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Accounting — The Language of Business and Finance

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Adapted from paper presented before American Management Association Seminars on Fundamentals of Finance and Accounting for Non-Financial Executives—February and October 1965

The new era of professional management ushered in by World War II has brought an awareness on the part of non-financial executives of the important part accounting plays in their day-to-day operations. Marketing managers, research managers, production managers, and other corporate executives have come to understand the effect of their financial statements on banks and the investment community. They realize that a corporation must earn an adequate return on the sums invested and that it needs to pay dividends to stockholders to attract new capital as required for growth and expansion.

At the same time there have been tremendous changes in the field of financial accounting and a considerable broadening of the area now generally known as management accounting. So great has been the expansion that even those with more than a superficial knowledge of these areas find it difficult to remain familiar with all branches of present-day accounting. In earlier days many companies were satisfied with a set of annual financial statements, a cost accounting system, and a few financial ratios or operating statistics. For most companies these now have broadened into responsibility accounting systems, budgetary control, standard costs, break-even charts, cash forecasts, profit planning, inventory control, and analyses of return on investment by divisions or products.

Actuarial and statistical techniques have been combined with the processing ability of electronic computers to assist in sales forecasting, production scheduling, new-product development, and capital budgeting. New forms of off-balance-sheet financing, such as equipment leasing, sale and lease-back transactions, and carved-out production payments have been added to the traditional forms of debt and equity financing. The need to reinvest surplus corporate earnings has led to mergers and acquisitions, time deposits, negotiable certificates of deposit, and other means of gaining income from idle funds.

Nor should we minimize the statutory problems brought about by enactment of tax legislation, manifesting itself in such matters as LIFO inventories, accelerated depreciation, guidelines, and the investment

credit. Among these concepts then are perhaps the principal reasons that have brought you here today, and the purpose of this seminar is to give you a general acquaintance with them. Let us therefore take a brief look at a few of the institutions that have arisen in the business, financial, and governmental fields to see what light they cast. An understanding of the part they have played in bringing about the economic structure existing today should lead us to a clearer view of the gradual emergence of accounting principles as they are now known and practiced. A better understanding of how business and accounting interlock should also result.

EXTERNAL REPORTING REQUIREMENTS— NEW YORK STOCK EXCHANGE

Publishing financial information for the benefit of stockholders has for many years been required by the New York Stock Exchange companies whose shares are listed there. Over the years these requirements have been gradually strengthened. Many accepted realities of today, such as comparative statements, adequate disclosure, and other reporting standards were brought about by the efforts of the New York Stock Exchange.

To some extent the influence of the New York Stock Exchange in this direction is limited to those companies seeking to list their securities on that exchange. Their action has been reinforced by other exchanges that have instituted similar practices and by other companies that have voluntarily followed the prescribed practices.

THE FEDERAL RESERVE BOARD

Another powerful force moving to establish accounting principles was the banking community. In 1917 the American Institute of Accountants was asked by the Federal Trade Commission to prepare a memorandum on balance-sheet audits. The Federal Reserve Board endorsed this memorandum and after a preliminary exposure published the memorandum under the title of "Approved Methods for the Preparation of Balance Sheet Statements." This publication received a substantial revision in 1929 by another committee of the Institute and was republished under the title of "Verification of Financial Statements."

Bankers normally are holders of short-term indebtedness. As such they are interested in whether a company is generating sufficient cash to

liquidate these obligations. They are also interested in other current assets that may be readily convertible to cash and in protective collateral. They are actively interested, therefore, in the accounting principles governing the financial statements submitted to them for credit purposes and have contributed substantially to the development of accounting principles.

SECURITIES AND EXCHANGE COMMISSION

Most new companies that make offerings of securities today must register these offerings with the Securities and Exchange Commission. In addition, companies listing these securities on national exchanges are required to file financial statements with the Commission annually. As the Commission has prescribed the form and content of financial statements to be furnished prospective investors, and inasmuch as the Commission has generally insisted that companies comply with generally accepted accounting principles, the Commission has had a very strong although indirect influence on the development of such principles.

ACCOUNTING THEORY

Basic accounting theory holds that revenues and expenses should be carried into the income statement in the fiscal year to which they relate. It is now generally accepted that costs should be matched with the revenues they produce and that expenditures made in one period to produce an expected future benefit in later periods should be deferred and charged against the income of such periods, if such benefits are reasonably certain.

In the first thirty years of this century accountants were much more concerned with capital than income and more concerned with the balance sheet than the income statement. Bankers were, and still are, interested in the asset values they regard as security for their outstanding commercial loans. The 1929 stock market crash and the resulting great depression of 1932 brought the fact home rather forcibly to bankers, investors, and accountants that earning capacity was the prime determinant of value. As it became evident that the determination of income for a given period was an essential purpose of accounting, the theory of income measurement began to develop slowly in both professional and academic circles based upon the older concepts of accrual accounting in the entity concept. This has come to be more generally known as the matching theory.

In 1932 the American Institute of Accountants formed a Special Committee to work with the New York Stock Exchange Committee on

Stock List and it is in the correspondence that passed between these committees that the matching theory might be said to have been given significant standing. Gilman in his *Accounting Concepts of Profit* wrote that "the period from 1932 to 1938 marks the real change from the former balance sheet viewpoint to the current profit and loss viewpoint with its insistence upon the dominance of the profit and loss statement and the necessity for proper allocation of cost or income items to accounting periods."

An underlying concept is that all production costs cling to the product as it passes through various stages of manufacture to the finished-goods stage. Production costs are those generally associated with making a product ready for the market. This would include labor and materials directly associated with the manufacture of a product as well as factory overhead costs. Together these form the "cost of goods sold."

This concept in turn forms the basis for distinction between product and period costs. Product costs may be deferred in inventory to match with future revenues, while other costs, such as selling and administrative expenses, are classified as costs of the current period and therefore to be deducted from current revenue. Assumptions based on practicality of measurement may modify the ideal matching of revenues and costs. Conservatism also modifies an ideal matching in insistence upon providing for all losses but anticipating no gains.

In the early days of venture accounting, income and expenses were totaled up for a period that might extend over several years, at the end of which the eventual profits or losses on the contributed capital were distributed to the venturers. As soon, however, as one similar venture, such as a trading voyage, followed closely on another, assets and inventories were valued and passed from one venture to another. Accruals of income and expense were required and profits could be computed and distributed even though all assets were not completely liquidated. It is well to realize that every business from a long-term viewpoint is a single venture and that no profits can really be earned until all assets and expenses have been liquidated or recovered. It was the need for reasonably precise periodic reporting of income in a continuing business, plus the inability to determine economic values and changes in such values, that gave rise to current practice.

ACCOUNTING PRINCIPLES BOARD

Over the years, accounting principles could be said to have generally evolved from practice, subject to the influences mentioned here-

tofore, and through Accounting Research Bulletins published by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants. In 1959, this group formed an Accounting Principles Board to conduct research in this area and an accounting research staff was formed under a Director of Accounting Research. Research projects are now conducted by this group and the research studies are widely distributed to members of the profession and the business and financial communities. This will enable all interested parties to express their view on these matters and the Accounting Principles Board will then issue a statement as to what they consider generally accepted accounting principles.

INTERNAL REPORTING

Thus far most of what has been said deals with reporting to outside interests, and this provides the proper perspective for what is to follow. Very few companies today can operate without outside sources of capital and to obtain that capital they must meet the necessary reporting requirements. While external reporting does not inhibit internal reporting in any way, external reporting does prescribe the framework within which internal reporting must exist.

Much financial analysis is external rather than internal, and many of the analytical techniques have developed from this viewpoint. These are often useful for internal purposes and should be used where they are helpful. They should not be considered as restrictive, however, for there are often better techniques for internal purposes.

You may hear, from time to time, such terms as current ratio, acid test, or liabilities to net worth, all of which have reference to short- or long-term debt-paying ability. For internal management purposes, however, a cash forecast is infinitely more suitable.

You may also hear emphasis on turnover of inventory, receivables, and sales. While these ratios are indicative and helpful, reliance on profit planning, budgetary control, inventory control and standard costs will have more long-run effect on profits.

In general, internal reports should provide each level of management with the information they need to know about their areas of responsibility. The reports should be timely and indicative and should not contain unnecessary or immaterial information. Where external reports may be on an annual basis, with selected data published quarterly, most companies now report internally on a monthly basis with selected data weekly. For very practical reasons some companies use reporting periods of even weeks rather than calendar months.

PERFORMANCE MEASUREMENT

Many modern accounting systems operate in several dimensions. The basic accounting data are classified in several ways so that they may be recorded and summarized not only by the accounting classifications required for external reporting, but also by responsibility within the organization and, in some cases, by the reporting requirements of regulatory bodies. This type of accounting has come to be known as responsibility accounting and is an essential ingredient of profit planning. Profit plans or budgets must necessarily be drawn up along organizational lines. Reporting along organizational lines permits the performance of individual units against the profit plan to be measured satisfactorily, thus pointing up the effect of various operating units on the over-all company performance.

There are, as you know, two ways to run a business—by plan or by chance. The first way, management appraises the situation and the problems of the business at appropriate intervals. It decides what it is going to do and reviews the performance. It knows, and the organization knows, where the business is trying to go and how it plans to get there. Future problems are anticipated insofar as possible and people are given definite goals to strive for. This is very different from saying "try hard and do the best you can."

The other way to run a business may be expressed in two words—to drift. Without an organized system of planning and control, decisions are made when they cannot be deferred and problems are met as they arise. Such an approach is not likely to bring forth the best efforts of the people in the organization. Most people respond to a challenge and like to be held responsible and accountable for a certain result. This causes people to think more about their jobs and to do them better.

RETURN ON INVESTMENT

The effective use of capital within a company is vital to its success. It is important to recognize the cost of capital and to use it where it will produce the best return on the investment. The use of the return-on-investment concept as an objective test of planning and as a measurement of performance has become more widespread in recent years, and those of you who have read *My Years With General Motors* by Mr. Sloan have a good perspective of how this concept works out in practice.

The return-on-investment approach was developed within General Motors Corporation as a result of Mr. Sloan's desire to determine the effectiveness of the various operating segments of the corporation. One

of the reasons for its success is that it translates financial objectives into more familiar terms, such as selling prices, profit margin, sales turnover, operating costs, and capital equipment, which are more easily understood by operating personnel.

WHAT ARE FINANCIAL STATEMENTS?

When we speak of financial statements, we are generally referring to the balance sheet, the income statement, and the statement of retained earnings. In recent years a source and application of funds statement has often been included.

A balance sheet tells what is owned by the company, what it owes, and what is the equity of the owners. It will indicate the relative liquidity of the various assets, the bases on which they are carried, and whether they are subject to any encumbrances. It may also indicate whether all the assets are currently used in the business.

The liability side of the balance sheet will show when the various debts have to be paid, and the relative preferences of the different classes of creditors. The stockholders' equity section will show the rights and preferences of the various classes of stockholders.

The traditional balance sheet form shows assets on the left-hand side, with liabilities and net worth on the right-hand side. The name derives from the fact that these two sides equal each other. Sometimes the assets may be shown above the liabilities and in some countries they may be reversed, but they should always balance.

Another form that has gained considerable acceptance is the financial-position form. In this presentation the current liabilities are subtracted from the current assets to show net working capital. Property, plant, and equipment are then added to the net working capital, and long-term debt, if any, would then be deducted to arrive at the amount of the stockholders' equity.

It is important to remember that a balance sheet is prepared on a going-concern basis and that the amounts are shown at historical cost. The balance sheet does not show liquidation value or the value of the business to a willing purchaser. No effect is given to price-level changes as a result of inflation or appreciation, so that many assets may be stated below their realistic values. This matter is now being studied quite carefully by the accounting profession, but until the situation becomes more troublesome than at present no substantial change is likely in this area.

As the result of a recent announcement by the Accounting Princi-

ples Board, leases that are determined to be—in effect—purchases will now be capitalized and shown on the balance sheet as assets and offsetting liabilities, giving effect to the financing charge contained therein.

INCOME STATEMENT

The income statement is sometimes termed an earnings statement. In years gone by, it was more generally known as a profit and loss statement. While some may regret the disappearance of this term, the more common usage today is either "income statement" or "statement of income." In past years the income statement was more likely to be in multiple-step form, but today the tendency is to the single-step form, which lists all income and revenues and deducts all costs and expenses to arrive at net income.

RETAINED EARNINGS

The statement of retained earnings is a relatively simple form which reconciles beginning and ending balances by showing the various transactions affecting retained earnings during the year. These would be net income, or loss, for the period, any cash dividends, any transfers to capital stock for stock dividends, and any charges or credits arising out of the ordinary course of business that would materially distort income if included in the income statement. This statement is frequently combined with the income statement.

CURRENT ASSETS

Current assets are usually the first item to appear on the balance sheet; they represent those assets that will be turned into cash within the normal business cycle. Those of you who are interested in this process will find a very complete explanation in *Working Capital* by Colin Park and John Gladson.

The first item under current assets is usually cash, which requires no further explanation. The bulk of such cash will usually be deposited in a bank or banks and the remainder would represent miscellaneous cash funds. Where available funds are in excess of short-term needs, the cash may be invested in U. S. Treasury Bills or other government securities.

Securities are usually carried in the balance sheet at cost unless the market value has declined since the date of the purchase. An adjustment of the carrying value will not necessarily be made if the decline is merely a temporary one, but a security should be written down to market

if there is a permanent decline in value. It is not customary, however, to write securities up to market and it is quite likely, therefore, that the market value of the securities may far exceed the amount shown on the financial statements. When this is so, the market value of the securities may be shown either parenthetically on the balance sheet or in the footnotes to the financial statements.

Accounts receivable are the amounts owed to the company by its customers for goods purchased from the company or for services rendered to them by the company. A suitable reserve for doubtful accounts is normally provided to reflect the realizable value of the receivables. Such reserves would vary in size or percentage from one company to another for the reason that the credit policy of one company may vary from that of another company, and the credit status of the debtors may also vary.

INVENTORY PRICING

Inventories consist not only of the finished products ready for sale but also of the work-in-process and the raw materials and supplies on hand to manufacture the goods for eventual sale. Inventories are usually priced at "the lower of cost or market" to avoid inflating earnings as a result of sharp increases in commodity prices. There are several methods of computing costs, however, each of which is in general use but each of which may produce a different value for the inventory.

The three principal methods in use are the first-in-first-out method commonly known as FIFO, the last-in-first-out method commonly known as LIFO, and the average-cost method. Most of the methods, other than the LIFO method, will produce substantially similar inventory values. If a company has been on a LIFO basis for a long period of time and if the inventory contains basic commodities that have increased sharply in price, the market value of such inventories may be several times the value shown on the balance sheet.

Pricing the inventories at cost ordinarily achieves the objective of proper matching of costs and revenues. A departure from costs will be necessary when the utility of the goods is impaired by damage, deterioration, obsolescence, or changes in price level. Any such loss should be charged to revenue in the period in which the loss occurs.

The term *market* as used in the phrase *lower of cost or market* means current replacement cost by purchase or reproduction as the case may be. There is, however, a ceiling and a floor to this market price. It should not exceed the estimated selling price in the ordinary course of business less an amount for reasonably predictable costs of completion

and disposal. Similarly the market price should not be less than the net realizable value reduced by a normal profit margin. To understand how this works out in practice, consider the following examples:

	A	*B*	*C*
Purchase replacement cost	50	50	50
Cost to reproduce	*45*	45	45
Net realizable value	48	65	*43*
Net realizable value less normal profit margin	40	*48*	38

CURRENT LIABILITIES

On the opposite side of the balance sheet you will first find the current liabilities. In the financial-position form they would be deducted from the current assets to arrive at an amount for net working capital. These liabilities consist of money owed to suppliers, employees, and taxing agencies, dividends declared but not yet paid, and the current instalments on any long-term indebtedness.

Generally speaking, these types of liabilities tend to increase as business increases, but there are certain relationships that creditors expect to see between current assets and current liabilities and between liabilities and net worth. The creditors do not like to be in the position of taking a stockholder's risk. The stockholder expects to gain most from a company's growth and success and should, accordingly take the greater risk.

WORKING CAPITAL

One of the most widely used ratios, and perhaps greatly overworked, is the current ratio or the ratio of current assets to current liabilities. The standard in this regard is that the current assets should be twice the current liabilities, and an increase in the current ratio is usually regarded as a sign of financial strength. After a certain point, however, this no longer holds true and it may, in effect, be a sign of weakness.

Some companies are very effective in the management of their working capital. A good cash-forecasting procedure can enable a company to handle bank loans intelligently and to utilize, efficiently, idle funds that may develop from time to time. Most bankers like to see short-term loans off the books at least once a year and preferably at the time of the published report. This can be done more readily when the firm adopts a natural business year, which means to arrange the fiscal year end to coincide with the low point in business activity. Among

other things, this will improve the current ratio and give a better financial appearance to the annual report.

FIXED ASSETS

Each year American industry makes sizable capital expenditures to obtain either additional production or more efficient production. Expenditures for research and development are constantly increasing, and each dollar spent on research and development requires the spending of three or four dollars subsequently on capital equipment. In each type of industry there is a fairly well established ratio between fixed assets and net worth. The more a business grows the more fixed assets and capital will be required. There is usually also a generally established ratio in industry between sales and fixed assets. In the heavy industries it is usually necessary to invest a dollar to get a dollar of annual sales, whereas other industries may have a large sales volume in relation to investment.

The fixed assets and their related reserve accounts deserve more attention than they probably get from readers of published statements. It is important to look behind the financial statements to know whether it is high-cost property or low-cost property, and what the bases may be for computing depreciation. There has been tremendous price inflation in this country in the last fifty years, but it is not uncommon to find land values expressed in financial statements at 50-year-old prices. Equipment that is stated at a net book value based on original cost may be well below the current replacement market. The net book value of similar pieces of equipment purchased in the same year, and at the same cost, by different companies could be different because of each company's using a different basis of depreciation.

Depreciation accounting aims to distribute the cost of capital assets over the estimated useful life of the unit. It is a process of allocation, not valuation, and does not provide a fund for replacement. Most companies use one of the accelerated-depreciation methods, such as the sum-of-the-years digits method, double-declining-balance method, or the straight-line method.

The straight-line method results in equal depreciation charges over the useful life of the asset. An accelerated method provides larger depreciation charges during the earlier years and smaller charges in a later period. The choice of approach will make differences in the net book values shown on the balance sheet and will also affect the annual earnings.

CAPITAL

The term *capital* is generally considered in financial circles to be long-term debt, preferred stock, common stock, and reinvested earnings. A bondholder is a creditor of the company and as such has certain legal claims over preferred stock and common stockholders. Long-term money may be borrowed at different times and at different rates. Premiums may be required if the bonds are called prematurely.

Bond indentures will normally carry provisions concerning the working-capital ratio that may be required, the percentage of long-term debt, the payment of dividends, or other such provisions that the bondholders may feel necessary to protect their investment. If any of these provisions are material they will be commented on in the footnotes. Long-term debt is attractive to a company if the earnings from such money will cover the interest, although it is generally felt that such earnings should cover the average cost of capital. Preferred stock is not used so much nowadays as a method of financing because bond interest is deductible for tax purposes by the company whereas dividends on preferred stock are not.

Long-term money will give considerable leverage to a company's stock and increase the earnings thereon. In depressed times or industries, however, this works both ways. Long-term lenders do not want to end up owning the company, so they normally expect the stockholders' equity to be twice the long-term debt. In public utilities, however, the long-term debt may quite often equal or slightly exceed the stockholders' equity. A test that is often applied in this connection is the number of times that interest charges have been earned before taxes. A satisfactory ratio for a manufacturing concern would be five to one and for public utilities a three to one ratio is considered adequate coverage.

STATEMENT OF INCOME

The items on the income statement tend to be more straightforward but the income statement usually deserves more attention than the balance sheet since the value of a business is primarily dependent upon its earning capacity. Income statements are usually in comparative form, comparing this year to last year, or, for internal purposes, this year in relation to the budget. Percentages are sometimes given showing the relationship of the various components as a percentage of net sales.

Sales are usually the first item shown on the income statement, and it is important to know not only whether sales have increased but whether these increased sales have brought increased profits. Sometimes

sales volume has not increased, dollar increases possibly being due solely to price inflation.

Costs are incurred on behalf of people performing useful company functions. Among the functions that are to be found in most industrial companies are production, purchasing, physical distribution, marketing, research and development, finance, and administration.

The historical accounting approach has been to translate production costs from functions to products, thereby arriving at product costs. From a practical viewpoint the separation of manufacturing costs from all other costs, treating the former as product costs and the latter as period costs, has been the established practice and has much to commend it.

Marketing and physical distribution costs have been steadily increasing as a percentage of the manufacturer's total cost. A recent study published by *Distribution Age* indicated that in the six industries of food, machinery, chemicals, paper, metals, and wood, the average of physical distribution costs alone was 22½ per cent of net sales.

EXTRAORDINARY ITEMS

One factor that must be considered in any analysis of the income statement would be the extraordinary items having the capacity to influence the net income materially. These items are usually of a non-recurring nature, such as sales of property or unusual losses, which may be presented in different ways, depending upon the materiality. If they are large enough and relate to prior years, they may be carried directly into the surplus account. In preparing subsequent registration statements it is the usual practice to adjust the various years these particular items may have affected.

Another matter that should be given consideration is the effect of carry-back and carry-forward provisions of the income tax law, as they may affect the current year's income. If, for example, a company has a loss of $500,000 before taxes and by carrying this loss back to previous years would be entitled to a refund of income taxes of half the amount, it would end up with a net loss for the year of only $250,000. If it had losses in all the previous years, however, there would be no current refund. There still would be the possibility of profits in future years, in which case the first $500,000 of such profits would be tax-free.

SOURCE AND APPLICATION OF FUNDS

A useful analytical tool in reviewing a company's operations for a period of a year or longer is to prepare a statement of source and appli-

cation of funds. Such a statement shows where a company obtained its funds, such as from operations, sale of assets, or outside financing, and how it used such funds, as, for instance, for the purchase of capital equipment, the reduction of debt, or investment in subsidiaries.

In recent years, partly as a result of an Accounting Research Study by Dr. Perry Mason, published by the American Institute in 1961, there has been more of a tendency to include such a statement in the annual reports and, in some cases, to cover it with the accountants' opinion. This trend is likely to continue as it is very helpful to financial analysts and the investment community generally.

SUMMARY

In summary, therefore, we can see that there has been a historical pattern to the development of accounting and that this development is continuing within the framework of the accounting profession. There is a body of generally accepted accounting principles that has been developed for use in stating various items on the financial statements. These are not rigid rules but are sufficiently flexible to meet the needs of different industries. Judgment must be exercised within the framework of these generally accepted accounting principles. Much time and effort go into the preparation of published financial statements and in seeing that companies make adequate disclosure of all matters that could have a material effect on items appearing in the financial statements.

The primary objectives of accounting are to measure income, to indicate financial liquidity, to determine the return on equity, and to make necessary reports to regulatory bodies. To these should be added, for management purposes, such objectives as evaluating performance and obtaining the necessary information for planning and making decisions. Various supplementary procedures, such as sales analysis, sales forecasting, cash forecasting, standard costs, expense budgets, capital equipment budgets, distribution-cost analysis, and product-profitability studies, are important tools of management control with the uses of which the non-financial executive needs to be thoroughly acquainted.