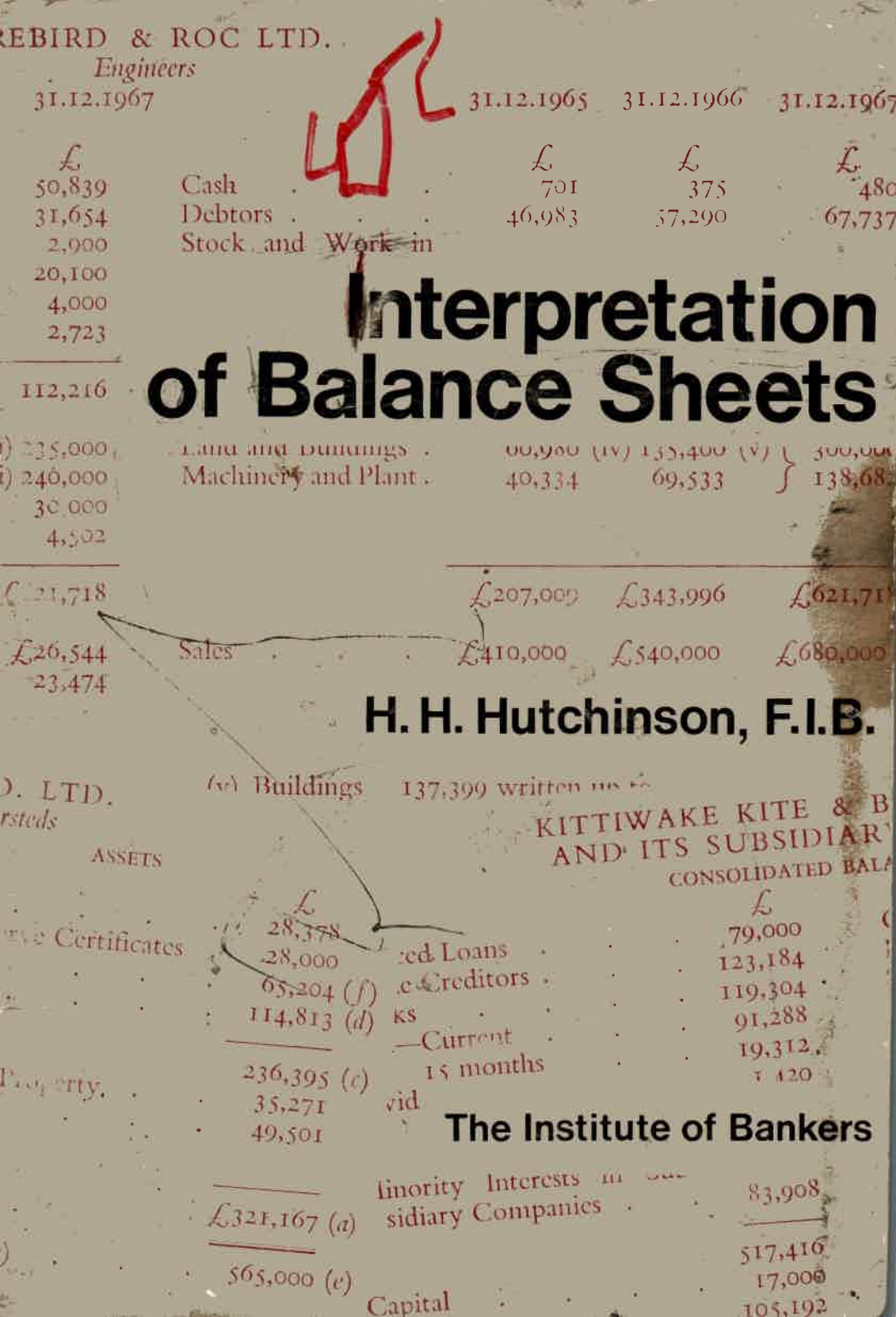
REBIRD & ROC LTD.
Engineers
31.12.1967
31.12.1965 31.12.1966 31.12.1967
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50,839 Cash 701 375 480
31,654 Debtors 46,983 57,290 67,737
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2,723
112,216
Land and Buildings
Machinery and Plant 40,334 69,533
£21,718 £207,009 £343,996 £621,71
£26,544 Sales £410,000 £540,000 £680,000
23,474
Interpretation of Balance Sheets
H. H. Hutchinson, F.I.B.
D. LTD.
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AND ITS SUBSIDIAR
CONSOLIDATED BALA
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565,000 (c) 517,416
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H. H. Hutchinso

THE INSTITUTE OF BANKERS
10 Lombard Street, London EC3V 9AS

1967

evised edition 1972

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Foreword

The first edition of *Interpretation of Balance Sheets* appeared in 1955. Since then it has become one of the most popular Institute publications, with sales of over 45,000 copies.

In this fourth edition, essential revision has been carried out, but the character of the original has been preserved. The principles of interpretation have not changed greatly since 1955, and the main textual addition is a new chapter on factoring. The appearance and ease of reference have been improved by the addition of a contents page and more headings.

If *Interpretation of Balance Sheets* were being written for the first time today, the examples might be set out in columnar form, but this is a matter of convenience rather than of principle. Again, the book's approach to lending is the traditional one, whereby advances are theoretically repayable on demand, subject to annual review; it does not cover the trends in banking towards formal medium-term lending and even equity participation.

Despite these recent developments, basic lending principles remain the same, and it is hoped that this revised edition will allow thousands more candidates—and their senior colleagues—to benefit from the author's clear style and common sense.

Institute of Bankers, 1972

I

The practical approach

This booklet is concerned with the interpretation, not the preparation, of balance sheets, and its viewpoint is that of the lending banker, not the shareholder.

A notable disadvantage of balance sheets is that they record a position which existed on a certain date in the past, whereas what a banker who reads them chiefly wishes to know is the position which is likely to arise in the months or years to come. It is proposed here to discuss, therefore, not only methods of gathering factual information from a balance sheet, but also its value as a guide in the assessment of the future outlook for the business to which it relates.

In itself a balance sheet has little significance, and to base an interpretation exclusively upon an examination of its constituent items, without knowledge of the real, living, changing enterprise which it only imperfectly depicts, is to attempt the futile. There is not much to be gained, for example, by pondering over a figure for stock-in-trade if the nature of the business has not been ascertained. The stock might consist of ladies' hats or fresh fruit or pig iron or a thousand and one other things. If it were possible to devise a universal key which would interpret every balance sheet purely on the figures comprised in it, a book of tables in which a banker could find precise mathematical answers to all his questions and so might assess his risk by resolving a formula, banking life would be much simpler than it is today—and much less interesting. But no such universal key exists. Balance sheets are as varied as the human activities which they represent and cannot be usefully interpreted by means of a formula. Each one, to be properly understood, should be studied as an individual thing with its own merits and peculiarities. As Bernard Shaw said (in a different context), the golden rule is that there is no golden rule.

To know how an accountant sets about constructing a balance sheet is an advantage to a banker, but it is not his prime concern; after all, a doctor takes the temperatures of his patients without needing to become an expert in the manufacture of thermometers. Conversely, the ability to break down a balance sheet into the original elements from which it has been composed is, by itself, not enough. Of greater value is the capacity to perceive the significance of the relationship which the balance sheet figures bear to each

other and to judge the various items in the light of what is known of the business generally. For instance, a figure of £5,000 for book debts does not carry the same implications if trade creditors amount to £2,000 as it would carry if the trade creditors figure were £10,000. And there is not much point in comparing the two figures at all without first finding out whether that particular business normally sells its goods for cash or on credit.

All this is the merest common sense; but then so much of the interpretation of balance sheets is mere common sense. The practical man, who knows how to run a business and how to make it pay, will usually form a much truer judgement of a balance sheet—assuming that he is able to read one at all—than can be obtained from the subtlest and most convincing exponent of pure theory.

Of necessity, these articles are less practical than the writer would have wished them to be. But it would obviously be impossible to reproduce actual balance sheets and the circumstances of real banking problems for discussion in public. An attempt has been made to achieve verisimilitude, largely by repressing the temptation to prove or demonstrate theoretical points by the production of distorted examples which could not possibly arise in practice. However, to embark upon the concoction of balance sheets entails making a voyage over perilous and uncharted seas; and whether the attempt at realism has fallen overboard in the process must be left to the reader to judge.

The banking proposition

When a banker examines a balance sheet his prime and practical concern, generally speaking, is a banking proposition involving the lending of money. Very probably he has been asked to lend, or to continue lending, without security and he wishes to ascertain whether the lending may be considered safe and whether repayment within a reasonable time can be fairly foreseen. Until he knows what banking proposition is to be put before him there is little object in a close study of the balance sheet. He will not know how a bank advance is intended to fit into the general picture and he may waste a great deal of time. To lend £10,000 to a company owning assets which exceed its liabilities by £75,000 is a very different thing from lending the same company £100,000.

A balance sheet, then, may be looked upon for our present purpose as an aid to the assessment of a banking proposition. It is one source of some of the relevant information and although it is an important document it should be kept sternly in its place—which is to say in perspective.

Of course, there is more to know about a banking proposition than

simply the amount of money required. The use to be made of the money is equally important. To lend a garage proprietor £12,500 to pay for new cars which he has already contracted for sale may be all very well; repayment should be almost automatic. To lend him the same amount of money so that he can maintain a larger stock of spares is something quite different; repayment will not come immediately from sale of the spares unless he reduces his total stocks to about their former level, which is the opposite of what he intends to do. If he asks for £12,500 to spend on altering his showrooms, still other considerations arise, as he could not repay by restoring his showrooms to their former state even if he wished to do so. Government policy has frequently compelled British banks in recent years to think critically about the use to be made of the money they are asked to lend; but we are not here concerned with government policy, and it is as a matter of sound practical banking that stress is laid upon the importance of ascertaining the purpose of an advance.

Asking the right questions

The main features of any banking proposition may be tabulated as follows:

(1) How much is required?

(2) What is to be done with the money?

(3) What are the plans for repayment?

(4) What will be the bank's position if the plans for repayment go wrong?

Points 1, 2 and 3 should be clearly grasped and in mind before examination of the balance sheet commences. Point 4 is a matter for the banker's personal assessment after he has examined the balance sheet and studied other relevant factors; he must also form his own opinion of the probability or otherwise of a failure of the plans for repayment as they are described by the borrowing customer.

With a firm grasp of what is proposed the banker should turn his attention to obtaining a clear picture of the business which wishes to borrow the money. What is the nature of the business? Who owns it? Who runs it and with what success? Is it a large business or a small one in relation to the proposed borrowing? Is it stable and well-established? Are profits distributed or retained in the business? He should also consider how the banking proposition will fit into the picture which is taking shape in his mind and should form some idea of what the balance sheet position is likely to be after the bank has lent.

Much of the necessary information may already be available to him from his general knowledge of his customers; some he can obtain by examining the current account; some from a study of the balance sheet.

It may be helpful at this point to introduce an imaginary banking proposition together with the balance sheet of the company concerned.

CASE 1

Merlin Smew & Co. Ltd. is a private limited company engaged in the manufacture of fine worsted cloths. The business is old-established and enjoys a good reputation in the trade; it has prospered under its present management.

The bank is asked to renew an unsecured overdraft limit of £45,000 for use in case of need. No substantial capital expenditure is contemplated and the money, if taken, will be used to finance trading. Little use has been made of the limit over the past twelve months and the account usually runs in good credit.

MERLIN SMEW & CO. LTD.
Manufacturers of Fine Worsteds

LIABILITIES	£		ASSETS	£	
Trade Creditors	35,874		Cash	28,378	
Cpn. Tax— 4 months	8,090		Tax Reserve Certificates	28,000	
16 months	24,000		Debtors	65,204	(*f*)
Dividends (gross)	13,410		Stock	114,813	(*d*)
	81,374	(*b*)		236,395	(*c*)
Capital	100,000		Freehold Property	35,271	
Reserves	49,100		Plant, etc.	49,501	
Profit and Loss Account	90,693	(*h*)			
	£321,167			£321,167	(*a*)
Profit (Year) after—	36,000	(*g*)	Sales (Year)	565,000	(*e*)
Tax	24,000				
Depreciation	7,768				
Directors' Remuneration	12,500				

Turning now to the balance sheet of this company (as shown above) we observe, first of all, that it has been set out in a simplified form. The object of this is to give prominence to certain features and also to present the main facts and figures without a distracting mass of details and technicalities. Extracting the figures of a balance sheet in this way forms a useful preliminary

to an assessment and, besides simplifying the general picture, prevents the overlooking of important items. The method of extraction adopted in these articles will be fully described later and it will suffice to remark here that the underlying principles are easy to grasp and may be mastered in a few minutes. Doubtless there are variations in detail between the methods of extraction practised in different banks, but the principles must be common to all.

A survey of the figures reveals the following points:

(i) That at the date of the balance sheet the company had at its disposal assets of £321,167 (*a*). No fictitious or intangible assets are included in this figure.

(ii) That at the same date the company's debts totalled £81,374 (*b*) (including a sum of £24,000 for corporation tax not due for some months after the balance sheet date.)

(iii) That the company's debts were covered nearly four times over by assets. In other words, if the assets were worth together only one-quarter of their aggregate balance sheet value all the debts could still be paid in full.

(iv) That the company had a surplus of £239,793 [(*a*) minus (*b*)].

(v) That out of total assets of £321,167 (*a*) no less than £236,395 (*c*) consisted either of cash or of items easily and regularly turned into cash (current assets). Thus, obviously, the company could pay all its creditors without having to sell its factory or plant; in fact the current assets are almost sufficient to cover all debts three times over [(*c*) compared with (*b*)]. In other words, the balance sheet shows a liquid position—and a strong one.

(vi) That stocks on hand were not too high in relation to sales [(*d*) compared with (*e*) shows stocks on balance sheet date equivalent to about one-fifth of the total sold during the preceding year]. This is a manufacturing business and some time necessarily elapses between the purchase of yarn and the sale of cloth. If it were a purely merchanting business, selling goods in the same state as that in which it bought them, a higher rate of turnover of stocks might be expected, and would be evidenced by a stock figure which formed a smaller fraction of the figure for annual sales. Whether in any given case stocks are too high in relation to sales cannot be estimated without some knowledge of the course of business followed and where a banker is in doubt he should talk the matter over with his customer

and use his own common sense and experience. For example, a whisky distillery advertising 'Not a drop sold till it's seven years old' will have a rate of stock turnover much slower than that of a fishmonger advertising 'Fresh fish daily'.

(vii) That debtors were not unduly high in relation to sales [(*f*) compared with (*e*)] suggests that only one-ninth of the goods sold during the year had not been actually paid for on the date of the balance sheet. Here, again, knowledge of the course of business pursued by the customer is necessary for an intelligent view. In this case sales would be on credit terms (few businesses, except retailers, sell much on cash terms nowadays) and a total of one-ninth outstanding suggests about 5–6 weeks' credit, varying, of course, if the trade has a heavy seasonal swing. At all events, if the outstanding one-ninth contains any debts which may prove to be bad the company has a surplus large enough to stand the loss. Bad debts are not probable, however, where a business has the successful profits record that this one can show.

(viii) That good profits were earned during the year (*g*) and have been made in the past (*h*). Note that profits earned and left in the business need not remain in the profit and loss account, but may appear as reserves, or may have been capitalised.

(ix) The only puzzle is why an overdraft limit of £45,000 is required at all. Perhaps, if several large contracts coincided the account would become temporarily overdrawn. Possibly the directors are preparing for a large expansion in turnover.

A branch manager could soon elicit this information and in recommending renewal of the overdraft facilities might add the following remarks to the usual form of application to his head office. 'The directors ask for renewal for use in case of need in the ordinary course of trading. Probably no overdraft will be taken unless large contracts coincide. The latest balance sheet is attached, showing a surplus of £240,000 over liabilities of £81,000 and a strong liquid position; and although we are unsecured there cannot be any risk. Good profits continue to be earned and a substantial proportion is left in the business'.

Head office ought to give an unqualified sanction.

The balance sheet summary

Before leaving the balance sheet of Merlin Smew & Co. Ltd., we will briefly examine the principles underlying the method of extraction demon-

strated by the simplified layout on page 4. The distinctive feature of the extraction is the horizontal line which divides both the liabilities and the assets into two groups as follows:

LIABILITIES (OR CLAIMS) SIDE

The line serves to divide the true liabilities from the owners' equity. *Above the line* are shown all the true liabilities of the business, including provisions for liabilities not yet due and including also any reserves which are in the nature of provisions; most reserves nowadays are not. Whether a reserve should be shown above the line or below depends on an assessment of the real purpose of the reserve. If the real purpose is to provide for some future liability or expenditure, or to offset some expected loss, the reserve should go above the line. For instance, a reserve for repairs normally indicates future expenditure necessary to maintain the value of the fixed assets, and should go above the line. A stock reserve will also go above the line if it indicates a doubt whether the stock will realize the figure at which it is extended in the balance sheet.

If there is any doubt about the purpose of a reserve, enquiry should be made of the directors. Where there are such medium-term liabilities as mortgages or debentures with fixed repayment dates, the dates should be shown.

Below the line are placed the capital, the remaining reserves and the balance of profit and loss account if in credit. If profit and loss account is 'in the red', i.e., in debit, it will appear among the fictitious assets on the other side of the extraction of the balance sheet, and, together with other fictitious assets, should be deducted from the total of capital and reserves in order to arrive at the true surplus, or net worth, of the business as disclosed in the balance sheet.

ASSETS SIDE

The line divides the quick or current assets from the fixed, long-term, intangible or doubtful assets. *Above the line* is the place for the assets relating to the day-to-day trading. For an ordinary commercial or industrial business they will consist of cash; debtors; stock; work-in-progress. With these should be included any *marketable* (i.e., quoted) investments and also any tax reserve certificates, or other temporary deposits of cash, such as local authority deposits, building society deposits etc.

Certain items which accountants include amongst the current assets are better placed for our purposes below the line. These include non-quoted investments; investments in and amounts due by subsidiary or associated

companies; and loans to directors. Prepayments also are usually placed below the line, but the amount is commonly quite small and so the point is not very important. The writer has, however, seen a balance sheet which disclosed a capital of £40,000 and prepayments of £51,000.

Below the line are set out such items as land and buildings, plant, motor lorries, etc.; the intangibles such as goodwill, patent rights and kindred items; fictitious assets such as preliminary expenses or a debit balance on profit and loss account; and any other assets which either do not relate to the day-to-day trading or are in any way dubious. Amounts owing by the directors or by associated companies go below the line not because they are considered bad, but because payment is frequently a matter of arrangement between the parties and may not arise naturally in the ordinary course of business.

To sum up: on the liabilities side the horizontal line divides the true liabilities and provisions from the capital and free reserves. On the assets side it divides the current assets from the rest.

The extraction of a balance sheet is not a complex matter, but it calls for some judgement and also for some consistency of practice if the results are to be clear and simple to grasp. Each person should ascertain and follow the practice of his own bank, but it is better to do so with understanding than by rule of thumb.

At the foot of the extraction we show certain figures taken not from the balance sheet, but from the usual accompanying accounts. Below the assets column appears the total of sales for the year, which may be obtained from the trading account. Below the liabilities column appears the net profit figure after allowing for tax and for the other items shown. The net profit (or loss) figure should always be compared with the increase (or decrease) in the surplus since the date of the last balance sheet and any difference accounted for. Any exceptional features, such as the introduction of fresh capital, the recovery or writing back of tax, profits or losses on sale of capital items, should be specially noted; and a prominent comment should be added if the company is factoring or discounting its book debts (see p. 22 on factoring).

CASE 2

It was easy to see from the balance sheet of Merlin Smew & Co. Ltd., that the proposed limit involved no risk. Let us now look at the affairs of a company in different circumstances.

Dipper Dunlin & Co. Ltd. are general merchants and shippers, buying a miscellaneous range of goods and selling them at home or abroad wherever

they find a suitable market. Some of their special lines are manufactured for them under contract. The account is an old one, going back to the days before the first world war. The managing director is the son of the original founder, and there is another director who joined the board when the company absorbed another business some years ago. Both directors are respected and trustworthy.

There is an overdraft limit of £15,000 originally granted for trading purposes and this is unsecured except for the joint and several guarantee of the directors. Formerly the account fluctuated well and credit balances were often seen, but over the past year there has been a marked change, fluctuations have grown progressively less, the overdraft now rarely falling below £12,000, and there have been some excesses.

The new balance sheet (below) accompanies a request for continuance of the limit.

DIPPER DUNLIN & CO. LTD.

General Merchants and Shippers

LIABILITIES	£	ASSETS	£
Trade Creditors	45,788	Cash	376
Loan Creditors	7,412	Debtors	37,972
Bank	14,626	Stock	31,732
	67,826		70,080
Capital	32,000	Furniture, Motors, etc.	5,902
Reserves	804	Trade Investments	4,066
Profit and Loss Account	2,182	Shares in Subsidiary Companies	2,300
		Patents and Licences	15,466
		Goodwill	4,998
	£102,812		£102,812
Loss (Year) after—	764	Sales (Year)	156,546
Tax	Nil		
Depreciation	636		
Directors' Remuneration	4,000		

The figures show liabilities of £67,826 and total assets of £102,812, giving a nominal surplus of about £35,000. However, the assets include goodwill, £4,998, and patents and licences, £15,466, and after deduction of these intangibles the surplus shrinks to less than £15,000. Even this is open to question as the assets also contain trade investments, £4,066 (a new item

since the last balance sheet) and shares in subsidiary companies shown at £2,300. The trade investments may or may not be marketable. The shares in subsidiary companies may be worth many thousands of pounds or nothing at all; without a sight of the balance sheets of the companies concerned it would be unwise to hazard a guess. If both these items were bad the surplus would fall below £9,000.

The liquid position is naturally even bleaker and there is practically no liquid surplus (£2,254 over £67,826). Profits are a minus quantity after the directors' drawings of £4,000.

Faced with these figures and bearing in mind the serious worsening of the run of the account, a branch manager might well feel concerned. Part of the heavier overdraft will have arisen as a result of the investment of £4,066, but more than that is needed to account for a swing over from an in-and-out overdraft to a solid lending of £12–15,000. Capital expenditure of £8–10,000 could account for the remainder of the change and whether this is, in fact, the cause may be ascertained by comparing the total of fixed assets in the new balance sheet with that in the previous one. If there has been no substantial capital expenditure the probability is that amongst the goods purchased during the year some £8–10,000-worth have proved unsaleable or at least have not yet found a buyer. The stock figure of £31,732 must accordingly be suspect. Other possible explanations are that debtors are taking longer to pay or that one big debt has been outstanding for a long time, or that creditors have been insisting upon prompter settlement; there may be a combination of these causes. A detailed comparison of the new balance sheet with the previous one will help in elucidating the problem, but in the end the best plan in such cases is to ask the customer for an explanation and then to check what he says by reference to the balance sheet figures.

The poor results for the year also throw doubt upon the stock figure. In a business like this stocks which have been well-bought and are turning over should naturally produce good profits.

If the company has, indeed, purchased £10,000 of goods which are unsaleable a serious situation may arise. We have seen that the surplus (or net worth) of the business may be only £9,000. A loss of £10,000 would transform that surplus into a deficit and the company might be forced into liquidation. This, in its turn, would create further losses since on a forced sale the remaining good stocks could not be relied upon to fetch more than 50 per cent. or so of their balance sheet valuation—say, £11,000 instead of £21,732. They might not realize more than £5,000 or £6,000. Thus, the first loss of £10,000 on the bad stock might well lead to an equivalent or

greater loss on a forced sale of the good stock. Any furniture and fittings would also sell very badly in a liquidation.

Of course, there is no need to suppose that a business is faced with ruin if it is left with unsold stock or, indeed, if it incurs an outright loss. The question is: has the business sufficient resources of its own to meet the loss—and, in particular, has it sufficient liquid resources? If a company loses money, it loses first the profits and reserves accumulated in the past, then its share capital and only after these are gone is the money of creditors imperilled. The whole stake of the shareholders in the business—capital, reserves and undistributed profits—has to be lost before the creditors lose a penny piece. Thus the surplus (net worth) forms a margin or buffer between the creditors and disaster.

For that reason it is important to ensure that an unsecured lending by a bank is not too great in relation to the surplus in the business: that the margin of safety is adequate. The adequacy of the surplus in relation to the total liabilities should also be watched, since in the last resort it is a margin of protection for all creditors.

What is a proper ratio between the surplus and an unsecured bank lending depends so much on the circumstances of each individual case that no useful figure can be suggested (there is no formula). It would be rash to lend without security the equivalent of half the surplus in a business if the surplus were all sunk in fixed assets or if there were a bad profit record or if unsold stock were too high. On the other hand, certain types of borrowers frequently borrow much more than their surplus. Corn merchants, for example, may overdraw heavily at the peak of their season when they are buying grain to fill firm orders.

Returning now to the affairs of Dipper Dunlin & Co. Ltd., let us suppose that the branch manager ascertains by enquiry that the 'trade investment' of £4,066 represents an interest-bearing loan obtained in lieu of an unsatisfactory book debt, and that the shares in subsidiary companies are valueless. The directors admit that they have paid £10,000 for stocks which have proved difficult to sell, but they still hope to bring off a satisfactory deal.

What the branch manager then decides to recommend will depend largely on the value which he is able to attach to the directors' guarantee which is held. If it is safely worth £10,000 there cannot be much risk; if it is of little real value some provision against ultimate loss may be advisable. He would, in the normal course, already know something of the position of the guarantors.

It would not be much use demanding a debenture, because of the publicity involved, which, in the circumstances of this company, would promptly

bring pressure from creditors and, unless the limit were increased so that they could be paid, liquidation might supervene before the debenture would have had time to 'harden'.

Balance sheet check-list

The main value of a study of a balance sheet is the help it gives towards obtaining a clear idea of the business to which it relates. In studying a balance sheet:

The *nature of the business* is an important consideration because it indicates what the stock consists of and suggests how rapid a turnover ought to be expected.

The *purpose of the proposed advance* is an important consideration because it indicates whether the advance will be self-liquidating, helps to show whether it should be short-term, fluctuating, or solid, and enables one to estimate whether the result of the lending will be an impairment of the liquidity of the business.

The *surplus* (net worth) shown in the balance sheet is important because it represents a margin or buffer which stands between the creditors (including the bank) and disaster. It is the stake which the proprietors have in the business and would all have to be lost before creditors could suffer.

The *liquid position* is important because it indicates whether liabilities could be met without recourse to the fixed assets of the business. To ensure this, there should be a margin of liquidity (liquid surplus) of adequate size in relation to the true liabilities. Ideally, the total of debtors (plus cash and quoted investments, if any) should equal the true liabilities, including the bank, so that the stock belongs to the proprietors. The many exceptions to this rule, however, make it of limited value in practice.

The relationship of *stock to annual sales* is important because it may point to over-stocking or unsaleable stock.

The relationship of *debtors to annual sales* is important as a rough guide to the average period of credit granted.

The *profits record* is important because if adequate and steady profits have been earned they support faith in the balance sheet value of the current assets and in the business capabilities of the management. Profits which have been left to accumulate in the business indicate growth and prudent control.

Working capital

The day-to-day running of a business requires finance over and above that which is necessary for purchase of fixed assets, and the volume of work or trading which can safely be undertaken depends not only upon the equipment and labour which the business controls but also upon the finance which is available. Debtors, stock and work-in-progress have to be carried all the time, and whilst the amount of each of these and the aggregate total of all of them may fluctuate very considerably, there must always be a matching aggregate total of finance upon which they can ride. This finance is provided either from the proprietors' stake in the business (capital, reserves and undistributed profits) or by borrowing (loan creditors, bank overdrafts, mortgages, etc.) or by obtaining credit for goods and services employed. In addition, money earmarked to meet liabilities not yet due, taxation for example, may be used meanwhile to finance current trading. And since none of these sources provides unlimited money or credit it follows that there is an upper limit upon the total of current assets which may be carried.

The proprietors' stake in an ordinary business, then, ought to be sufficient to cover, in the first place, the amount sunk in fixed assets and intangibles plus any amounts lent to directors or invested in other businesses; there should then be a further sum available to finance trading (i.e., available as working capital). To ascertain from a balance sheet how much working capital there is, it is necessary merely to subtract from the surplus the total of those assets which under our method of extraction are shown below the line.

Here is a simplified balance sheet by way of illustration:

AORNON LIMITED

	£		£
Trade Creditors	6,000	Debtors	8,500
Loan Creditors	1,250	Stock	5,790
Bank	1,175	Work in Progress	4,625
Cpn. Tax— 5 months	740		
17 months	1,520		
	10,685		18,915
Capital	6,500	Land and Buildings	5,000
Reserves	4,600 (a)	Plant, etc.	1,200
Profit and Loss Account	3,580	Loan to a Director	250
	£25,365		£25,365

The business has a surplus of £14,680 (*a*) of which £6,200 is sunk in premises and plant and £250 has been lent to a director. Deduction of these items from the surplus leaves £8,230 available as working capital for the running of the business.

Current assets totalling £18,915 were being carried at the balance sheet date and these were being financed from the following sources:

	£
Working capital	8,230
Borrowed money	2,425
Credit obtained for goods, etc. employed	6,000
Unpaid tax	2,260
	£18,915

The total of current assets naturally fluctuates from day-to-day, with a corresponding fluctuation on the other side of the balance sheet. There will also be changes in the composition of the figures for current assets and current liabilities. Thus a payment of £500 for wages would increase both work-in-progress and the bank overdraft; payment by a debtor of an amount of £750 would decrease both debtors and the bank overdraft; purchase of raw materials for £600 would increase trade creditors and stock; payment of £500 on account of taxation would decrease the tax liability and increase the bank overdraft. But the two sides could not get out of line. It would not be possible, for example, to acquire a net £10,000 more stock *and* increase the total of current assets by that figure without a corresponding increase on the liabilities side. The business would of necessity either owe for the stock or pay for it, and in the latter event the money paid would have to be provided either from earnings or as additional share capital or by a lender.

Effect of increased turnover

In all businesses, if the volume of trading and the course of business remain steady, the limits within which the total of current assets will fluctuate are fairly well defined and so long as the maximum figure for current assets can be matched without overstretching the finance available the trading remains four-square and firm. But suppose that the directors decide—or are tempted—to undertake twice as much business, what will be the effect on the structure of the trading finance? Doubling the turnover, if the same period of credit is still allowed to purchasers, will double the

average amount owing by debtors and probably the peak amount also. Doubling the output of the factory will perhaps double the amount of work in progress. Stocks of raw materials and of finished goods will also show an increase. Thus the total of current assets will certainly increase very sharply and may well double as the turnover doubles. What about finance? Unless more cash capital is introduced, the amount of working capital available will remain as it was, rising gradually if profits are earned. Trade creditors will increase, since more raw materials will be purchased, probably to about double the former figure if the company has a good record, but this will not fill the whole gap. Let us look again at the trading figures in the balance sheet of Aornon Ltd.

If trading doubles, the current assets of Aornon Ltd. may rise to about £38,000—perhaps more at peak periods. How can this be carried?

	£
Working capital (as before)	8,230
Credit obtainable (double)	12,000
Unpaid tax	2,260
	22,490
Balance to be raised by borrowing	15,510
	£38,000

It will be seen, therefore, that if no additional capital is put into this business a very large increase in borrowing would become necessary if turnover were doubled (possibly £15,510 compared with £2,425). In addition, a larger margin of cash would have to be available for peak periods or for emergencies. If the company asked their bank for the additional money, an overdraft limit of, say, £16,000 would be needed instead of about £1,500—a very different proposition in relation to a balance sheet surplus of £14,680.

By a similar calculation it will be found that redoubling the turnover might necessitate an overdraft limit of as much as £40–50,000.

Perhaps it should be stressed here that doubling the turnover does not automatically entail doubling the current assets, trebling the turnover trebling the current assets and so on. Any large increase in turnover leads to an increase in current assets but the extent of the increase is a matter for calculation and enquiry.

Overtrading

Overtrading, that is to say undertaking more business than can be conveniently supported by the finance available, has ruined many good little businesses and not a few large ones. It is difficult for an enterprising young manufacturer to understand that there is anything imprudent in accepting profitable orders; moreover he knows that if he declines them he may not get similar chances in future. If he takes on more work than he ought there follows inevitably a distortion of his trading position, and this will eventually be reflected in his balance sheet. In order to have cash for wages he postpones paying his trade creditors; when the trade creditors press he starts trying to collect his book debts early, or pays the creditors small amounts on account, or gives out post-dated cheques, or persuades the bank to give him a temporary excess overdraft on the strength of money expected in from debtors. Eventually, in a bad case, he may reach a point where he has a stock of partly-manufactured goods which cannot be completed because he can neither pay cash for some essential components or materials, nor obtain them on credit. Or he may have to discharge labour in order to reduce his wages bill; then production will fall behind and ready cash will be further off than ever. His skilled workmen will leave him for more reliable employment.

The writer knows of a case where a whole consignment of expensive machinery was held up for two months for lack of paint to finish it off. The workmen in the factory were highly skilled, and rather than allow the team to disperse, the manufacturer kept them employed on such parts of the jobs in his overflowing order book as could be turned out from the materials which he had in store. Meanwhile every penny which he could raise, from his bank and elsewhere, went in wages and the factory became cluttered up with half-finished jobs; nothing could be completed and so nothing could be delivered and turned into money.

However, there are degrees of overtrading and it should not be supposed that every business which overtrades is doomed. Indeed some very fine and substantial businesses have passed through periods of what a purist would call overtrading. Most bank managers, particularly in the London area, have customers who seriously overtrade but yet survive. The acrobatic feats of finance by which some of them conduct their businesses without visible means of support have to be seen to be believed.

CASE 3

The two balance sheets which now follow reveal a sharp contrast in the relationship of the various trading figures. The first is the balance sheet of a well-managed company of timber merchants and shows substantial working capital. Overdraft facilities of £50,000 are available without security; the account swings comfortably and, except at the seasonal peaks, borrowing is usually well below the limit.

PRATINCOLE PLOVER & CO. LTD.

Timber Merchants

	£		£
Creditors	6,973	Debtors	38,060
Bank	6,960	Stock	27,950
Cpn. Tax— 2 months	5,424		
14 months	6,450		
Bonus to Directors	375		
Dividends (gross)	3,700		
	29,882		66,010
Capital	50,000	Freeholds	9,805
Reserves	18,000	Plant and Machinery	8,875
Profit and Loss Account	3,260	Shares in Sub. Companies	13,839
		Trade Investments	1,927
		Loans	686
	£101,142		£101,142
		Sales	230,000

Of the company's surplus of £71,260, fixed assets and other 'below-the-line' items absorb £35,132, leaving £36,128 available as working capital.

The directors of the business, therefore, have to say to themselves:

'We must not allow our aggregate current assets (debtors and stock in this case) to run up to a figure which is higher than the total of the following items, plus any profits earned as we go along'.

	£
Working capital	36,128
Banking facilities	50,000
One month's creditors, say	15,000
Future tax	6,450
	£107,578

'We will call it £95,000 to be on the safe side and to leave a margin of overdraft for cash requirements. If our total of stock and debtors looks likely to rise above that figure we must start drawing in our horns, unless we can get more overdraft from the bank. Furthermore, if we decide to spend substantial sums on fixed assets or to buy more trade investments we must remember that by so doing we are consuming some of our working capital and are therefore reducing to that extent the total of current assets which we are able to carry.'

CASE 4

The balance sheet of the second company discloses a very different state of affairs. Godwit & Goldfinch Ltd. is a small company of clothing manufacturers managed by two directors, who are capable, energetic, go-ahead young men with good knowledge and experience of the trade. They have no means outside this business and one or two other small companies in ancillary trades. The account was transferred from another bank about six months ago and has been active with a substantial turnover; it swings into good credit month by month but gives a little trouble about the time of the monthly settlement.

An application is made for an unsecured overdraft limit of £12,000 to finance a large contract from first-class buyers for a quantity of raincoats. The contract is for £50,000 and repayment of the overdraft is promised within four months.

GODWIT & GOLDFINCH LTD.

Clothing manufacturers

	£		£
Trade Creditors	55,065	Cash	11,946
Loans by Directors	5,318	Trade Debtors	16,613
		Stock and Work in Progress	23,034
	60,383		51,593
Capital	2,500	Plant, Machinery and Motors	8,540
Profit and Loss Account	267	Prepayments	640
		Goodwill	2,335
		Preliminary Expenses	42
	£63,150		£63,150
Stock Purchases	138,400	Sales	210,000
Profit (Year) after—	4,257		
Tax	Nil		
Depreciation	1,240		
Directors' Remuneration	4,800		

Nominally there is a surplus in this business of £2,767 but it shrinks to £400 after deduction of the intangibles (goodwill and preliminary expenses), and apart from this the only item which can be dignified with the name of capital is the directors' loans amounting to £5,318. Loan capital is a very different thing from share capital but at least the directors have some money in the business, and it might be possible to have the loans postponed to the bank. However, even if we regard the directors' loans as capital, the whole surplus—and nearly £3,000 more—is sunk in plant, machinery and motors. Thus there is a deficit of working capital, reflected in the fact that the balance sheet is unliquid to the extent of nearly £9,000, or nearly £3,500 if the directors' loans are regarded as capital. In other words, the whole of the finance which carries the current assets, plus £3,500 more, has been found by the trade creditors. Do not be deceived by the fact that on the balance sheet date there was £11,946 cash in hand and at the bank; the money clearly belongs to the creditors in every moral sense and it is only through their forbearance that the company's banking account shows a substantial, though temporary, credit balance. Looking at the trade creditors figure of £55,000 in relation to a business with a capital of £5,700, nearly all on loan, and a turnover of £210,000, one is tempted to remark that the forbearance of its creditors is this company's principal asset.

Part of the figure for trade creditors will represent accrued expenses, but if there is £50,000 owing for materials the period of credit which the company is taking is far above normal. Stock purchases for the whole year were only £138,400. The liability to trade creditors needs probing—the balance sheet tells us no more about it than that it is high—and in particular the bank manager should enquire who are the principal creditors and whether they have any family connection with this company.

The profits for the year covered by the accounts were good but it will be seen that the profit and loss balance is only £267 after bringing in net profits of £4,257; the previous balance sheet must therefore have shown the profit and loss account on the wrong side to the tune of £3,990, evidence that substantial losses had been incurred in past trading.

The strength of the proposal is the contract; the buyers are undoubted for £50,000 and the raincoats are to be completed and delivered within four months. The contract price provides an ample profit margin and the directors press strongly for the bank's support. They offer personal guarantees and postponement of their own loans but refuse a debenture on the plea that this would bring the company's creditors about their ears.

Quite probably, if the bank lent the £12,000 all would go well; but is the risk worth taking? The company has little resources to weather any

storm and might be in trouble if there were a power-cut or a strike or a breakdown of machinery and the raincoats were not completed by the contracted date. Even the most undoubted of buyers cannot be expected to accept delivery of goods which come to him too late and have missed their market. Moreover the company is very vulnerable to its creditors, who could bring it down at any moment and who might, after all, be compelled to call for their money by circumstances outside their own control. The company has incurred losses in the past, possibly owing to bad costing or faulty workmanship, and although the company has survived so far £12,000 would be a rash lending without tangible security.

This is a case of gross overtrading, and evidence of it is in the distortion of the trading structure, of the relationship between current assets and current liabilities. Not only is there no liquid surplus but also creditors have been forced up to a figure far exceeding debtors. Naturally, if a profitable business both takes and allows the same period of credit, the debtors figure should exceed the trade creditors figure as a consequence of the sale of goods for more than has been expended on them. This is not to be regarded as a rule for general application but in this particular case the disparity is so great, even after reducing the creditors figure by the amount of cash in hand, and allowing for a possibility that at the date of the balance sheet some of the work in progress may have been at the point of completion and delivery, as to give rise to an immediate suspicion of overtrading.

Another indication that the business is over-extended may be seen in the fact that it owes amounts so vastly in excess of the stake of the proprietors.

Increase of fixed assets

Before leaving the subject of overtrading there are two further important points to mention. The first is the interrelation between overtrading and expenditure on fixed assets. Primarily, overtrading is a matter affecting the trading figures of a business: the current assets and current liabilities. In practice, when a business embarks upon a substantially increased volume of work the directors generally find that they need to increase the fixed assets. To cope with the enlarged order-book more plant and machinery may be needed, more delivery vans, perhaps an extension of the factory. Unless fresh capital is introduced, the purchase of additional fixed assets will entail the absorption for that purpose of a greater part than before of the proprietor's stake in the business (the surplus) with a corresponding reduction of working capital. Thus, just when more finance is needed to carry the increasing turnover, one part of the finance available becomes lessened. Where resources are ample this does not matter in the least, but where an enlarged turnover

is itself going to expose the business to the risk of overtrading, the purchase of more fixed assets, by depleting the working capital, creates an additional strain. Similarly, where the existing level of trading is already calling fully upon the financial resources available to a business, the sinking of a substantial sum in additional fixed assets may create an overtrading position by reducing working capital below the safety figure, even though there is no increase in turnover. In fact an unwise purchase of fixed assets may entail an enforced reduction of turnover and so prevent the new acquisitions from earning their keep.

Stock and debtors

The other important point is the relationship between overtrading and liquidity, using the term 'liquidity' in its stricter sense to denote having cash ready to meet cash calls. When we say that a balance sheet is liquid we may mean no more than that it shows an excess of current assets over current liabilities, but a business which is liquid in that sense may still be short of the wherewithal to pay the wages or the rate collector or a trade creditor. Book debts and stock are current assets, but it has been remarked elsewhere that cheques cannot be drawn on book debts; neither will workmen accept their wages in stock. A business must always have available to it a margin of cash or of unused overdraft facilities. Without cash on the spot and when it is required, the fact that trading is profitable will be cold comfort. Overtrading, as we have seen, imposes a strain upon all the finances of a business, not least upon the banking account, and where too great a part of the resources is tied up in stock and book debts there will be constant pressure on the overdraft limit and constant difficulty in finding ready money to meet wages and to pay accounts as they fall due. The practical question for a banker is how to recognize or detect serious overtrading by examination of a balance sheet; unfortunately there is no brief practical answer to it. So much, as always, depends upon the nature of the business, the experience and skill of those who are running it, and the terms of credit which it is customary to obtain and to allow in the particular trade.

Warning signs

Overtrading should always be suspected, however, in the following circumstances:

(i) Where a business is obtaining longer credit and/or allowing shorter credit *than is customary* in that particular trade. Test for this by comparing creditors with purchases, and debtors with sales and by enquiry of the directors as to their terms of business.

(ii) Where a business is obtaining longer credit and/or allowing shorter credit *than it used to do*. Test this by comparing balance sheets for three successive years. If creditors are steadily rising and debtors are falling or static, or if the ratio between the two is steadily deteriorating, ask for an explanation.

(iii) Where the current liabilities of a business are much in excess of the surplus, particularly where such excess cannot be explained by seasonal peaks in the trade and where it shows a substantially rising tendency over three successive years.

(iv) Where the banking account reveals signs of hand-to-mouth finance: for example, a rising average overdraft coupled with a smaller swing and the development of a 'hard core'; weekly excesses for wages and pressure on the limit generally (assuming that the limit is not unduly small!); failure to cover cheques until they are presented; payments to suppliers in round amounts (too much importance should not be attached to this unless other signs are present); issuing of post-dated cheques.

Factoring

Since this booklet first appeared, there has been a considerable development in the 'factoring' of book debts; indeed factoring is one of the financial services now offered by many banks through their associated companies.

Basically, factoring need involve no more than an arrangement with a specialist company for supervising, insuring and collecting book debts. Approved book debts are assigned, at the invoice stage, to the factoring company, which collects the money in due course and pays it over to the trading company approximately when received.

Owing to the expense of factoring, it is not usually worth while unless annual sales run up to £100,000 or more, and individual debts are well into four figures.

It is quite common for the trading company to be allowed to borrow from the factoring company before the book debts fall due; and such borrowings may be with or without recourse should the book debts prove bad. Interest is charged in addition to the usual factoring charges.

Factoring companies will also, in suitable cases, provide loans against book debts which are not subject to a factoring arrangement, and which the trading company itself will collect. This is called invoice discounting.

The effects of arrangements of these types on a trading company's balance sheet are as follows:

(i) Pure factoring has no visible effect on the balance sheet itself; the total of book debts remains the same, although the factoring company has undertaken responsibility for them. Factoring charges will appear in the profit and loss account accompanying the balance sheet.

(ii) Where the trading company borrows against factored debts *without recourse*, the primary effect on the balance sheet is analogous to that of a sudden increase in the proportion of cash sales. Debtors, as shown in the balance sheet, fall in amount, and there is a resultant increase in other assets or a decrease in liabilities, or both. Factoring charges, and interest, will appear in the profit and loss account.

(iii) Where such a borrowing is *with recourse*, or where there is borrowing by way of invoice discounting, the effect on the balance sheet *figure* is the same as (ii) above, but there will be a separate *note* on the balance sheet showing the amount of the contingent liability under the recourse agreement. Interest and other charges will appear in the profit and loss account.

In none of these cases is a charge registered against a borrowing company under s.95 of the Companies Act 1948. The transactions are treated, technically, as purchase-and-sale transactions, not borrowings; and the factoring company becomes the owner of the book debts which it has bought from the trading company. Where a bank holds a debenture giving a floating charge on the book debts of a company, any such transactions would necessitate an agreement between the bank and the factoring company (itself possibly part of the same banking group).

Factoring is not yet a large-scale phenomenon in this country, but it is expected to grow, and every banker dealing with trading or commercial advances should be alert to the possibilities. Where a company has sold or mortgaged its book debts, there is obviously less scope for ordinary bank lending, particularly by way of unsecured overdraft.

Deferred liabilities

Now just a brief word on the rather important topic of deferred liabilities. Corporation tax is the example most frequently seen.

Generally speaking, corporation tax is assessed as at 31st March annually (the end of the fiscal year) on the profit of a company for its preceding trading year; and payment becomes due on the succeeding 1st January.

The *trading* year of a company may end at any time within a fiscal year; but it is on 1st January following the end of the *fiscal* year that corporation tax becomes due.

Thus there is a minimum time-lag of nine months between the end of the trading year in which profits are earned and the due date for payment of corporation tax thereon. If the company's trading year ends before 31st March the time-lag becomes longer up to a maximum of twenty-one months. A company whose trading year ends, for example, on 31st January gets eleven months' time-lag instead of nine. A trading year ending on 30th September gives fifteen months' time-lag, and so on.

By the due date for payment, if business is satisfactory, further profits will have been earned and a further sum of future corporation tax will have accumulated in the hands of the company. This process may continue for years and the result may be that the company has in use as working capital for all that time a substantial revolving sum over and above the true working capital. There is nothing wrong in this but it does explain why a banking account sometimes runs so much more easily than the extract of the balance sheet suggests that it ought.

So far as the figures appearing in the balance sheet are concerned, corporation tax for the year covered by the accounts will appear as a liability due on 1st January not more than twenty-one months nor less than nine months after the balance sheet date. Where the time-lag is more than twelve months there will be two liabilities shown for corporation tax—one arising out of the previous year's profits and due on 1st January next after the date of the balance sheet, and another, arising out of the profits covered by the accounts and due on 1st January next but one after the date of the balance sheet.

In estimating the future requirements of a company by way of overdraft it is important to know when tax will have to be paid and unless the due date is shown in the balance sheet the bank manager should enquire of the directors or of the company's accountants.

A rather similar position arises where loan moneys or mortgage moneys have been put into the business for a fixed or minimum term. The liquid position as indicated by the extract of the balance sheet will be much less favourable than the directors will find it to be in practice. For the duration of the loan or mortgage they are able to use the money which has been lent as though it were part of the capital of the business.

Conduct of the account

The banker has one very great advantage over other students of balance sheets or providers of finance for businesses in that he is in daily touch with the borrower's banking account, which discloses both the turnover and the average overdraft. Any really pronounced increase in the average debit balance on an overdrawn account should always be investigated and suitable

enquiries made if the reason is not obvious. If an increased average overdraft is accompanied by the development of a 'hard core' in a borrowing which formerly fluctuated, and is associated with a sharp increase in turnover, overtrading may be the cause. The same phenomena but without increase of turnover may indicate purchase of fixed assets, failure of stocks to move off, investments in or loans to other companies or loans to directors. A falling turnover with a rising average overdraft often indicates that losses are being incurred and may throw doubt upon the saleability of stocks.

III

Purpose of the bank advance

Security, it has been well said, means freedom from worry. A balance sheet is not a security and when a banker lends money because he has heard an acceptable proposition and has seen a balance sheet which he thinks adequately strong to support it, he cannot dismiss certain worries from his mind with the nonchalance that he could display if he had obtained a charge over something solid and tangible. He is much more in the hands of his customer and if he allows himself to be led away by some smooth fairy tale he may have cause for regret.

To take a simple instance: suppose a customer borrows £7,000, saying that he wants it for use in his business, and gives the bank security in the form of a mortgage over a house worth £10,000. The banker might justifiably feel annoyed if he found that the customer had not used the money in the business at all, but had gambled it away at the dogs or had spent it on gifts of jewellery for some frivolous acquaintance. But he need not worry about the safety of the advance; at a pinch he could obtain repayment by selling the house. If, however, the £7,000 had been lent without security, and upon the strength of a balance sheet, the banker's emotions might amount to something more dire than mere annoyance. The money which he thought would be profitably employed in the business has been frittered away and instead of helping to strengthen the balance sheet the banking facilities have helped to weaken it.

A balance sheet cannot be expected to disclose whether or not a customer is truthful; the banker must make up his own mind on that score and if in doubt he should not lend—or at least not without adequate tangible security. A more difficult situation arises where an unsecured lending is genuinely

required for business purposes and would be justifiable if the money were employed in certain ways, but not if it were used differently. For instance, an overdraft limit which could be quite happily granted to finance a thriving company's increasing turnover might be declined if it were needed by the same company to enable it to repay directors' loans or to distribute a large dividend. Generally speaking, a bank will be more ready to lend money which is to stay in the borrower's business (i.e., which is to be matched by an increase in current or fixed assets) than to lend so that other liabilities may be reduced. Customers very often do not appreciate this distinction. They tend to think that banks assess the creditworthiness of a business as an amount of money, without regard to the purpose to which it is to be applied; and if, without adequate enquiry, a banker jumps to the conclusion that his money is intended to increase business activity, and finds out too late that it has been used to pay off pressing creditors, or to enable the company to buy a new Mercedes for the managing director, he has only himself to blame.

Beware, therefore, of vague generalities and of the traditional clichés which so often appear upon applications sent by a branch for the sanction of head office: 'The advance is required for business purposes' or some similar formula, unelaborated and unadorned. Payment of corporation tax or purchase tax is a legimate 'business purpose' but it is important for a banker to distinguish between finance to enable tax to be paid when it falls due and finance for payment of tax which is in arrear. The former is very often financed temporarily by means of a bank overdraft, which is usually repaid within quite a short time by the inflow of (not yet taxable) earnings. Payment of arrears of tax is a very different matter; if it has not been possible to pay off the tax in the ordinary course of business, how will it be possible to pay off the overdraft? A banker who steps unwittingly into the tax-gatherer's shoes may find that it is not easy to step out again.

Working capital or fixed capital

The banker, obviously, should always ascertain whether his money is to be used to swell the assets of the borrower or to decrease outstanding liabilities. If it is to swell the assets he should also ascertain whether it is to finance current assets or fixed assets. Once again 'business purposes', which would cover either case, is a formula too vague to be useful. Purchase of plant; extension of a factory; launching a large advertising campaign; acquiring the goodwill of a rival business; these are all perfectly normal business purposes and no customer need feel embarrassed at asking for bank finance to help with them. But a banker will realize that a purchase of fixed

or intangible assets with bank money will reduce the liquidity of the borrower's balance sheet and in some cases will create an unliquid position. This is an important consideration when deciding whether or not to lend and should never be overlooked. Sometimes it is necessary to stipulate, when granting a limit, that the bank's money shall not be used to finance the acquisition of fixed assets or other businesses.

But, it may be objected, suppose a banker grants an overdraft limit for one purpose and it is used for another. Will he remain in ignorance of what has happened until he sees the next balance sheet? And will it not then be too late to take any effective action? These are cogent questions. Let us take the first one first.

The banker will guess that something has gone awry when he finds that the banking account is not running in accordance with his expectations. Substantial expenditure on fixed assets or intangibles, if financed from bank money, will give rise to a 'hard core' in the overdraft (i.e., a point below which the overdraft does not dip) and a heavier average borrowing. Drawing on bank facilities to pay off loan creditors or arrears of tax would have a similar effect, and so, also, would losses in trading. Faced with a marked change in the working of an account, the banker should endeavour to track down the cause by examining the transactions which pass through his hands and ascertaining the names of payees of large cheques. If these do not supply answers to the questions in his mind, he can always ask his customer what is going on. Failure to notice a really marked and substantial change in the working of an account, or, having noticed it, failure to establish the true cause, is a very common background to bad debts and troublesome accounts.

In a pronounced case of misuse of a bank advance, the banker ought certainly to be able to find out what is happening without waiting for the balance sheet. He has a fund of local knowledge to draw upon as well as the picture shown by the banking account. Can he take any effective action? Where there has been a clear breach of a condition laid down by the banker when he agreed to lend the money, there is always the remedy of calling in the advance. Few bankers, however, would act drastically or hastily in such a situation. Disapproval would probably be voiced, and there would be pressure for reductions. If disregard of the bank's wishes had been particularly blatant some additional control over the future drawing of cheques might be insisted upon. Fortunately, there are few customers who would deliberately flout the expressed terms of an advance made by a bank; and the few that might not scruple to do so are perhaps deterred by the thought that a banker's confidence, once destroyed, is difficult to rebuild.

CASE 5

Let us now examine the affairs of Grackle & Grebe Ltd. and consider the respective effects of two possible borrowing propositions. In both cases the overdraft limit required is the same, but there is a difference between the two in the use which is to be made of the money.

Grackle & Grebe Ltd. is a private company of oil, colour, and chemical merchants, in a prosperous country town. The business is old-established, but remained quite small until the two present directors developed an active trade in lubricating oils and agricultural chemicals. They have been spared that curse of old family businesses, a multiplicity of directors, but are under a moral obligation to pay out substantial dividends to aged relatives who need the money.

There is an unsecured overdraft limit of £10,000 and the account fluctuates well, showing credit balances at times. The bank is asked to increase the limit to £25,000.

Proposition 1. The additional £15,000 is needed to finance increasing trade and to enable the company to allow more credit to farmers before the harvest money comes in.

Proposition 2. The additional £15,000 is needed to finance the erection of a new store to cost £9,000 and the purchase of an oil tanker for £4,000 and a lorry for £2,000.

GRACKLE & GREBE LIMITED
Oil, Colour and Chemical Merchants

	£		£
Trade Creditors	12,821	Cash	73
Director's Loan	1,177	Trade Debtors	24,574
Bank	3,120	Stock	11,650
Cpn. Tax	3,240		
Dividend (gross)	3,300		
	23,658		36,297
Capital	8,000	Land and Buildings (Freehold)	7,542
Reserves	6,126	Fixtures and Fittings	538
Profit and Loss Account	10,303	Vehicles	3,389
		Loan to a Director	321
	£48,087		£48,087
Profit for year after—	4,860	Sales	103,000
Tax	3,240		
Depreciation	1,045		
Directors' Remuneration	4,250		

Proposition 1. The surplus in the balance sheet is not quite £25,000 and a limit of like amount looks heavy without security. There is a liquid surplus of £12,000 over current liabilities of £24,000, which is satisfactory. Debtors are well in excess of creditors and (in an agricultural community) are not unduly high in relation to sales for the year. Stock is about one-ninth of sales, which suggests a brisk turnover. At the date of the balance sheet the bank overdraft stood at £3,120, and within the existing limit of £10,000 there was room for payment of the dividend and the immediate corporation tax. Profits for the year were good and considerable amounts have been ploughed back in the past.

The business looks healthy enough and provided that debtors are to be well-spread an unsecured limit of £25,000 as a seasonal peak would carry no undue risk in these days of comparative prosperity for farmers. Allowing for payment of the dividend and the corporation tax, one could expect current liabilities to rise at the peak to £40–45,000, with current assets, say, £52–60,000, and the account ought to swing into good credit after harvest.

Proposition 2. Here the bank's money is to be spent on 'below-the-line' assets, and after the overdraft has been taken and the dividend and immediate corporation tax paid, the balance sheet might look something like this:

	£		£
Trade Creditors	13,000	Trade Debtors	24,600
Director's Loan	1,177	Stock	11,700
Bank	24,000		
	38,177		36,300
Capital	8,000	Land, Buildings, Fixtures, etc.	17,000
Reserves	6,126	Vehicles	9,000
Profit and Loss Account	10,303	Loan to a Director	306
	£62,606		£62,606

The liquid surplus would disappear. A credit balance on the banking account would become a virtual impossibility, at least for some considerable time, and the overdraft would develop a 'hard core' of probably £10,000 even if the turnover did not increase. But the additional store and vehicles would be expected to earn their keep, and presumably the directors are contemplating a substantial increase in turnover, which would entail carrying a large increase in debtors and stock. How is this to be financed? Unless more capital is introduced or loans raised elsewhere, £25,000 from the bank is not going to be enough. The directors' plans for the future should be discussed

in detail, preferably with the advice of the company's auditors, and the full financial implications studied. If the bank were expected to find all the additional money required, involving a limit, probably of £35,000, the proposition would be a formidable one, even with the security of a debenture. The heavier overdraft would result in heavier interest charges, and as dividends have to be maintained and the directors' own drawings are not extravagant, a banker would require a good deal of convincing that there would be sufficient retainable profit to provide adequate reductions in the limit.

Consequences of illiquidity

Where a balance sheet discloses an unliquid position the stability of a business must always be suspect. Creditors may want their money without delay—they themselves may have come under pressure from their own creditors—and if the total of current assets is less than the total of current liabilities a dangerous situation can quickly arise. It should be borne in mind, however, that deferred or medium-term liabilities are not current liabilities in the strict sense. For example, the holder of a debenture repayable in twenty annual instalments cannot normally call for immediate repayment in full unless the instalments or the interest payments fall into arrear or the business is on the point of breaking down. A liability secured by a mortgage may similarly be of a long- or medium-term nature; the balance sheets of property-owning companies, for instance, commonly disclose an unliquid position which is, nevertheless, quite stable and satisfactory if the mortgages can be serviced out of rents receivable. Where those liabilities which are strictly due for current payment exceed the total of current assets, there is definite instability and the business is vulnerable to pressure from its creditors.

The converse, however, is not necessarily true, and a clear and substantial excess of current assets over current liabilities is no guarantee of stability or of invulnerability. A great deal depends upon how current the current assets really are; in other words, how frequently they are turning over and turning into cash. The following example shows a balance sheet with a total of current assets approaching twice the total of current liabilities (more than twice if corporation tax may be regarded as a deferred liability); nevertheless the company has got itself into an extremely vulnerable position.

CASE 6

Quetzal Quail & Co. Ltd. is a private company manufacturing cut leather soles. The business was started up after the war by two friends who had learned the trade in their employment with other firms. Capital was

available, good profits were earned and a fair proportion left in the business. An unsecured overdraft limit of £12,000 was granted some years ago and has been renewed from time to time. Formerly the account fluctuated well and credit balances were seen, but the advance has now developed a 'hard core' of about £8,000 and there have been excesses.

The bank is asked to increase the limit to £25,000 to enable the company to buy leather to fill firm orders.

QUETZAL QUAIL & CO. LTD.
Manufacturers of Cut Leather Soles

	£		£
Trade Creditors	20,779	Cash	117
Bank	10,080	Trade Debtors	18,412
Cpn. Tax— 3 months	4,158	Stock	52,247
15 months	4,140		
	39,157		70,776
Capital	20,000	Machinery, etc.	1,943
Reserves	9,700	Vehicles	3,241
Profit and Loss Account	9,808	Loans to Directors	2,345
		Prepayments	360
	£78,665		£78,665
Profit for year	6,255	Sales	174,000
after tax	4,140		
Depreciation	1,098		
Directors' Remuneration	5,994		

The surplus shown in the balance sheet is about £39,500 and the liquid surplus £31,500. The relationship of debtors to sales is satisfactory but, on the balance sheet date, trade creditors exceed debtors by £2,300, a fact which calls for some explanation.

The outstanding item is, of course, the figure for stock, which dominates the whole picture and is more than £12,000 in excess of the surplus. And the increase in the overdraft is required for the purchase of yet more stock! Something is obviously out of gear and the most probable explanation is that the wrong raw materials have been purchased in the past and have failed to move off. Enquiry of the directors and a comparison with the balance sheets of earlier years will be necessary. On the face of things there may be £35,000 of stock which is not turning over at all.

Situations like this are not uncommon and the directors usually say that

the surplus stocks are held as a reserve and are worth far more than the figure shown in the balance sheet. That may well be, but even so it is not a banker's function to finance the holding of stocks which are not turning over and are unnecessarily high for the business. If customers wish to invest in (or to speculate in) commodities they should not expect their bankers to put up the finance. Apart from considerations of public policy, it is far too risky a pursuit for a prudent banker. Prices can fall as well as rise, and inflation does not bring with it a perpetual and unbroken bull-market for stockpilers. Leather, wool, cotton and many other staple commodities have shown spectacular fluctuations in price during the last twenty years.

Causes of vulnerability

A business may be vulnerable, then, if it is not turning over its stock-in-trade quickly enough, even though the balance sheet shows a liquid surplus. The logical way to look at liquidity, in such cases, is to consider the surplus stock as a non-quoted investment and (mentally) to place it below the line.

Vulnerability may also arise in the following cases:

(i) Where too long a period of credit is allowed. This will attract weak purchasers and will be evidenced by too high a figure for debtors in the balance sheet. Sometimes a favoured debtor receives special terms and such arrangements can be dangerous, particularly where the favoured debtor is another company and the two companies have an interlocking or related directorate.

(ii) Where there is one predominant creditor or one predominant debtor. This cannot be seen from the balance sheet; the banker should either know the facts from the banking account or make suitable enquiries of the directors. A predominant creditor may suddenly call for his money or refuse further credit; a predominant debtor may fail or demand longer credit. Either may enforce harsh terms and cut profits down to the bone.

(iii) Where good profits have been made and have been sunk in fixed assets without regard to the eventual tax liability. This is particularly dangerous if profits subsequently fall away.

(iv) Where a trade is subject to fluctuations of taste or fashion.

(v) Where a comparatively small business is trying to make headway amongst much larger competitors.

(vi) Where a business depends wholly upon the skill or flair of one man.

Strictly speaking, not all these points are directly connected with balance sheets, but nevertheless they are very relevant to the interpretation of balance sheets in relation to the assessment of banking propositions and banking risks. The list is not and could not be exhaustive, nor is it suggested that a business which is vulnerable is necessarily not creditworthy. Banks, like other businesses, expect to undertake a certain amount of risk; the important thing is that when they do so they should be able to see their risks as clearly as possible and weigh them up with care and understanding.

Banking—the lending of money by banks—is not an exact science; despite all study and analysis there always remains room for differences of opinion and what appeals to one banker as good business may strike another as an unjustifiable adventure. Nowadays banks compete strongly for borrowing accounts, and, provided that a banking proposition does not conflict with whatever directives the Chancellor of the Exchequer may issue from time to time, it must be unattractive indeed if no clearing bank is willing to agree to it.

IV

Past records

In making commercial lendings, especially without security, a banker traditionally pays particular regard to the 'three C's' of the borrower—Character, Capital and Competence. Borrowers, on the other hand, are said to seek bankers who display faith, hope and charity.

A borrower's balance sheet, although only one of several sources of information, is of considerable help in the assessment of all three of the 'C's'; and a series of balance sheets, extending over three years or more, is still more informative. Capital in this context means, of course, the surplus shown in the balance sheet. A sequence of balance sheets discloses not only the amount of the surplus at the balance sheet date, but also whether it has been increasing or decreasing from year to year during the period.

Competence is denoted, or suggested, by success, especially steady and repeated success. A consistently good profits record, extending over a long period of years, constitutes powerful evidence of the competence of those in control of a business. For this purpose the record of three years is hardly enough and it is best to examine results over a period sufficiently long to ensure the inclusion of years when trading was difficult as well as times of easy prosperity.

A series of balance sheets and their accompanying accounts supply numerous pointers to character. Prudence, extravagance, rashness, ambition, optimism, selfishness, unscrupulousness and many more characteristics may be suggested by or inferred from the figures. It is desirable, however, to stress once again the danger of reading too much into balance sheets; there is no substitute for knowing one's man, and inferences based solely upon the figures can be seriously misleading.

Analysis of past trends

Trends and variations are shown up clearly by summarizing a sequence of balance sheets in parallel columns. An example is given on page 36 and for ease of reference a few comments are added there.

When an established customer wishes to borrow for the first time, or where a commercial account is offered by transfer from another bank, with a request for an advance, balance sheets for at least three years should always be seen and compared. To rely upon the latest balance sheet alone is imprudent without knowledge of what has gone before.

Broadly speaking, the trends which require examination when a sequence of balance sheets is under scrutiny fall into the same groups as the figures of a single balance sheet and it is convenient to examine them in a regular order:

(i) surplus;

(ii) liquidity;

(iii) prior charges (mortgages, etc.);

(iv) trading figures;

(v) profits record;

(vi) any special items.

(i) *The Surplus.* No variation in the amount of the surplus can take place without cause. There are, in fact, surprisingly few ways by which a change in the surplus can be brought about, as a few moments' reflection will verify, and the source and circumstances of any change should always be ascertained and considered. The most common cause is profits or losses arising in the ordinary running of the business, and to a prospective lender there are few signs more encouraging than a steady rise in the surplus over a period of years, resulting from the retention of profits.

The issue of additional capital is another source of increase in the surplus, although trading losses, if any have been incurred, will naturally go to offset such increase. An issue of capital should be specially noted on the balance sheet summary and the note should state whether the issue brought new cash into the business, whether it represented capitalization of loan money already employed, or whether it arose upon the transfer of physical assets from, or upon amalgamation with, another company.

Sometimes the surplus is increased as the result of a revaluation of fixed assets. This is not a good sign if the object is merely to make the balance sheet figures look larger and more imposing, but when it occurs in the course of an amalgamation or reorganization it is very often a necessity of accounting. The full story should be ascertained and briefly noted.

Refunds of taxation, or the release of provisions set up in the past for taxation or for other purposes, may also increase the surplus, and conversely any new provisions will normally decrease it unless they are taken from the undistributed profits of the year covered by the accounts.

(ii) *Liquidity*. If the summary discloses a marked change in the amount of the liquid surplus the cause should be ascertained and noted. Capital expenditure is the most usual cause of a reduction; others are trading losses or bad debts, trade investments, and the distribution of profits accumulated in previous years. An increase in the liquid surplus may be due to the earning and retention of profits, the sale of capital assets or trade investments, the repayment of loans, or the introduction of additional capital.

Besides changes in the amount of the liquid surplus, changes in its relation to the total of current liabilities should also be considered. Obviously a liquid surplus of £5,000 which would be comfortable when current liabilities were £10,000 would become very thin if current liabilities rose to, say, £60,000. The proportion which the liquid surplus bears to the current liabilities should therefore be carefully watched and the effect of any marked change should be assessed. Deterioration in the *proportion* (as distinct from the amount) of the liquid surplus is one of the results of an increase in turnover without an increase in capital resources and it may, therefore, be one of the early signs of overtrading. However, each case must be judged on its facts and merits. A declining turnover may improve the liquidity

[*continued on page* 38]

CASE 7

FIREBIRD & ROC LTD.

Engineers

	31.12.1965	31.12.1966	31.12.1967		31.12.1965	31.12.1966	31.12.1967
	£	£	£		£	£	£
Creditors	35,987	46,012	50,839	Cash	701	375	480
Bank	18,998	31,780	31,654	Debtors	46,983	57,290	67,737
Tax—Current	2,000	2,300	2,900	Stock and Work in			
Future	4,500	7,700	20,100	Progress	58,011	81,398	114,819
Deferred Repairs	5,000	4,500	4,000				
Proposed Dividend	2,723	2,723	2,723				
	69,208	95,015	112,216		105,695	139,063	183,036
Capital	45,000	(i) 145,000	(ii) 235,000	Land and Buildings	60,980	(iv) 135,400 (v)	300,000
Capital Reserve			(iii) 240,000	Machinery and Plant	40,334	69,533	138,682
Revenue Reserves	90,000	100,000	30,000				
Profit and Loss Account	2,801	3,981	4,502				
	£207,009	£343,996	£621,718		£207,009	£343,996	£621,718
Profit	£7,210	£17,203	£26,544	Sales	£410,000	£540,000	£680,000
After Tax	6,400	9,800	23,474				

(i) £100,000 preference capital issued for cash.
(ii) £90,000 capitalized from reserves.
(iii) Surplus arising on revaluation of buildings and plant.
(iv) Another factory purchased.

(v)				
Buildings	137,399	written up to		300,000
Plant	61,283	,,	,, ,,	138,682
	198,682			438,682
Net increase (See note (iii).)				£240,000

These balance sheets show a picture of a progressive company with well-managed finances. Turnover has expanded rapidly, but retained profits have been sufficient to keep the trading figures in a healthy state, and the liquid surplus has increased in amount; moreover its proportion to current liabilities also shows an increase. A second factory, and the additional machinery to cope with the increasing output, were purchased in 1966 from the proceeds of an issue of preference capital for cash, the result in the balance sheet being an increase in the surplus and an increase in fixed assets.

The capital shows an increase of £90,000 in 1967, arising by way of a two-for-one bonus issue of ordinary shares. This amounts to a transference of £90,000 from reserves to capital and does not increase the surplus nor alter the assets side of the balance sheet.

The capital reserve of £240,000 arises out of a revaluation of fixed assets. It increases the surplus (on paper), but has no effect on the physical assets of the business, nor its earning capacity.

Firebird & Roc Ltd. is a private company and the bonus issue and revaluation suggest that the directors intend to apply for the shares to be quoted on one of the recognized stock exchanges.

ratio, but may nevertheless indicate a state of affairs more unhealthy than a modest amount of overtrading.

(iii) *Prior charges.* Any mortgages or charges should be considered and details noted if the amount is large. Generally speaking, banks do not expect to lend without security if other creditors are secured. It should be remembered that assets may have become encumbered since the date of the last balance sheet, and whilst there is not much risk of this having been done without the banker's knowledge where he is lending to a customer whose account he already has, enquiry or search may be desirable where he is taking over an account from another bank.

(iv) *Trading figures* (creditors, debtors, stock, work in progress). Any marked changes should be scrutinized, particularly where one or more of the categories starts 'ballooning'. Watch should also be kept upon the trend of the following relationships:

(*a*) trade creditors to debtors;

(*b*) debtors to sales;

(*c*) stock to sales.

If bills payable or bills receivable start appearing where there have been none previously, or if the company starts selling its book debts, the circumstances should be ascertained and recorded.

(v) *Profits record.* The size, trend, and steadiness of results should be observed and also the extent to which profits are retained, especially in a business which is owned by its directors.

Profits figures are often affected by special items—refunds of tax, profits on sale of vehicles or surplus machinery, compensation to outgoing directors, expensive lawsuits, etc. It is advisable to deal with items of this kind by means of a special note, otherwise the true trading results of different years will not be readily comparable.

(vi) *Special items.* Every large item in any balance sheet should be examined and considered, and similarly any substantial change in such an item should be weighed up when a sequence of balance sheets is under review. 'Ballooning' should be watched for, especially in the stock figure or in amounts owing by or invested in associated companies. No value should be attached to the latter items unless the balance sheets of the associated companies are produced or some other reliable information about them is available.

Group accounts

The linking up of businesses through association of companies produces many financial complexities. The association most commonly found, although it is by no means the only one, comprises a holding company and one or more subsidiary companies. Some of these organizations are gigantic financial empires, others are of rather lesser importance, others again are quite small. Perhaps the small and medium-sized organizations give the banker more difficulty. He may be asked to lend to a subsidiary company and upon examining its balance sheet may find that the principal asset is money owing by a second subsidiary in the same group; the balance sheet of the second subsidiary could show substantial sums owing by a third and a fourth member of the group; their balance sheets may show large loans to the holding company; the balance sheet of the holding company may disclose no assets except shares in and loans to its various subsidiaries.

There is no need for suspicion nor for despair. If the affairs of a company are inextricably interwoven with those of other members of the same group the banker's best plan is to turn his attention to the financial position of the group as a whole and to endeavour to frame answers to the following questions:

(i) What are the true assets and liabilities of *the group*, i.e., after excluding debts and investments within the group itself?

(ii) Is the proposed limit justifiable in relation to the financial position of the group, and what other bank accommodation is there available to the group?

(iii) Is the plan for repayment practicable out of group finances?

(iv) Can the banker rely upon those who are in control of the group to carry out the plan for repayment?

(v) Is security necessary and, if so, is it available?

To obtain an overall view of the assets and liabilities of the group, the banker should examine the consolidated balance sheet. In this the inter-company indebtedness will have been omitted (it cancels out) and broadly speaking the consolidated figures will show the financial position of the group in relation to the outside world, much as though all the companies were one. A consolidated balance sheet is not the actual balance sheet of any company nor of any legal entity; it is simply a summarized statement of the group position. Thus, the banker is able to obtain answers to his first three questions (except the second part of question (ii)) from the consolidated

balance sheet. Accommodation available at other banks should be the subject of enquiry of the directors.

However, that is not the end of the task. If the proposed borrowing looks acceptable in relation to the group's figures, the banker has still to decide what position he wishes to occupy in the group's financial structure. He cannot lend to a consolidated balance sheet. He lends, if at all, to one or more of the companies in the group. What possibilities are open to him and what do they involve?

(i) He could lend without security to one of the companies. To do so without misgiving he would have to feel completely satisfied that the group could easily repay him and that those in charge would undoubtedly see to it that money came to him for that purpose.

(ii) He could lend as in (i) but with the added support of a guarantee by the directors.

(iii) He could lend to a subsidiary with the support of a guarantee by the parent company. This would, in effect, put the consolidated surplus behind him; he would have that to fall back upon. Of course, he would have no direct claim against the assets of the other companies in the group, but in the event of disaster he could not lose any money until the whole of the consolidated surplus had been lost. Note, however, that minority interests in subsidiary companies do not form part of the consolidated surplus, and will not be behind the guarantee.

Much the same situation would result if the banker lent to the parent company without security.

(iv) He could lend to one company with the support of a guarantee by each of the other members of the group. He would then be able to call upon any or all of the companies for repayment of the advance, and in liquidation proceedings he could prove for his debt alongside the creditors of each company. Thus wherever in the group there were realizable assets to be found he would be able to put in a claim to a share of their value.

Very often where a group of companies borrow from one bank cross-guarantees are taken, each company guaranteeing each other company. If this is done the banker's technical position in a liquidation would be quite a good one. For the full total owing to him by the group he would be entitled to receive a dividend in the £ at a rate no worse than the best dividend paid by any of the companies to its other unsecured creditors. He might receive more, but could not be compelled to accept less.

With cross-guarantees it is convenient for the banker to assess his risk by regarding himself as an unsecured creditor on the consolidated balance sheet for his aggregate lending to the group. It is long odds that his technical position would be better than that in case of disaster, and such an assessment is, therefore, on the cautious side. Minority interests, in such a case, would not be in conflict with the bank and could be regarded as forming an addition to the consolidated surplus.

(v) He could stipulate for tangible security.

(vi) The strongest position of all is where the banker obtains cross-guarantees, as in (iv), and these are supported by debentures on all the companies. With cross-guarantees and debentures he is broadly in the position of a debenture-creditor on the consolidated balance sheet for his aggregate lending to the group.

Various permutations and combinations of the foregoing points may arise in practice: for example, guarantees by some fellow subsidiaries but not all; a debenture by the parent company but not by the subsidiaries; guarantees covering only part of the limit granted, etc. Quite frequently these midway positions represent a compromise between what the banker would have liked to obtain by way of security and what the directors were prepared to offer.

Where a debenture by the parent company is held it should be remembered that this is more than merely a power to realize that company's assets. A standard form of debenture used by a bank would normally include powers adequate in case of need to enable the bank to control and manage the parent company and, through it, the business of the whole group.

CASE 8

After all this theorizing it may, perhaps, be a relief to turn to another illustration.

Kittiwake Kite & Buzzard Ltd. is a private company of manufacturing clothiers. The account was obtained from another bank, and although the limit has been twice increased during its twelve-months run and now stands at £80,000, it has not proved sufficient and there have been frequent excesses. The directors are energetic young men, able, ambitious and secretive. It is known that certain retailing subsidiary companies have been acquired in the past, but the accounts are with other banks. The £80,000 limit is secured by a debenture and the branch manager has been eagerly awaiting the new balance sheet, as the directors have told him that they have had a most successful year. When it arrives his heart sinks.

KITTIWAKE KITE & BUZZARD LTD.

Manufacturing Clothiers

	£		£
Trade Creditors	37,028	Cash	48
Bank	91,076	Debtors	43,708
Tax—Current	33,824	Stock	88,148
15 months	4,716		
	166,644		131,904
Capital	17,000	Land and Buildings	9,364
Capital Reserves	4,212	Machinery and Plant, etc.	29,000
Profit and Loss Account	66,708	Due from Sub. Companies	12,196
		Shares in Sub. Companies	72,100
	£254,564		£254,564
Loss for year after—	3,556	Sales	518,000
Tax	4,716		
Depreciation	7,172		
Directors' Remuneration	5,000		
and after writing	18,116 off stock.		

The directors explain that the writing down of stock is purely a precautionary measure and say that in reality the current value is about £150,000. The true trading results for the year, they say, were excellent. The branch manager is still not happy. The balance sheet shows an immediate tax liability of £33,824 with no obvious liquid resources to meet it; the directors agree that they are being pressed and ask to have the limit increased to £120,000, adding airily that the shares in subsidiary companies are worth 'many times the balance sheet figure'.

Under pressure, they eventually produce the consolidated balance sheet of the group (see opposite).

The consolidated surplus is £170,000 after deduction of intangibles. There is a liquid surplus of £64,000 on paper, but the stock figure is very high. However, loans amounting to £79,000 are secured by mortgages on shop properties and thus are deferred liabilities rather than current; furthermore, the trade investments prove upon enquiry to be quoted and marketable and could, therefore, go up above the line. The liabilities, excluding the secured loans, are £354,500 and the current assets, including the investments, £525,000, giving a substantial liquid surplus, though the heavy stock figure must not be overlooked, nor the taxation liability. Trade creditors of the group exceed group debtors, but the debtors of the retailing companies are naturally not large.

KITTIWAKE KITE & BUZZARD LTD.
AND ITS SUBSIDIARY COMPANIES
CONSOLIDATED BALANCE SHEET

	£		£
Secured Loans	79,000	Cash	44,356
Trade Creditors	123,184	Debtors	64,588
Banks	119,304	Stock	388,200
Tax—Current	91,288		
15 months	19,312		
Dividends	1,420		
	433,508		
Minority Interests in Subsidiary Companies	83,908		
	517,416		497,144
Capital	17,000	Land and Buildings	105,812
Capital Reserve	105,192	Machinery, Plant, Fittings, etc.	56,504
Profit and Loss Account	90,856	Trade Investments	28,240
		Premiums on acquisition of shares in Subsidiary Companies	32,768
		Goodwill	9,996
	£730,464		£730,464
		Group Sales	£1,250,000

Consolidated profit figures not produced.

The capital reserve of £105,000 has arisen from the sale by one of the retailing companies of certain freehold shop properties, on a return-lease basis, for more than balance sheet value. The directors say that further sales by another subsidiary are pending and that these will bring £160,000 liquid cash into the group after clearing the secured loans. They promise a reduction of £50,000 in the limit of the parent company.

It should be borne in mind that the debenture does not cover all the assets shown in the consolidated figures, but, nevertheless, the branch manager would feel a good deal happier when he saw the complete picture, which discloses a more substantial position than might be expected from an examination of the parent company's balance sheet only.

In many instances the opposite occurs, and the consolidated figures disclose more strain on the finances than the parent company's balance sheet would lead one to expect.

The essential thing in dealing with group finances is to ascertain and weigh up the true assets and liabilities of the group, and then to attempt to envisage the whole in some sort of perspective. Only then is it possible to judge the financial strength behind the particular company or companies for which bank accommodation is required.

Thus, for groups as for isolated companies there is no short cut, no formula; and no golden rule, except, perhaps, the advice given to the writer many years ago: Keep on pegging away until you get a clear picture.

		£	31.12.1965	31.1
7,328	Cash	48		
1,076	Debtors	43,708		
3,824	Stock	88,148		
4,716				
6,644			£	£
7,000	Land and Buildings	131,904	35,987	46,0
4,212	Machinery and Plant, etc.	9,364	18,998	31,7
9,709	Due from Sub. Companies	29,000	2,000	2,7
	Shares in Sub. Companies	12,196	4,500	7,7
		72,100	5,000	4,7
564			2,723	2,7
		£254,504		
556	Sales	518,000	69,208	95,9
716			45,000	(i) 145,0
			90,000	100,0
			2,801	3,9
			207,009	£343,9

CKLE & GREBE LIMITED
, Colour and Chemical Merchants

£		£	£	£
12,821	Cash	73	£7,[illegible]	£17,[illegible]
1,177	Trade Debtors	24,574	6,400	9,8
3,120	Stock	11,650		
3,240				
3,300				
23,658				
8,000	Land and B			
6,126	Fixtures and			
10,303	Vehicles			
	Loan to a I			
£48,087				

MERLIN SMEW
Manufacturers of F

		LIABILITIES	£	
497,				
105,	Capital		84,374 (*b*)	
56	Reserves		100,000	Fre
28	Profit and Loss Account		49,100	Pla
			90,693 (*h*)	
32			£321,167	
[illegible]	Profit (Year)			
	after—		36,000 (*g*)	Sale
£73[illegible]	Tax			
	Depreciation		24,000	