D. Irwin, Inc., 1958), pp. 417–18.

[2] In individual companies, these broad objectives may be more clearly spelled out and serve more accurately as a guide to the credit executive's operations.

department's own operating costs. It also will be recalled that in setting these objectives of his credit department, the credit manager has an implied responsibility to three interests:

1. The firm which employs him.
2. The debtor whose credit he accepts.
3. The business and social community whose well-being may be affected by his actions.

This is equally as true for commercial credit as it is for consumer credit transactions. (For further discussion of this implied responsibility, the reader is asked to review Chapter 17.)

TESTS OF CREDIT DEPARTMENT OPERATIONS

Certain tests of credit department operations have become more or less conventional. To the extent that these tests permit comparisons between the subject firm and other similar firms, they are more useful because they have more meaning. Additional tests may be developed to meet the requirements of special situations which seem to be significantly important. Some analysis of credit department operating results may be used to test closeness of fit between policies and actual operations or to see whether policy or operation is faulty. On occasions an analysis of operations should be undertaken as a guide to the formulation of new policies.

Bad-Debt Loss

Too often the bad-debt loss ratio is the main basis of judging performance of credit management. While it has been said that there are only two kinds of bad-debt losses, those that a good credit manager could have been expected to anticipate and those that only God could have predicted, at the same time this manager is too often judged by those losses he did not anticipate rather than by his contribution to the sales effort of the firm. In most instances the following ratio will be used to compute this index:

$$\frac{\text{Bad-debt loss}}{\text{Total credit sales}}$$

This is similar to the ratio computed for consumer credit operations, with the exception that a breakdown of the bad-debt loss ratio would not be made into open charge, installment, and revolving credit transactions as is suggested for consumer credit operations.

As in consumer credit, the problem of pairing bad-debt losses in one period with sales of the following period continues to plague the credit analyst. Such factors as increased sales, changed credit policy, and varying business conditions may alter a firm's figures to such an extent that the analyst may be unable to determine accurately the credit department's selectivity in accepting credit during the period under consideration. Likewise, figures for different companies may lack comparability because of the differences in the treatment of write-off and recovery.

Some analysts have suggested that the bad-debt ratio would be revealing when it is accompanied by a comparison of these losses with the company's sales to the accounts which produced these losses. Such a comparison has the advantage of relating these losses to the specific decisions which permitted the credit sales.

Credit Sales

It is important to know and to follow the trend of what percentage of total sales is represented by credit transactions. While such information has some benefit to the firm accepting commercial credit, its value is reduced by the fact that credit is the generally accepted way of doing business between two business concerns. Studies made in this area place the over-all percentage somewhere between 85 and 95 per cent, and many individual firms know that the percentage of cash transactions is so small in their business as to be insignificant.

Of more importance perhaps is a classification of accounts by risk categories. For example, the following type of breakdown may be carried out within the broader framework of an industry or product-line classification of accounts:

1. *Government.*
2. *Prime*—large, well-established firms involving no real credit risk.
3. *Good*—companies which can be expected to discount but lack the stature of prime accounts.
4. *Limited*—companies which are suspect enough to be held within a definite credit line.
5. *Marginal*—high-risk accounts which bear constant watching.[3]

Such a classification has the advantage of enabling the credit analyst to determine more accurately whether there has been any significant change in the pattern of his company's credit decisions from period to period; whether the change that has occurred will have any effect on the timing of future collections with an ensuing influence on cash needs; whether certain individuals are doing a better job of accepting credit

[3] *Ibid.*, p. 406.

than are other members of the credit department; and, whether marginal accounts are really producing enough orders to make it worthwhile to bother with them. All of these items plus many others may be of value to the credit analyst if he is willing and able to justify the expense of added bookkeeping in order to provide such detailed information on the basis of the suggested or similar classification.

Collection Percentage, Days to Collect, and Turnover of Receivables

These ratios tend to tie in with the quotation, "A sale is not a sale until the cash register rings." These three measures are included under one heading because they simply are different ways of stating a similar fundamental relationship. The formulas commonly in use to compute these measures are as follows:

$$\frac{\text{Collections made during period}}{\text{Receivables outstanding at beginning of period}} = \text{Collection index.}$$

$$\frac{\text{Net credit period}}{\text{Collection index}} = \text{Average collection period}$$

$$\frac{\text{Total credit sales}}{\text{Average receivables outstanding}} = \text{Receivables turnover rate.}$$

$$\frac{360 \text{ days}}{\text{Receivables turnover rate}} = \text{Number of days to collect credit accounts.}$$

There are limitations associated with the use of these measures, difficulties well recognized by experienced credit personnel. These limitations are well described as follows:

> . . . Since all of the preceding measures are stated as averages or summary figures, they conceal the peculiarities of individual cases. Many credit men believe that the department's effectiveness in handling collections should be judged to a considerable extent by its success in dealing with the most difficult collection problems. The latter are understood to include situations where it is necessary to arrange extended payment schedules, provide financial advice, participate in creditors' committees, and the like.
>
> It might be argued that the credit department should be censured for getting into these situations rather than commended for getting out. With an aggressive sales program, however, accounts may be accepted with the full knowledge that they are likely to develop into collection problems. The subsequent salvage negotiations require judgment and a disproportionate amount of work if they are to be handled successfully; therefore they do provide a specialized test of the effectiveness of the department's collection operations. As their significance

is completely lost in summary statistics, they often deserve to be made the subject of special credit department reports.[4]

These measurements have an advantage over the bad-debt loss calculation in that they can be figured earlier in many instances and can help to forecast difficulties in collections sufficiently in advance to permit the application of some corrective measures. Such measures of credit activity also make it possible to detect the effects of the adoption of unsound policies early. For example, the adoption of unduly lenient terms, the solicitation of unsound classes of customers, the yielding to competitive temptations to outdo the other fellow in credit—all of these will reveal their fruits in a falling collection percentage. In addition, unduly stringent collection activity, overly conservative acceptance of credit, undue hesitation in the taking of risks will tend to be detected earlier by study of the trend of collection percentages.

Number of New Accounts Opened and Acceptance Index

In connection with these measures, it must be remembered that one of the dual objectives of a credit department is to maximize sales. These statistics simply summarize the nature of the decisions—approvals or rejections—which were made on the applications received during a given period. They also will tend to indicate the extent to which emphasis is being placed upon credit service and whether or not the business concern is alive to its opportunity for attracting new trade.

As previously discussed, the classification of accounts by risk categories has importance in connection with these measures, and many firms not only are interested in how many new accounts are opened and what percentage of applications is accepted but they also want to know what types of risk accounts are accepted and what types are rejected. Thus the acceptance ratio, which normally is computed by dividing applications accepted by applications submitted, can sometimes be used to compare the adherence of credit practice to policy or to judge whether current credit decisions match those of earlier periods. Likewise, firms with a regional credit organization may use these measures to check the adherence to company "S.O.P." of one district with another.

Aging of Accounts and Past-Due Index

The aging of accounts receivable is simply a distribution by the time periods these accounts have been outstanding. The classification often

[4] *Ibid.*, p. 414.

used is current, overdue less than 30 days, overdue 30 to 60 days, overdue 60 to 90 days, and so on. When drawn from a monthly trial balance of a concern, these figures are available to credit management on a regular basis. In other concerns different alphabetical groupings may be processed each day and thus aging is carried on continuously; in still other companies aging is an annual operation.

Closely connected with the aging process is the computation of the past-due index. This measurement, which is usually figured by dividing the total past-due accounts by the total amount outstanding, has more significance after it has been computed for several successive periods. Under this arrangement, it can serve as a barometer indicating whether the general trend of poor pay is upward or downward. If this percentage increases faster than management thinks it should at any given time, proper steps usually can be instituted to curb the trend or perhaps bring it back to the normal position.

It must be recognized that not all credit authorities accept these measures without some limitations. Aging of accounts is believed by some to be too much the result of accidental factors, to be too expensive to compute, and to be too broad for successful use. These observers point out that if the accounts which are originally accepted on deferred-payment terms or from slow-paying governmental agencies are combined with ordinary trade business, the aging report is almost certain to reflect a distorted picture of the credit department's operations and to prevent a valid comparison of actual operations with any performance standards established.

Cost Analysis

Any final summation of the results of credit department activities should include cost figures. Credit management is on much sounder ground in deciding on important credit and collection policies, if accurate knowledge is available concerning the cost of operating on a credit basis and of carrying receivables on the books. To be sure, bad debts afford one such measure, but losses from bad debts are only one item in the operation of a credit department. In addition to bad debts, there are other expenditures the total of which normally exceeds all bad-debt losses. Wages and salaries of persons employed in credit and collection activities are the most important single category of credit expense. This expense in addition to interest on outstandings, fees and dues for credit information, travel, and charges for outside assistance in making collections constitute the bulk of the costs incurred. Practice varies by com-

pany as to inclusion of overhead, legal expenses incurred in nonroutine collections, expenses of a public relations nature, and other types of indirect expense items.

Costing of credit operations may seem needlessly complex, involving a detailed accumulation of data. At the same time, effective credit management cannot and should not be expected to work blindly without facts. Nor can intelligent policies be adopted other than upon the basis of known facts.

ADAPTATION OF NEW MANAGEMENT TOOLS TO TESTING CREDIT OPERATIONS

The tests of efficiency and control of credit decisions discussed to this point are generally measured against past results. This technique of measuring actual results has been in common practice for many years. More recently, the truly professional commercial credit manager and a few industry spokesmen have been directing their attention toward forecasting credit department performance and then measuring the periodic results against actual commercial credit activity; the measuring of costs for various classifications of customers versus sales and profitability; and, the development of methods which explain reasons why certain phenomena occur in credit department accounts or groupings of accounts. Quite obviously these techniques and the more revealing resulting data stem from the current emphasis placed on forecasting and budgeting procedures, cost and distribution analysis, statistical correlation analysis, and the electronic processing of masses of data. Despite the fact that these approaches may appear somewhat sophisticated for the average credit executive, the fact remains that some of the larger commercial credit departments are now utilizing these devices in order to improve their contribution to the total company objectives and to plan their operations on the basis of data not previously available. The rapid advancements made in developing more modern tools of management and the rapidity with which they are being accepted certainly indicate that the medium-size and small-size credit departments will not be insulated from them. Accordingly, students and the practicing credit manager will have to be alert to these techniques and be able to adapt to them as these techniques begin to pervade business life more completely.

Cost and distribution analysis affords most credit departments a research tool which can be useful in estimating probable costs, or costs savings, when change in credit policy is contemplated. For example, the functional expense statement (one of the accounting techniques used

in the area of cost and distribution analysis) is useful in plotting costs of credit authorization, accounts receivable, invoicing, and the like against credit accounts classified by payment experiences and also classified by sales volume attributable to the various groupings. Credit and collection costs, as all other marketing costs, enter into the determination of the profitability of various classes of customers and hence subject themselves to this technique. In other words, part of the answer to the question "is this group of customers (classed by size of order, location, industry type, etc.) a profitable or potentially profitable class of customers in view of our costs of selling them?" can be had by employing devices which are known to be scientifically superior to older methods.

Similarly, some credit departments find it managerially desirable to classify their customers according to credit risk; and then, at later dates measure the volume of business conducted, the volume of outstanding receivables, and the past collection efforts expended according to the predetermined categories of risk. One of the most fruitful areas of credit department activity has come from measures which determine to what extent their rehabilitation efforts have been helpful in moving a particular group of customers from low classifications to higher classifications. Most of the techniques suggested here are particularly significant when we reflect that decisions in accepting credit are, for the most part, based upon an estimate of other future phenomena such as changes in the nation's economy, trends in an industry, and changes in the individual firm. Unless some of the forecasting techniques are adapted to credit management we find ourselves basing our everyday activity on future results, but at no time do we know whether a target has been reached.

THE MEASURED RESULTS

Most of the measurements referred to call for further refinement of concepts and greater skill in the use of the tests employed. Some observers have pointed out that with increasing and continuing experience and research, it may be possible to develop reasonably reliable mortality tables (similar to those used by credit insurance companies) for different indentifiable groups of credit applicants. As various credit authorities point out:

> . . . These estimates could then be applied to cost and gain figures of the type described, to indicate the expected profitability and hence acceptability of particular *classes* of accounts. This approach would not be appropriate for companies with few active accounts or with large unit sales; it also would have no value to companies in the comfortable position of rationing output among

good-risk customers. A large area of potential application is left, however, the ultimate test of the method's usefulness being the ability of analysts to develop adequate business mortality estimates.[5]

As credit management becomes more and more conscious of the need to measure its own operations, better credit decisions will be made. Such an improvement will benefit the firm, the debtor, and society in general.

REVIEW AND DISCUSSION QUESTIONS

1. What is the purpose of measuring the various activities of the commercial credit departments? Is the purpose the same when one measures the results of a consumer credit department? Why or why not?
2. Can tests of credit operations be objectively compared with data from other firms?
3. List the tests applicable to commercial credit department operations. Explain each one.
4. How may commercial credit risks be classified? What are the advantages to such a classification?
5. What disadvantages are apparent to you in use of the collection percentage, days to collect, and receivables turnover tests?
6. Could an acceptance ratio be related to other activities and other results of the credit department? Explain.
7. What is the accepted procedure for aging accounts receivable? What distortions may result from the use of this device?
8. Do any of the recently refined tools of business management have applicability to credit department operations?
9. The rehabilitation of poor accounts and the moving of accounts from low classifications are regarded as a profitable expenditure of time. Design a technique which would reveal the results of such activity over a one-year period of time.

[5] *Ibid.*, p. 422.

APPENDIXES

APPENDIX A

Credit Instruments

CREDIT INSTRUMENTS provide the tangible evidence that a credit transaction has taken place. They specify the obligation which exists between the parties to the transaction, and often they set forth the conditions and terms under which the credit was accepted. Credit instruments vary with the type of credit involved and the purpose it serves for the parties. All instruments, regardless of their form, have common characteristics as the *creditor-debtor relationship, futurity,* and *risk.*

Credit instruments may be classified according to acceptability of the instrument, the function of the instrument, or the form of the instrument.[1] Instruments of unlimited or general acceptability include all the money of the United States Treasury which is in circulation. Money is the instrument of the United States government and includes the various issues of the authorized monetary authorities (principally the Treasury and the Federal Reserve banks). United States currency, such as silver certificates, standard silver dollars, Federal Reserve notes, Federal Reserve bank notes, and the like, have unlimited acceptability and pass freely from hand to hand. In contrast to money, all other credit instruments are said to be of limited acceptability, because their acceptance is contingent on the acceptability of the credit of an individual or business concern.

If credit instruments are classsified according to function, they would be classed as consumer credit instruments, business credit instruments, and government credit instruments. Obviously, such a classification results in some duplication. Furthermore, this classification would include a further subclassification so as to distinguish between short-term and long-term credit instruments.

To classify by form of instrument as "promises to pay" and "orders to pay" is the most common method of classification. Promises to pay include open-book accounts, promissory notes, and bonds. Orders to pay include checks and other bills of exchange, all of which are commonly referred to as "drafts." While these are not all the credit instruments in general use today, they do represent the ones with which students and credit managers should be acquainted in order to appreciate more clearly the problems of credit management.

PROMISES TO PAY

Open-Book Accounts

The simplest and most elementary evidence of a credit transaction is the open-book account, or the *open account* as it is sometimes called. This is the

[1] Watrous H. Irons and Douglas H. Bellemore, *Commercial Credit and Collection Practice* (2nd ed., New York: Ronald Press Co., 1957), p. 57.

seller's accounting record showing the value (and other descriptive elements) of the merchandise or services delivered to a buyer. The transaction may or may not involve a written instrument signed by the creditor and the debtor; and because of its great simplicity and informality, it is the most commonly used instrument of record in credit transactions. To the creditor it is regarded as an account receivable; to the debtor, an account payable.

Despite the lack of written acknowledgment of the debt in certain instances, it is seldom questioned as evidence of debt, but on occasion is questioned in so far as the *extent* of debt is concerned. In general, books of account are admissible as legal evidence of merchandise sold or services rendered. For example, it serves to support "proof of claim" in bankruptcy proceedings.

Promissory Notes

Second only to the open account in frequency and commoness is the promissory note. As the name implies, it is a written promise of one party to pay another party a definite sum of money at a specified future time. No specific wording of the promissory note is required, but the wording must acknowledge the indebtedness as due from one to another.

Promissory notes may be either negotiable or nonnegotiable. Most states have adopted the Uniform Negotiable Instruments Law. It is desirable for creditors to require that a promissory note be in a form which will render it a negotiable instrument under the statute. The necessary requirements for this purpose are that the instrument (1) be in writing, (2) be signed by the maker, (3) contain an unconditional promise to pay a certain sum of money, (4) be payable on demand or at a fixed or determinable future time, and (5) be payable to the order of a specified party or to bearer. If the instrument lacks any of these requirements, it is nonnegotiable. For example, the following is a nonnegotiable promissory note:

$1,000 00

Chicago, Illinois
February 14, 196–

Sixty days after date I promise to pay to the Midwest Wholesale Company one thousand dollars ($1,000.00), with interest at 6 per cent per annum for value received.

(Signature of Maker)

The following is a negotiable promissory note:

$1,000.00

Chicago, Illinois
February 14, 196–

Sixty days after date I promise to pay to the order of the Midwest Wholesale Company one thousand dollars ($1,000.00), with interest at 6 per cent per annum for value received.

(Signature of Maker)

A negotiable promissory note may be discounted at a commercial bank and, hence, both the creditor and debtor are able to use their credit by virtue of the same instrument.

In general, the use of notes in commercial credit transactions is quite restricted. In a few wholesale lines their use is customary when the transaction involves either high merchandise value or high risk of the customer group. Credit managers recommend the use of promissory notes (1) when the transaction is with a concern of inferior credit standing and (2) when an extension of time is granted in effecting collection of an account. This instrument is very common in connection with bank loans to individuals and commercial houses.

Another form of the promissory note is the *collateral note* which is used by commercial banks when making a loan secured by some form of collateral. The collateral note is in all respects a promissory note with the description of the property pledged as collateral appearing on the face of the form. Commercial banks often use this instrument and prefer that the collateral consist of marketable stocks and bonds; although receivables, warehouse receipts, other securities, and real estate may be pledged.

Bonds

A bond is a written promise to pay a definite sum of money at a specified future date. They are similar to promissory notes except they are issued in standard denominations as $1,000, $500, and even $100. Interest is usually paid semiannually at a fixed rate. Typically, they are issued in series for periods in excess of five years and are used by governments and private corporations to raise large sums of money. Because of these characteristics, bonds are usually classed as an investment credit instrument.

Bonds may be secured or unsecured. Oftentimes the security is in the form of a mortgage on some specified property which has been conveyed to a trustee. Collateral also may take the form of securities, and, if so, the bond is known as a "collateral trust bond." Bonds issued as a general credit obligation of the corporation with no specific security are known as "debenture bonds." These instruments may be registered both as to principal and as to interest, or they may be registered as to principal only with interest payable to the bearer. Registration provides the owner protection in the event the bond is lost. Unregistered bonds and bearer securities are generally negotiable instruments, whereas registered bonds may be transferred only if the transferee's name is also registered on the corporation's records. The transfer of a registered bond constitutes an assignment in contrast to general negotiability.[2]

ORDERS TO PAY

Bills of Exchange

In addition to promises to pay, bills of exchange or drafts are the other instruments which evidence the extension of credit. The Negotiable Instruments Law defines a bill of exchange as "an unconditional order in writing addressed

[2] Stock certificates are not credit instruments as they do not represent a promise to pay and there is no obligation on the part of the corporation to repay the principal.

by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to order or bearer."

Checks. Checks are the most commonly used bill of exchange in satisfying credit obligations. They are always drawn on a bank and are payable on demand. The drawer of a check may name anyone as payee including himself, but usually the payee is another person or corporation.

The use of checks has increased to such an extent that oftentimes they are considered as synonymous with money rather than as a credit instrument. The widespread use of checks is accounted for by the great convenience, simplicity, and safety which they afford. In all respects, despite their common use, checks possess the characteristics of credit instruments with limited acceptability.

Certified and *cashier's* checks result in the guarantee of payment of the check by the bank. Cashier's checks are drawn by the bank cashier on his own bank, whereas a certified check is drawn by the depositor who requests his bank to "certify" it. Certification is accomplished by the bank officer stamping the word "Certified" across the face of the check and signing it. This indicates that the bank will honor the check if properly endorsed and presented for payment. Certification of a check converts the drawer's order into a bank's promise to pay.

Drafts. There are a number of kinds of drafts, all of which are bills of exchange. Drafts are very similar to checks. They are signed by the creditor and directed to the debtor. A draft directed to a debtor functions to request the debtor to make payment. When a debtor endorses his acceptance on a draft, it becomes a promise to pay and has the same legal status as a promissory note.

Bank drafts are used between banks to carry on their banking transactions. This instrument is simply a draft drawn by one bank against its account in another bank. Usually the bank draft is drawn upon out-of-town banks, where the drawer bank maintains an account. Obviously these drafts facilitate banks in making payments at distant locations.

Commercial drafts may be used in domestic trade or between parties to foreign trade. In the former instance they are classified as domestic drafts whereas in the latter instance they are referred to as *foreign drafts* or *bills of exchange.* Commercial drafts may be drawn payable at sight in which case the instrument is known as a *sight* draft, or they may be drawn for payment at some specified future date in which case they are known as *time* drafts. The debtor (drawee) has the right to refuse acceptance of a draft, and for this reason the draft is of no value until accepted. The acceptance of a sight draft takes place as the debtor makes payment to the bank of the amount involved. The time draft becomes "accepted" as the drawee endorses it across the face with the words "accepted." An accepted draft becomes an unconditional promise to pay by the debtor.

Commercial drafts are not widely used in the sale of merchandise except in the case of C.O.D. orders or when the seller desires payment before shipping the goods. These instruments are presented to debtors or buyers through their banks. As the buyer accepts the draft the shipping documents attached to the draft are released, and their possession gives the buyer the right to possess the merchandise. A more common use of the commercial draft is in the collection

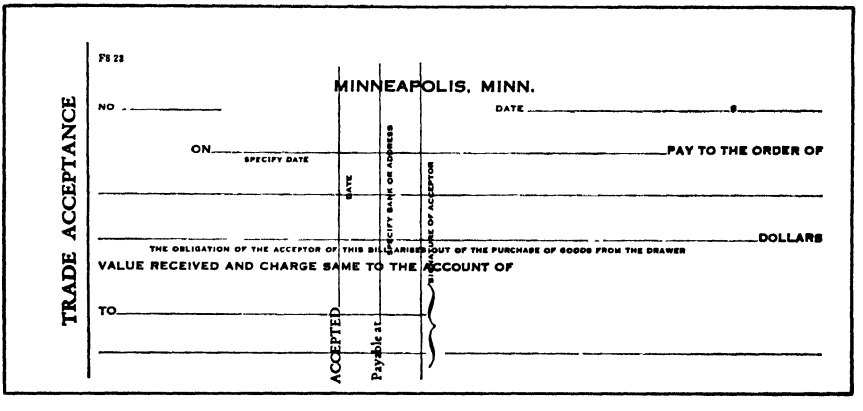
of past-due commercial accounts. The use of sight drafts, time drafts, and letters of credit between parties to export trade is discussed in Chapter 21.

Acceptances are of two types, the banker's acceptance and the trade acceptance. A banker's acceptance is a written agreement obligating the bank to pay the seller of goods on behalf of the purchaser of such goods. The acceptance stipulates the amount, the time, and the place of payment. The sole difference between a banker's acceptance and a trade acceptance lies in the fact that it is drawn upon a bank rather than upon a buyer of goods.

The banker's acceptance comes into existence when a seller refuses to deliver goods on the basis of a buyer's credit alone. To obtain the goods, the buyer requests his bank to underwrite his purchase. For all practical purposes the buyer is requesting a loan. If the bank agrees to the transaction, it may require the buyer to pledge some form of collateral; or, if the buyer maintains an account the bank will require the buyer to keep a certain amount on deposit. Once the seller has been informed of the buyer's arrangements with the bank, the seller may draw an acceptance upon the bank. The bank in turn will honor such bills as the seller might legally draw upon it. Clearly, most sellers would prefer a bank's acceptance to a trade acceptance, because of its "gilt-edged" nature and ease of negotiability. Sellers can readily discount such bills and receive their cash immediately. This instrument is used extensively in foreign trade, and to a lesser extent in domestic trade.

A trade acceptance comes into existence as the seller draws the instrument on a buyer. The common form of the trade acceptance is illustrated in Figure A–1.

FIG. A–1. Trade Acceptance.



This type of bill is used in the sale of merchandise and never for the collection of past-due accounts. It often arises that a buyer does not have the ready cash to make payment for merchandise purchased. The buyer will, however, be able to pay when he sells the goods he is purchasing. The trade acceptance affords the buyer a means of acquiring the goods, and the seller a means of selling the goods. The seller issues the bill to his own order, drawn on the buyer. The buyer acknowledges the acceptance by affixing his signature across the face of

the instrument in the space provided. As the buyer acknowledges the acceptance his obligation becomes absolute. The seller may now discount the bill at his bank, or hold it until the buyer honors it on the date specified. In general, trade acceptances are more acceptable to banks because they are two-name papers and evidence bona-fide commercial transactions.

APPENDIX B

Summary of State Installment Sales Laws

DURING THE past decade there has been continued legislative activity on the subject of installment credit sales. In all likelihood legislative interest in this phase of consumer financing will continue for years to come. The membership of the American Finance Conference (a national association of independent sales finance companies) endorses the enactment of state legislation which is appropriate to the good of the public and the installment credit industry.

The following summary of state installment sales laws is reproduced from *Time Sales Financing,* Vol. XXIII, No. 9, September, 1959, pp. 3–7. Interested students and credit managers are referred to this publication for the most up-to-date summary of such laws. The authors gratefully acknowledge permission to reproduce, in part, the association's material here:

Laws now in effect in the United States which have a bearing upon, or relation to, instalment selling practices include generally:

(*a*) Special instalment sales acts.

(*b*) Conditional sales and chattel mortgage laws.

(*c*) Special credit insurance laws.

Toward the end of the 1959 legislative year, some 30 states had statutes, special or regular, related in a direct and material way to instalment selling as such. Two additional states [Texas and Virginia] had statutes touching the subject in a minor way. In other states, the subject is dealt with, if at all, only indirectly by the conditional sale and chattel mortgage laws and other general statutes.

Special Statutes

The 30 states with special statutes (or legislation in effect amounting to such) on the subject of instalment sales, and the dates of the enactment of the major present statutes, are:

California (1945)
Colorado (1951)
Connecticut (1947)
Florida (1957)
Idaho (1957)
Illinois (1957)
Indiana (1935)
Iowa (1957)
Kansas (1958)
Kentucky (1956)
Louisiana (1958)
Maine (1944)
Maryland (1941)
Massachusetts (1958)

Michigan (1939 and 1950)
Minnesota (1957)
Mississippi (1958)
Montana (1959)
Nebraska (1957)
Nevada (1953)
New Jersey (1948)
New Mexico (1959)
New York (1956)
North Dakota (1957)
Ohio (1949)
Oregon (1957)
Pennsylvania (1957)
South Dakota (1957)
Utah (1953)
Wisconsin (1935)

While most of the state statutes still apply only to motor vehicles, more and more are being written (Kansas, Montana, etc.) with all-goods coverage, and some (Florida, etc.) with revolving credit coverage also.

Licensing and Examination

Licensing. In 21 of the 30 states, Colorado, Connecticut, Florida, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, New Jersey, New Mexico, New York, Pennsylvania, South Dakota and Wisconsin, a license is required to do business as a "sales finance company." In five of the above noted states, Colorado, Connecticut, Maryland, New Jersey and New York, retail instalment sellers are not required to be licensed unless they carry their own paper and thus also become "sales finance companies" by legal definition. The states of Indiana, Iowa, Maine, Michigan, Pennsylvania, and Wisconsin require licenses of retail instalment sellers.

No licenses are required of either sales finance companies or retail instalment sellers in the states of California, Illinois, Nevada, North Dakota, Ohio, Oregon, and Utah.

In some of the states, specifically named types of financial institutions are exempt from the licensing provisions of the Act. For the most part, these exempted institutions are already under some other form of state control.

Examination Provisions. Provisions of the statutes with reference to the powers of designated state administrative authorities to investigate complaints, examine records of licensees, and prosecute violations, vary greatly from state to state. In some there are no provisions in the statutes for such authority. Under these statutes, complainants must utilize the general enforcement machinery of the state, or the provisions of the statute itself in seeking redress upon their complaints.

In a few states, administrative officials have authority to investigate specific complaints and to examine licensees' records pertaining to these complaints. In most states, state officials have broad general power to investigate complaints against licensees, inspect records, require reports, establish rules, and to enforce generally the provisions of the laws in effect in their respective states.

Contract Requirements

Practically all of the statutes set out in some detail a number of requirements with reference to contract form and execution, items that must be disclosed by the contract (or other instrument in writing), and prohibited practices or provisions. Some of the laws are broader in scope and more complete and specific than others, but generally the following are the requirements to be found in one or more of the statutes pertaining to: (1) form, (2) disclosure, (3) prohibitions.

Contract Form and Execution. The statutes provide that the instalment sale contract (*a*) must be in writing (all states) with minimum type-size spelled out; (*b*) must contain all agreements between the parties (*c*) must be signed by the buyer *and* seller in most, (*d*) copy must be delivered to buyer at time of execution

(or within 5 days in New Jersey). Where a separate memorandum of sale is permitted, this must be prepared and copy given to buyer prior to execution of the contract. A number of states specifically prohibit the signing of contracts with blank spaces.

Disclosure. The disclosure requirements detailed or mentioned in the statutes include: (*a*) name and address of parties and date of contract signing, (*b*) description of goods sold and/or taken as security, (*c*) cash price, (*d*) amount of down payment (some states require separate itemization of cash and articles traded in, with value of each), (*e*) unpaid cash price, (*f*) cost of any insurance and/or other benefits (with types of coverage described and in some cases names of parties to whom payable), (*g*) fees paid or the amounts of any other charges (and their purpose), (*h*) unpaid balance, (*i*) amount of the "time price differential" or "finance charge," (*j*) contract or time balance, (*k*) number, amount and dates of instalments. Most statutes permit the grouping of insurance costs and the time price differential or finance charge But where this is done, the seller or his assignee must within a definite period (usually from 15 to 30 days) furnish the buyer with a breakdown of such costs.

Prohibited Provisions. Some states as a matter of legislative policy have prohibited the inclusion of certain provisions or features in instalment contracts. Among the items specifically mentioned in one or more of the statutes here under review are the following: (*a*) power of attorney to confess judgment, (*b*) provisions creating a lien upon goods previously or subsequently purchased by buyer, (*c*) the waiver of statutory rights regarding repossession, resale, or other rights given buyer by statute, (*d*) wage or other income assignments, (*e*) certain irregular or uneven payments (balloon notes), (*f*) provision for acceleration of payments where seller deems himself insecure, (*g*) waiver of tort claims, (*h*) provisions making seller or holder agent of buyer, (*i*) permission for unlawful entry upon premises of buyer, (*j*) waiver of legal remedies of buyer, (*k*) execution of series of negotiable notes that would cut off buyer's defenses. Kentucky prohibits the taking of a lien upon any other goods except the motor vehicle which is the subject matter of the contract. Some of the statutes state specifically that any right afforded the buyer by the law cannot be waived.

Procuring Insurance

All of the statutes here under review, tacitly, if not specifically, recognize the right of instalment sellers to require insurance coverage on the chattels sold in order to protect their collateral. These statutes also recognize the historical practice whereby the seller or his assignee may procure such insurance for the benefit of the seller and buyer, and extend credit to the buyer for the amount of the premium involved. Some states limit the seller's specific right to require coverage to "damage, destruction, and theft," but recognize the further rights of the parties to make additional insurance arrangements if they so desire.

However, many of the statutes, as well as companion laws, prescribe certain rules with respect to the handling of such insurance. These rules center somewhat around the following: (1) placement, (2) costs and coverage, (3) relation to financing costs; policies and their delivery, (4) cancellation and rebate.

Placement. Most all states prohibit the coercion of the instalment buyer in the placement of insurance. He has the right to choose his carrier or purchase the required coverage but the seller also has the right to approve such coverage and the carrier. The seller likewise has the option of extending credit for the amount of the premium. Some states require that the carrier must be licensed to do business in the state.

Costs and Coverage. Some of the statutes state that the cost of insurance included in the instalment contract cannot exceed the actual cost to the seller, or the applicable "manual" or filed rates. Most statutes provide that the coverage to be procured by the seller must be clearly stated. Some provide that such coverage must be "dual" interest. One state gives the buyer the right of offset in the case of overcharge and another the right to credit such overcharge against the last instalment. Some require specific notice to the buyer when personal liability and property damage coverage is not included in insurance coverage.

Relation to Financing Costs—Policies. As indicated earlier, most statutes permit the combination of insurance and financing costs in the original contract disclosure. But if this is done, the seller or his assignee must furnish the buyer within a specified time; (5, 15, 25, or 30 days) (*a*) a breakdown of the cost of insurance and financing charges, (*b*) a policy or certificate containing all the terms, conditions, etc. of coverage, with amount of the premium. In Ohio, the first instalment on contract may not be collected until such policy is delivered or refund made.

Cancellation and Rebates. In some states cancellation (other than by carrier) may be had only at the request of the buyer. One state gives the buyer the right to transfer the coverage on the motor vehicle traded-in to his new purchase. Another provides that any rebate of premium on a trade-in must be refunded to buyer or credited to his next payment. The Pennsylvania statute provides a procedure for replacing insurance where the carrier cancels coverage. Some statutes provide that rebate in case of cancellation must be credited to the last maturing instalment. Others provide that such rebates must be remitted to buyer or credited to his account.

Pre-Payment and Rebates

The statutes in almost all of the states having special instalment sales laws, specifically give the instalment buyer the right to prepay his contract and to secure a refund upon such prepayment. The amounts vary in the several states. Yet most of them follow a basic pattern, that of using the so-called "12/78th" or "sum of the digits" method for determining the basic amount of rebate after deducting an allowable minimum finance charge. Indiana and Wisconsin have a comparable special formula which has the effect of recognizing an acquisition cost or minimum charge in the initial month of the contract in the event of prepayment.

Collections—Repossessions

Delinquency Charges. Most all of the statutes have provisions dealing with delinquency charges and repossession practices. Almost all of the 30 states specifically permit the collection of default or delinquency charges. There is no uniformity as to the allowable amount of these charges, but . . . one or two states allow "reasonable" charges and interest on delinquent payments, while the others vary in the specific charges permitted.

In addition to these delinquency charges, many states allow attorney's fees of 15 percent of amount delinquent, plus court costs, to attorneys not salaried employees of the creditor.

Repossession Rules. Only about half of the states' instalment sale statutes have general provisions regarding repossessions and rules in connection therewith. This does not mean, however, that all of the other states leave this area unregulated. In states such as Indiana, New Jersey, Ohio and Wisconsin the applicable provisions of the Uniform Conditional Sales Laws in effect in these states govern this area of activity. These matters are dealt with in varying ways in other state statutes.

The provisions of some of the special instalment sales laws regarding this subject

are generally comparable to those in the Uniform Conditional Sales Act. These provisions, among others, relate to: (*a*) method of retaking—(must be done peacefully, otherwise by legal process)—any restrictions thereon, (*b*) notice to buyer after repossession, if by non-judicial means—contents of such notice and method of giving, (*c*) redemption or reinstatement rights and procedures—waiting period, etc., (*d*) resale—optional or compulsory—public—private—valuation—price, (*e*) proceeds of resale—application to collection and repossession costs, balance due, etc.—handling overage or deficiencies, (*f*) rights of parties when there is no resale, (*g*) election of remedies—rights of buyer and seller, (*h*) recovery of part-payment, (*i*) and other items.

In some cases special rules may apply to certain classes of goods (such as household) or to certain dollar sizes of contracts. Likewise there may be special rules when more than a designated percentage has been paid on the contract obligation.

Extensions—Refinancing

Frequently an instalment buyer finds it necessary or desirable to extend a payment or payments due or reschedule his payments. This situation is recognized in most of the state statutes through the inclusion of statutory provisions to permit such extensions or rescheduling In two other states, Indiana and Ohio, the general rate structure permitted in their statutes is such as to make such extensions or rescheduling possible without special provisions.

The permitted rates of charge for such extension or rescheduling vary somewhat but their net effect in most instances is to allow a charge that will approximate the effective rate under the original terms of the contract. Some of the specific rates provided are. Connecticut—12 per cent per year "true interest"; Kentucky—$5 flat charge, plus 1 percent per month, Maryland—15 percent simple interest on descending balances, Michigan—two options, at current model rates, permitted by statute; New Jersey—$5 flat fee plus 10 percent simple interest on declining balances; New York—1 percent per month on declining balances by extension, and maximum finance charges on rescheduling, Pennsylvania—two options: (1) extend monthly payments at monthly rates, for Class I—1 percent; Class II—1½ percent; Class III—2 percent, (2) rewrite or reschedule whole contract, balance plus delinquency costs, less prepayment rebate, at original contract rates allowable by statute; Wisconsin—10 percent simple interest

Permitted Charges

For several decades there has been a well established principle of law, both in the state and federal courts to the effect that a seller of merchandise may offer his goods for sale at a "cash" price, or at a "time price," if the buyer wished credit in connection with the sale, and that the difference between these two offering prices (the "time price differential") was not interest within the meaning of the statutes controlling interest rates. This legal principle permitted the seller lawfully to add to his "cash" price the economic costs of credit, including the amount by which he would have to discount the obligation if it were sold and assigned to a financing agency, in order to establish his "time price."

Thus the amount of this differential became a matter of bargaining and agreement between the buyer and the seller. It was upon this legal foundation that the whole system of instalment sale credit and sales financing developed in the United States.

However, as special legislation pertaining to instalment selling developed, most of the states enacting such legislation have imposed limits upon the amount of this "time price differential" or "finance charge." As of August, 1959, 27 of the 30 states

having instalment sales legislation had some designated limits on these charges. Among the states having legislation, only Idaho, Illinois, and New Jersey do not impose limits. The methods used to establish these limits vary among the several states having such limits. Most of them have established classes of contracts and then have fixed limits (usually in dollars per $100 per year, but occasionally, as in Iowa, Louisiana, and South Dakota, on a percent per month basis) for each class of contract. A few states, California, Nevada, and Utah, have fixed as limits, an amount equal to 1 percent of the unpaid balance of the contract, multiplied by the number of months the contract is to run, with a minimum charge of $25 or $15. Ohio allows a base charge of $8 per $100 per year on the principal contract balance plus "a service charge of 50 cents per month on the first $50 unit, or fraction thereof, of the principal balance, for each month of the term of the contract, and an additional service charge of 25 cents per month for each of the next five $50 units, or fraction thereof, of the principal balance for each month of the term of the contract."

Although the New Jersey statute does not control rates, it does require that current rates used must be filed with state authorities.

Penalties

In general, the penalties for violation of the licensing provisions are more severe than the penalties for violation of other provisions For failure to be licensed as a "sales finance company" or "seller" the penalties range from a fine up to $500 and 30 days imprisonment in Kentucky, to a fine of up to $5,000 and 3 years imprisonment in Michigan and Pennsylvania. For violation of rate, contract provisions, disclosure, rebate and other similar sections, the penalties range from the right of the buyer, under certain conditions, to bring a civil action to recover overcharges or amounts due, to criminal penalties. The more common penalties for such violations include loss of charges, inability to enforce contract, fine and imprisonment and/or revocation of licenses. The Wisconsin statute includes severe penalties for violations by automobile manufacturers, manufacturer affiliated finance companies, and manufacturers' agents or field men.

As indicated earlier, the conditional sales and chattel mortgage laws in many states have a relation to and bearing upon the instalment sale of goods Therefore, these should be read and studied in connection with the instalment sale laws here under review. For a summary review of the provisions of all these conditional sale and chattel mortgage laws we suggest that you consult the *1959 Credit Manual of Commercial Laws,* published by the National Association of Credit Men, 229 Fourth Avenue, New York 3, N Y. As supplementary to this article we suggest the reading of the Uniform Conditional Sales Laws, the Uniform Commercial Code, Sec. 9, and the Conditional Sales Laws in the other states studied, particularly in Ohio. Also, related or pertinent parts of the chattel mortgage statutes should be studied.

INDEX

Index

A

Acceptance
  limited, 5
  risk, 6
  time, 6
Acceptance index, 353, 620
Acceptances
  banker's, 397 n.
  trade, 601, Appendix A
Accounts receivable
  assignment, *see* Assignment of accounts receivable
  factoring, *see* Factoring
  financing of, 364, 402–3
Acid-test ratio, 545
Acts of bankruptcy, 608
Addressograph-Multigraph Corporation, 290–91, 290 n.
Adjustment bureaus, 612
Age analysis of accounts, 354, 620–21
Aggregate data, 51
Air travel card, 105
American Bankers Association, 143, 143 n., 403
American Credit Indemnity Company of New York, 582
American exporters, 423
American Express credit card, 55, 67, 105
American Finance Conference, Appendix B
American Institute of Banking, 431
Analysis of financial statements; *see* Financial statements, analysis and interpretation
Analytical reports, 465, 468–72
Application, 202–7
  analysis of, 209–13
  for credit
    formal, 202–4
    informal, 204–5
  signature on, 206–7
Arrangements, 611–12
Assignment of accounts receivable, 402–3, 402 n., 601
Associated Credit Bureaus of America, 175, 222–24
  Collection Service Division, 224, 338–39
  Credit Bureau Reports, Inc., 224
Attorney credit reports, 455–56
  value of, 456
Attorneys, collection by, 340–41
Authorization of charge purchases
  "charge-send" purchases, 297–98
  off-the-floor, 295–97
    authorization telephone, 296
    pneumatic tubes, 295–96
    telautograph, 297
  sales floor, 293–94
    floor-release limit, 293–94
Average collection period, 326, 619

B

Bad-debt loss index, 348–50, 617–18
Balance sheet, 521
Bank charge accounts, 74–78
  advantages
    conversion of accounts into cash, 76
    freedom from department detail, 77
    increased sales, 76
  disadvantages
    cost of bank service, 77
    loss of store traffic, 78
Bank of America, 77 n.
Bank credit, *see* Cash loan credit *and* Commercial banks
Bank credit reports, 418, 454–55
  interpretation, 455
  nature, 455
Bank loans, kinds of, 363–65, 396–98
Bankruptcy
  acts of, 608
  arrangements (Chapter XI of Bankruptcy Act), 611–12
  debts not discharged, 610
  defined, 607
  discharge in, 610
  firms covered by, 608
  kinds of, 607
  petition in, 608
  possible improvements in, 613
  procedure, 608–10
  purposes of legislation, 605–7
  receiver in, 608–9
  referee in, 609
  responsibilities of credit managers, 610–11
  trustee in, 609
  "wage earners" provisions, 342
Banks, as source of information, 216, 454–55
Bartels, Robert, 433 n., 572 n., 592 n.
Barter, 4

Beckman, T. N., 126 n, 433 n., 572 n., 592 n.
Behind the Scenes of Business, 543–44
Bellemore, Douglas H., 455 n.
Billing, cycle, 67
Bills of exchange, Appendix A
"Black" lists, 223
Bonds, *see* Appendix A
  government, 366
Book accounts, 379, *see also* Retail charge account
Bradstreet Company, The, 462
Bradstreet, John M., 462
Bulk sales laws, 612
Business credit
  defined, 19, 362
  nature of demand for, 362–63
  productivity of, 372–73
  use of, 361–62

C

C's of credit, relative importance of, 188–91
Capacity, 188
Capital, 9, 188
Cash; *see* Money
Cash credit
  defined, 363
  intermediate-term loans, 365
  long-term loans, 364–65
  short-term loans, 363–64
Cash or credit policy, factors determining, 59–62
Cash discounts, 381, 388–92
  equivalent rates of interest, 391
  misuse of, 389–91
Cash loan credit
  commercial banks
    changing character, 144–47
    types of loans, 141–44
  consumer finance companies, 147–52
    character of loans, 150
    customers of, 150–51
    services rendered, 150
  credit unions, 40, 152–56
    character of loans, 154–55
    growth and increasing importance of, 155–56
    origin and characteristics of, 153–54
    types of customers, 155
  illegal lenders, 159
  industrial banks, 156–57
    character of loans, 158
    interest rates, 158
    Morris Plan Banks, 157
  institutions, 139–59
    relative costs of, 159–62
Cash terms, 386–87
C B D. terms, 385
Chandler Act, 605
Chapin, Albert F., 399 n., 429 n., 593 n.
Character, judgment of, 188–91
Charga-Plate, 290
Charge account banking; *see* Bank charge accounts
Charge account credit; *see* Retail charge account
"Charge-send," 297
"Charge take," 293–97
Chase National Bank, 77 n.
Chattel mortgage, 124–25
Checks, Appendix A
C I A. terms, 385
C.I T. Financial Corporation, 131, 364
C.O D. terms, 385–86
Collateral, 141, 265
Collecting accounts
  by adjustment bureaus, 612
  by assignment, 603–4
  by assignment of accounts receivable, 601
  by attorneys, 329, 340–41, 601
  by bankruptcy, 604–12
  by collection agencies, 329, 338–40, 601
  by composition arrangement, 329, 338, 601, 603–4
  by drafts, notes, and trade acceptances, 601, Appendix A
  by extension agreement, 329, 338, 601, 603
  by garnishment, 329, 340
  by invoices, 329, 601
  by letter, 329–37, 601
  by personal call, 329, 337, 601
  by statements, 329–32, 601
  by suit, 329, 341, 601
  by telegram, 329, 333, 601
  by telephone, 329, 333, 601
  by wage assignment, 329, 340
Collection agencies, compensation, 339
Collection percentage index, 351–53, 619–20
Collection policies, commercial
  factors affecting, 587–96
    capital, 590–91
    classification of debtors, 587–90
    collection policy followed, 592
    compensation, 591
    profit margin, 591–92
  type of business and of goods, 591
  types of records, 592–96
Collection policies, consumer
  factors affecting, 325–27
  impact of, 342–43
  types of, 324–25
Collection practices, commercial; *see also* Collection practices, consumer
  devices available, 601–13
  group-creditor actions, 603–12

Collection practices, commercial—*Cont.*
single-creditor actions, 601–3
third-party actions, 612
Collection practices, consumer
impersonal appeals stage, 328, 333–36
impersonal routine stage, 328, 330–33
legal action stage, 328, 337–42
personalized appeals stage, 328, 337
Collection system, commercial, preliminary steps in establishing, 596–98
Collection tickler system, 596
Commercial banks, *see also* Cash loan credit *and* Home mortgage loans
compensating balances, 400–401
credit policy, 399–400
discount rates, 398–99
interest rates, 398–99
kinds of loans, 396–98
line of credit, 400–401
need for loans from, 396
Commercial credit
changing attitudes toward, 378–79
defined, 363
direct investigation of, 448–56
evaluation of, 457–58
essential to mass-distribution, 377–78
financing the movement of goods, 376–77
sources of information classified, 443–44
sources of information, how to select, 444–47
Commercial Credit Company, 131
Composition arrangement, 338, 603–4
Conditional sales contract, 121–24
Conditions, 188, 196–97
Consumer credit
Civil War to 1920, 39
convenience, 11
cyclical pattern, 30
defined, 16
early use, 37
an economic force, 46
in the economy, 26–32, 46–47
government regulation of, 47–49
necessity, 11
1920 to 1930, 41
reasons for, 53–57
relative to business activity
disposable personal income, 49
index of industrial production, 50
personal savings, 49
retail sales, 49
since 1930, 43
standard of living, 11
types, 15, 17–19
Consumer debt outstanding, 43–45
Consumer finance companies; *see* Cash loan credit
Consumer goods, variety of, 113–14
Consumers, 26–27
Continuous report service, 472
Converse, P. D , 209
Cost analysis, 621–22
Credit
as aid to full employment, 28
as aid to higher standard of living, 29
as aid to mass distribution, 28
as aid to mass-production, 28
classification, 15
defined, 4
distinguished from capital, 9
distinguished from charity, 260 n.
distinguished from debt, 8
distinguished from wealth, 9
expansion and contraction of, 367–72
individual's use of
for convenience, 54–55
to increase life satisfactions, 53
for necessity, 55
as a power, 8
standards, 184–86
what it does for
consumer, 11
economy as a whole, 14
manufacturer, 13
retailer, 12
service concern operator, 12
Credit Bureau, Inc , *see* Retail Credit Company of Atlanta
Credit Bureau of Montreal, Canada, *see* Retail Credit Company of Atlanta
Credit bureaus, retail, *see* Retail credit bureaus
Credit and business cycle, 30–31
Credit clearing division of Dun & Bradstreet, Inc , 482–83
Credit Recommendation Service, 482–83
Credit Clearing House, *see* Credit clearing division
Credit Currents, 282
Credit department authorization; *see* Authorization of charge purchases
Credit department, commercial
operation of, 436–40
place in company organization, 431–33
in accounting department, 432–33
in financial division, 432
independent department, 433
in sales division, 431–32
tests of operations, 616–22
Credit department, retail
cost analysis of, 354–55
how to present measured results, 355–56
responsibility of, 345–46
tests of operation, 346–55
Credit Exchange, Inc., 501–2
Credit and Financial Management, 508

Credit grading form
for cash loan credit, 265
for open account credit, 264
for sales finance credit, 266
purpose of, 262–65
Credit instruments, Appendix A
Credit insurance, consumer
nature of, 320–21
origin and development, 321–23
regulation of, 323–24
types of policies, 320
Credit insurance, commercial
advantages, 578–79
basic features, 582–85
back coverage, 583
forward coverage, 583
cost, 580
disadvantages, 579–82
insolvency for purposes of policy, 577
purpose of, 576–77
Credit interchange bureaus
appraisal, 518–20
method of operation, 509–13
organization, 509
reports
contents and interpretation, 513–18
when to use, 518
Credit limits; *see* Credit lines, commercial
Credit limits, consumer, 271–75
advantages, 273–74
assigning of, 274–75
Credit lines, commercial
advantages, 568–69
limitations, 569
methods of setting, 569–73
use of house standard
controllable factors, 565–66
external factors, 564–65
whether to inform customer, 574
Credit lines, *see* Credit limits, consumer
Credit Management Handbook, 401–2, 436 n, 567 n., 615–16, 618, 619–20
Credit Management Year Book, 282
Credit manager; *see* Management
Credit Manual of Commercial Laws, 121 n., 421
Credit period, 381
Credit Research Foundation (NACM), 430
Credit risk, 6
Credit sales index, 350–51, 618–19
Credit Side of Selling, The, 452 n.
Credit standards, 184–85, 564–65
Credit Union National Association, 153, 155
Credit unions; *see* Cash loan credit
Credit Women's Breakfast Clubs, 281–82
Current ratio, 544–45
C.W.O. terms, 385

D

Daily reporter, 237–38
Data recording methods, 439–40, 622–23
Dauer, Ernst A., 26
Dauten, Carl A., 409 n.
Debt, 8
Debtor-creditor relationship, 4
Decision
essence of credit work, 260–61
evaluation and analysis leading to, 261–63
need for, 259–60
product of analysis, 269–70
Delinquency index, *see* Past-due index
Diners' Club, 55, 67, 105
Direct interchange among creditors, 213–19, 448–56
Discount operations (Federal Reserve), 369
Discounts, 381, 388–92
Divided payment accounts, 79
Documents, 6, Appendix A
Double-name paper, 397–98
Down payment, 116–17
Drafts, 420–21, Appendix A
clean, 421
documentary, 421
Dun & Bradstreet, Inc.
credit reports, 463, 465–73
use of, 473–74
evaluation of, 479–80
Latin American Sales Index, 417
methods of collecting information, 464–65
miscellaneous services, 463–64
organization, 462–63
origin and development, 460–62
ratings, 475–77
reference books, 463, 474–78
use of, by credit managers, 478
Dun, R. G., 462
Duncan, D. J., 282 n.
Duplicate invoice system, 596

E

Economic Advisory Council, 31
Efficient utilization of funds, 284
Einzig, Paul, 37
Electronic data processing, 439–40, 622–23
E.O.M terms, 387–88
Ettinger, Richard P, 587 n.
Exemptions, 341
Export credit insurance, 415–16
Export-Import Bank, the, 415
Export trade credit
currency and exchange, 412–13
problems of, 412–17
Extension agreement, 338, 603

F

Factbilt reports, 175–79, 226, 229, 235–37
Factoring, 364, 401, 405–8
  extent of, 406
  general method of operation, 405–6
  terms and charges, 406–7
  use by businesses, 407–8
False financial statement legislation, 532–36
Farrington Manufacturing Company, 290
Federal Credit Union Act, 153
Federal Housing Administration, 167
Federal Reserve Bulletin, 43
Federal Reserve policy
  impact of, 370–72
  instruments of, 368–70
FHA insurance, *see* Home mortgage loans
FHA Title I loan, 143
Filene, Edward A., 153
Finance companies, *see* Cash loan credit, Consumer finance companies
Financial credit, *see* Cash credit
Financial statements
  falsification of, 528–32
  as source of credit information, 521
  sources of, 522–23
Financial statements, analysis and interpretation
  false legislation, 532–36
    requirements for prosecution, 533
  methods of, 536, 539–59
  preliminary appraisal, 526–32
  purposes of, 523–26
Fixed assets, to fixed debt ratio, 555–56
Floor-plan financing, 132–33
Flow of goods and services 25
Flow of money and credit, 25
Forced savings, 29
Foreign credit information, sources of, 417–19
Foreign Credit Interchange Bureau, 412, 417–18
Foulke, Roy A., 381, 461 n., 543, 544 n
Freedom of choice, 56
Futurity, 4

G

Garnishment, 340
General Electric Credit Corporation, 364
General mercantile agency, 460
General Motors Acceptance Corporation, 131, 364
Gilliland, J. C., 74
GI loans, *see* Home mortgage loans
Glover Company, 295
Golieb, David E., 587 n.
Government credit; *see* Public credit
Grading the credit, 263–69
  credit grading form, 264–65, 268–69
  elements to be graded, 264–65
  supplementary uses, 270–71
Graduate School of Credit and Financial Management, 430
Grinager, R. M., 286

H

Handling of orders, 437–40
Hertz Rent-a-Car System, 105
Hilton "Carte Blanche," 55, 105
Home mortgage loans
  commercial banks, 171–72
  FHA insurance, 166–67
  GI loans, 165–66
  life insurance companies, 168–71
  mortgage companies, 173–74
  mutual savings banks, 172–73
  savings and loan associations, 168
  sources of, 167–74
Hooper-Holmes Bureau, Inc., 222, 244
Household Finance Corporation, 39, 152
Housing and Home Finance Agency, 165
Hudson's, J. L. credit plan, 89
Huegy, H. W., 266

I

Identification of charge customers
  coins and cards, 291–92
  credit plate, 289–91
  personal recognition, 292
  signature, 292
  waiver of, 292
Illegal lenders, 159
Industrial banks, 156–57
  character of loans, 158
  interest rates, 158
In-file report, 511–12
Inquiry
  credit group meetings, 453–54
  direct, 213–19, 448–56
  mail, 214–16, 452
  outside representatives, 217–18, 449–50
  telephone, 217
Installment credit, *see* Retail installment credit
Installment loans, 141
Instruments, Appendix A
Interchange of ledger experience; *see* Commercial credit, direct investigation of
Interest
  nominal rate of, 125–26
  versus service charge, 144
  true rate of, 56, 125–29, 142, 391
Interviews, 207–9
Investigation, consumer credit
  centralized clearance, 213–14
  direct inquiry, 213–19

Investigation—*Cont.*
direct inquiry—*Cont.*
by mail, 214–16
by outside representative, 217–18
by telephone, 217
through group meetings, 218
how much to investigate, 197–99
in-file ledger facts, 219–20
no investigation policy, 198–99
purpose of, 186–87
qualities to investigate, 191–96
what to investigate, 188–91
where to investigate, 199
Investment credit, 364, 408
Irons, Watrous H , 455 n.

J

Jewelers Board of Trade, 495

K

Kemmerer, Donald L , 63
Key-account reports, 472–73
Koontz, Harold, 440 n.

L

Laws, state installment sales, Appendix B
Ledger facts, 509, 513–14; *see also* Investigation, consumer credit
Legal interest rate, 98, 144, Appendix B
Letter of credit, 421–22, Appendix A
Life insurance companies, *see* Home mortgage loans
Limited acceptance, 5
Loans, *see* Cash loan credit *and* Commercial banks
London Guarantee and Accident Company, Ltd., 582
Long-term loans, 408–10
Lyon Furniture Mercantile Agency, 492–95
credit reports, 494–500
Lyon Red Book, 492–94

M

Mail inquiries, 214–16, 449
Management, commercial credit
changing status of, 429–31
credit executive, 428–31
education leading to, 430–31
functions of, 433–36
qualifications for, 429–31
Management, money-lending institutions, 299
Management, retail credit
credit department organization, 282–83
functions, 283–86
organizations of, 281–82
policy, 285–86
Management, service credit, 299
Master card file, 232–35
Maximizing of sales, 283, 434
McBee "Keysort" card, 593, 595
McCauley, J. L., 583 n.
Mechanical processing; *see* Electronic data processing
Medical credit bureaus, 257
Medium of exchange, 4
Mercantile agencies, general, *see* Dun & Bradstreet, Inc.
Mercantile agencies, special; *see* Special credit reporting agencies
Mercantile credit; *see* Commercial credit
Minick, J. B , 320 n
Minimizing of losses from bad debts, 283–84, 434–35
M O M terms, 387–88
Money, 4, Appendix A
Moran, E. B., 452
Morris Plan Banks, *see* Cash loan credit
Morris Plan Insurance Society, 321
Mortgage Bankers Association of America, 173
Mortgage bond, 170
Mortgage companies, *see* Home mortgage loans
Mortgages
amortized, 174-75
straight, 174–75
Mutual savings banks, *see* Home mortgage loans

N

National Association of Credit Management, 429
adjustment bureaus, 612
organization and activities, 506–8
trade group meetings, 453–54
National City Bank of New York, 41, 140
National Consumer Finance Association, 148
National Credit Office, Inc , 483–92
bank service department, 489
credit reports, 485-86
Metals and Electronics Industry Survey, 486
National Retail Credit Association, 224, 281
National Retail Merchants Association, 282
Neifeld, M. R., 147 n , 150
Net profit
to net sales ratio, 558–59
to net worth ratio, 557–58
to total assets ratio, 558
Net working capital
to debt ratio, 554
to fixed assets ratio, 556
represented by inventory, 554
New accounts opened, number of, 353, 620
Nonnotification plan, 402 n.
Notification plan, 402 n
Nugent, Rolf, 39, 64, 111–12

O

Occupations, analysis of, 209–12
Open account; *see* Retail charge account
Open market operations, 368–69
Opening of new accounts, 303–10, 436–38
Order approval
  automatic initial orders, 566–67
  handling from new customers, 436–38
  handling from old customers, 438–39
  nonautomatic initial order, 567
Orders to pay, Appendix A
Ordinary terms, 387

P

Packard, Vance, 145 n
Past-due index, 353–54, 620–21
Pawnbrokers, 38
Payables turnover, 554
Percentage-comparison method, 539–40
Personal finance companies, 147–52
  borrowers from, 150–51
  services rendered, 150
Personal loans, *see* Cash loan credit
Petition in bankruptcy, 608
Phelps, Clyde William, 120 n, 129 n, 348 n, 403 n, 405 n
Philanthropic agencies, 158
Phillips, C F, 282 n
Pneumatic tube system, 295–96
Policy, cash or credit, 184
Prepaid inquiry ticket, *see* Retail credit bureaus
Price discrimination, 391–92
Primary loss, 581
Private credit, defined, 16, 361
Prochnow, Herbert V, 403 n.
Productive credit, 372–73
Profit and loss statement, 521
Promises to pay, Appendix A
Promissory note, Appendix A
  advantages, Appendix A
Proximo terms, 387
Public credit
  defined, 16, 361
  use of, 365–66
Purchasing power, 30

R

Rail Travel Credit Agency, 105
Rating books, 237
Ratings, *see* Rating books *and* Reference books
Ratios
  liquidity, 544–54
  managerial efficiency, 557–59
  solvency, 554–57
  standard, 546–52
Ratio analysis, 542–59
  balance and proportion in, 543
  illustrated in use, 559–61
Receivables turnover index, 351–53, 553, 619–20
Receiver in bankruptcy, 608–9
Referee in bankruptcy, 609
Reference books, 474–78, 483, 486, 492–94, 495
Regular reports, 465, 466–68
Regulation W, 47–49, 66
Reinhardt, Hedwig, 429 n, 564 n, 579 n.
Remington Rand "Kolect-a-Matic" System, 593 n, 594
Replevin, 340
Repossessions, 340
Reserve requirements, 369–70
Retail charge account
  early use of, 62–64
  factors involved, 60–62
  how financed, 73
  increasing frequency of use of, 64–66
  per cent of total consumer credit, 65
Retail credit bureaus
  beginning and development of, 223
  collection service, 238
  confidential nature of, 225–26
  cost of services, 240–41
  educational activities, 239–40
  evaluation, 241–42
  organization and ownership, 224–25
  prepaid inquiry ticket, 229–30
  scope of, 232–40
  sources of information, 226–32
  supplementary services, 237–40
  types of reports, 235–37
Retail Credit Company of Atlanta
  cost of services, 255
  Credit Bureau, Inc, 244, 245 n
  Credit Bureau of Montreal, Canada, 244–45
  disappearance broadcasts, 255
  evaluation, 255–58
  history and organization, 245–46
  methods of investigation, 246–50
  reports, 250–51
  Retailers Commercial Agency, 244, 245 n
  special services, 251, 255
  users of services, 246
Retail credit manager, *see* Management, retail credit
Retail Credit Survey, 42
Retail installment credit
  changing attitude toward, 114–15
  characteristics of, 120–29
  charges for, 118, 125–29
  contract, 121–25
  development of, 111–14

Retail installment credit—*Cont.*
factors affecting decision to sell on, 108–11
how financed by retailers, 129–30
importance of, 112–13
increasing frequency of use, 112–13
principles of, 115–20
Retail revolving credit
basic plans, 83–87
benefits and pitfalls, 93–98
carrying charge involved in, 94–95, 98–100
chart and flexible limit plans, 87–88
compared with installment, 90
compared with open charge, 89–90
factors affecting, 90–93
state laws applicable to, 99–101
variations in, 88
Wanamaker's, 81
Retailers Commercial Agency; *see* Retail Credit Company of Atlanta
Revolving check credit, 141 n.
Revolving credit; *see* Retail revolving credit
Risk, 6
Robinson-Patman Act, 391–92
Rodgers, Raymond, 403 n.
R.O.G. (A.O.G.) terms, 389
Rogers, Thomas W., 41, 132
Russell Sage Foundation, 40, 148

S

Safety factor, 524
Sales
to fixed assets ratio, 557
to net working capital ratio, 553–54
to net worth ratio, 556
to receivables ratio, 351–53, 553, 619–20
to total assets, 557
Sales finance companies
dealer reserve, 134
defined, 130–31
development of, 130–31
financing of consumer purchases, 129–30
nonrecourse plan of purchase, 133
recourse plan of purchase, 133
repurchase plan, 133
wholesale financing, 132–33
Sales representatives, credit, 316–17
Salesmanship
good will activities, 314–17
how to get credit customers, 303–10
how to get more sales from credit customers, 310–14
selling credit department to others, 317–18
Salesmen as credit reporters, 451–52
value, 452
Savings and loan associations; *see* Home mortgage loans
Savings and loan mortgage, 169
Scripbook accounts, 79
S.D.-B.L. terms, 385–86
Sears, Roebuck & Co , 301
Secured loans, 397
Service credit, defined, 102
Shaw, Edith, 281–82
Sheraton Dining Club, 55, 105
Shultz, William J., 429 n., 564 n., 579 n.
Signature identification, 292
Simple-evaluation method, 539
Single-name paper, 397
Single-payment loans, 44, 138, 141
Skips, 96
Sloan v. *Sears, Roebuck and Co.,* 99 n.
Small Claims Courts, 341
Small-loan companies; *see* Personal finance companies
Small-loan laws, 147–50
Special credit reporting agencies, 481–504, 506–20
appraisal of services rendered, 502–4
Special-purpose reports, 472–73
Standards, credit, 184–85, 564–65
Statute of Limitations, 341
Stock turnover ratio, 545, 553
Suing of debtor, 341
Survey of Consumer Finances, 52
Survey of Current Business, 50
Survey Research Center, University of Michigan, 52

T

Tappan, Lewis, 461
Teenage accounts, 195
Telautograph, 297
Telephone credit card, 105
Terms of sale, 185–86, 379–92, 419–23
Terms of sale in commercial trade
cash terms, 386–87
consignment terms, 389
establishment of, 379–81
factors influencing, 381–85
ordinary terms, 387
prepayment terms, 385–86
under Robinson-Patman Act, 391–92
single-payment terms, 387–88
special-datings terms, 388–89
Terms of sale, export, 419–23
Tests of credit department operations; *see* Credit department, commercial *and* Credit department, retail
Thomas, Rollin G., 367 n., 396 n.
Time, 6
Total assets, to fixed assets ratio, 555
Trade credit; *see* Commercial credit
Trade discounts, 389–90

Trade group meetings, *see* National Association of Credit Management
Trapp, Joseph T., 577 n.
Trotta, A. Leonidas, 96
Trustee in bankruptcy, 609

U

Undue optimism, 528
Uniform Small Loan Laws, 147–50
  provisions of, 149–50
Universal credit card, 106
Unsecured loans, 397
U.S. Bureau of Census, 38
U.S. Department of Commerce
  Bureau of Foreign and Domestic Commerce, 42, 419
  Survey of Current Business, 27
U.S. Treasury, Appendix A
Usury, 98, 144

V

Veterans Administration, 165–66

W

Wage assignment, 340
Wage earner's plans, 342
Wall, Alexander, 544
Wealth, 9
Welshans, Merle T., 409 n
Where-got, where-gone method, 540–42
Wholesale financing, 132–33
Window dressing, 527

Y

Young, Ralph A., 370 n.

Z

Zone of operation, 510

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