

Cash Flow vs. Collateral Based Lending: Is There a More Informative Middle "C"?

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Emphases in agricultural lending have tended to oscillate between periods of "cash flow" based lending and "collateral" based lending. We discuss potential forces behind the oscillating emphases, the overly "conservative" nature of short-term cash flow based lending and the overly "liberal" nature of collateral based lending. Acknowledging the limitations of both methods, a banking executive stated that his most useful "C" in assessing the credit worthiness of a loan applicant was an admittedly informal assessment of the applicant's "character".

We propose another "C" that provides a more objective measure of a loan's credit worthiness and eventual loan repayment capacity, i.e. the use of "Constant Dollar" or "Price Level Adjusted" financial statements and ratios. We demonstrate procedures that are consistent with FASB "Reg 33" and provide more useful and accurate measures of the agricultural firm's "operations performance" over time. The proposed methods directly address the effects of inflation upon the firm's financial position without relying upon "ad hoc" procedures commonly in use.