1959

Accounting -- a tool for business success (pattern speech)

American Institute of Certified Public Accountants

ACCOUNTING -- A TOOL FOR BUSINESS SUCCESS

(This is a speech outline which covers the same subjects as the attached speech text. You may find, as many people do, that your delivery is more spontaneous and convincing if you speak from an outline instead of reading a text. The minutes listed in the left column indicate the time you might spend on each topic and thus cover all important points in about 30 minutes. The illustration of how accountants use a somewhat scientific approach in order to help businessmen make bigger profits (pages 6-8) might easily be cut if you wish a somewhat shorter speech, or if you feel that this material is too technical for your audience.)

(6) I. <u>The importance of accounting as a tool for business success is growing</u>.

A. Reasons for success in business -- as revealed in "success stories".

1. Rockefeller

2. Harriman

3. Carnegie -- and the use of accounting to get the "inside details".

B. How the business world has changed since Carnegie's day.

1. Bigger businesses

2. Central banking system, guaranteed deposits, guaranteed mortgages.

3. Group insurance, pension funds, Social Security.

4. Expansion, mergers, product diversification.

5. Taxes

6. Standards of disclosure

7. Repricing, cost inspection, renegotiation.

C. Expansion and refinement of accounting.

1. Evidence of this in <u>Journal of Accountancy</u>.

2. Use of accounting in financial interpreting, office systematizing, budgeting, cost control.

ACCOUNTING -- A TOOL FOR BUSINESS SUCCESS

(pattern speech)

I. The importance of accounting as a tool for business success is growing.)

A generation or so ago, business leaders had the quaint habit of confiding to the public why they had been successful. This was not a bad custom. While the explanations were not always helpful as guides to action, they threw light on the characters of some interesting people.

For example, the first John D. Rockefeller once confessed that he seldom went to sleep at night without saying something like this to himself: "Now you have a little success. . . Because you have got a start, you think you are quite a merchant. Look out, or you'll lose your head. Go steady!"

The railroadman Edward H. Harriman's recipe was "an honest return for the other man's dollar." Which, in the long run, is no doubt better than a certain super-salesman's advice: "Sell the sizzle and not the steak!"

However, the thought that has the most direct bearing on what I'm going to talk about was expressed by Andrew Carnegie. Some competitors once sent some men to Pittsburgh to find out how he managed to undersell them. Carnegie heard about their visit and invited them to inspect the plant. Finally he showed them what he called "the secret of my success" -- a room full of clerks at work on documents. "It costs me $80,000 a year to run this room," Carnegie explained, "and it's worth all it costs; for it gives me the inside details of my business, and I know what I'm doing."

These remarks put in a nutshell how accounting can be used for business success -- that is, can give management "the inside details", so that they can know what they are doing.

(10) II. <u>The general character of accounting as a management tool -- two examples.</u>

A. Illustration of how a professional is needed in helping a businessman with taxes (for example). The story of the chicken farmers whose partnership was changed into a corporation with tax savings that in 5 or 6 years amounted to about a million dollars.

B. Illustration of how somewhat scientific methods in accounting can be used to maximize profits.

A formula for applying the concept of return on capital employed.

(12) III. <u>The scope of accounting as a management tool -- two areas in which a small businessman can easily make a start toward more scientific management.</u>

A. Different rates at which big and little business adopt advanced accounting techniques.

B. Budgets -- where a small business can begin to use the advanced accounting techniques.

1. Results of survey reported in Institute bulletin -- 65% of small businesses without budgets.

2. Misconceptions about budgets

a. That they are complicated -- actually simple.

b. That they are expensive.

c. That they limit management.

d. That they are just a "guessing game".

(Comparison -- a well-drilled football team and a sandlot team. . .)

3. Advantages of budget in assisting decision-making:

a. Costs

b. Credit

c. Inventory

C. Paperwork -- a specialized area in which there is very often an opportunity to improve.

1. Findings of Columbia University and Records Management Institute study.

   b. 2,000 pieces of paper for each person on payroll in average company -- $400 for each man.

   b. 65¢ on each dollar wasted.

2. How waste comes about:

   lack of care in checking performance of office workers, compared with production workers.

3. Effect of wasted effort in paperwork:

   amount of business needed to produce a letter, a file drawer, or an unnecessary $500 to $1000 a year in clerical expense.

4. Standards developed by Records Management Institute (average manufacturing concern with 100 employees).

   a. 62 file drawers -- average 103

   b. 29 in office -- average 70

   c. Storage of less active records -- $27.20 a year

   d. Vital records in one file drawer.

   e. Protection of vital records -- half-cent a paper.

(2) IV. <u>Conclusion</u>

A. Accounting for management a large study -- list of books for accountant's library recommended by the Institute's library.

B. Speech has been illustrative, not comprehensive.

C. Accounting a useful and sometimes necessary chart for management.

Total time:

about 30 minutes

Of course, even the largest businesses in Carnegie's time were relatively small by today's standards and were mainly in basic industries where the management of capital followed practices that were fairly well established. How elementary the economic life of that period now seems! There were no central banking systems, no guaranteed deposits or guaranteed mortgages. There were no group insurance, pension funds or Social Security system. Today's almost irreversible trend toward expansion, mergers, and diversification or products had barely begun.

Also, Carnegie didn't have to worry about the income tax, and other new types of taxes that began to appear after World War I. His corporation didn't have to comply with standards of disclosure that were developed during the 1930's. He didn't have to cope with cost inspection, repricing, and renegotiation -- which developed during and after World War II.

All in all, what Carnegie said about the secret of his success can now be doubled in spades -- because doing business today has become a much more complicated job.

Accounting is just one of the arts or sciences that a businessman may find useful or necessary. The <u>laws</u> relating to his business have become more complex -- along with such matters as the determination of what insurance he should carry, or where and to whom he should attempt to sell. A businessman should know how and when to acquire -- or hire -- several kinds of professional skills.

For example, how many businessmen still decide to open a retail store just because they look a neighborhood over and for somewhat subjective reasons just like the looks of it! A market research expert, for a comparatively modest fee, can make a survey and come up with the factors that determine how great a volume of business can be expected. This kind of information is crucial before plunging with your life's savings!

However, since I am a certified public accountant, I'll talk about what I know.

Reflecting events, accounting itself has also become more complicated. Every issue of The Journal of Accountancy, the leading professional publication of certified public accountants, contains articles describing new techniques, or applications of techniques to new areas. Quite a few of them have to do with financial interpreting, office systematizing, budgeting, and cost control -- but this little list is by no means inclusive. Like engineering and some of the physical sciences, accounting has become a more comprehensive body of knowledge, and as such it is making a big contribution to the technological breakthrough of our era.

Let's now look at a couple of examples of how accounting gives management the "inside details" it should have. They will illustrate the importance and general character of accounting as a management tool.

(II. The general character of accounting used as a management tool -- two examples.)

My first illustration is a short and true success story about three brothers who ran a chicken farm. One of the brothers was a whiz at genetics. He had little textbook knowledge; but simply by crossing the handsomest birds over a period of years, he became one of the first in his region to develop the big-breasted chickens that now make fast-selling items at the butcher's. If his birds weren't quite all white meat clear down to the drum-sticks -- as in the old folk saying -- they were close to it.

As one might expect, the three brothers prospered, earning about $100,000 a year each. They employed about 20 people.

Their business was set up as a partnership, and with this kind of organization their assets were regarded as almost negligible, considering how much they earned. They had buildings worth perhaps $40,000. Their equipment was trifling.

One fine day, they became aware that their accounting system was not all that it might be -- and called in a CPA to set up a new one. After about a half-hour's work, it was obvious to this CPA that the brothers should change from a partnership to a corporation. This would enable them to capitalize good will on their financial statements at a very respectable figure indeed, since their return on their capital was so great. Then they would be in a position to set up a debenture against the good will -- in such amount to assure that the corporation was adequately capitalized. The profits of the corporation could then be used to pay off the debenture to the three brothers. The CPA and his client consulted a lawyer on the legal propriety of this step. It turned out to be okay. Subsequently, by going through this legally proper and advisable step before landing in the pockets of the brothers, profits were not reduced so much by taxes. In fact, the portion of profits that paid off the debenture could be taxed at the rate for capital gains. In five or six years, the three brothers increased their take by over a million dollars!

You must understand that those chicken farmers were <u>not</u> less informed about accounting matters than the average small businessman. A public opinion research group recently sampled small business attitudes and found general agreement that certified public accountants are important to profitable operations because of their tax services. But the same sampling revealed that only about half of these businesses even attempted to use accounting in a systematic way as a prerequisite of effective tax planning.*

One company official noted that their CPA, in making out the tax return, always told them how to avoid in the future the mistakes that were made in the past. He remarked to the interviewer, "That's tax planning, isn't it?" Of course, from an accounting point of view, hindsight during the April madness is deplorably late, and is not really "planning" at all.

Now -- in spite of any appearance to the contrary -- the moral of this story is not necessarily that you should rush to a CPA, who will promptly turn you into a millionaire! Actually, every businessman is himself an accountant too -- to a degree. The degrees vary -- not only because of differences in accounting knowledge, but also because of differences in time available to apply accounting knowledge.

There is, however, a somewhat more subtle lesson in the story. I think it could be put like this: every businessman should know enough about accounting so that he knows when he can handle his accounting problems properly and when he can't. If he knows he can't, then he can take steps -- either by making changes in his own accounting system or department (if he has one), or by using the services of his CPA.

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* See the Institute's Bulletin #2 Economics of Accounting Practice -- Small Business Looks at the CPA.

Accounting is essentially a social science that is employed to a degree by everybody who handles money. Every professional accountant worth his salt hopes for the day when the non-professionals know enough about accounting so that they know when they need professional help, and when they don't.

My second illustration of the general character of modern accounting as a management tool is not a story of a particular company. Rather it is a formula that the experience of many companies has shown to be useful. The development of useful formulas that illuminate the significance of the relationships between variables in business operations appears to be an important and growing trend in accounting.

While a number of illustrations might suit our purpose, let's take one that has a bearing on the core problem of any business. This is: <u>are you getting your money's worth out of your capital</u>?

For many businesses, the question has become increasingly urgent during the past few years. A recent <u>Fortune</u> magazine survey revealed that only 4 out of 12 major industry groups represented in the 100 largest United States industrial corporations made a better showing on capital in 1955-56 than in 1950-51. In a word, there seems to have been for several years a harder squeeze on profits, and I do not need to tell this audience that many little as well as big businesses have felt it.

To resist the pinch, alert management has relied more and more on the concept of return on capital employed as a basis for several kinds of decisions. For example, General Electric, to name one company among many, has adopted a policy of not being interested in new ventures unless they earn 7 per cent of sales after taxes, or a 20 per cent return on capital.*

The concept may also be useful to many a small business, and some accountants have fairly recently reduced it to a formula that works like this:

First, you divide the sales by the capital employed to find the rate of capital turnover. For example, if the Acme Box Factory has sales of $500,000 from the employment of $250,000 of capital, capital is turned over two times during the period.

Next, profit is divided by sales to give us our earnings expressed as per cent of sales. The Acme Box Factory has a profit of $50,000. Divided by $500,000 in sales, this gives us 10 per cent earnings on sales. This kind of measuring is done by practically all companies, but it does not tell the whole story and can at times be greatly misleading.

We have a far more significant measure when we multiply the rate of turnover by the per cent of earnings on sales and get the per cent of return on capital employed. For the Acme Box Factory, this is 2 times 10 per cent, or 20 per cent.

Naturally, the formula gains in significance with use, since a more meaningful standard for periodic comparisons is established. What we look for is briefly this: more sales while maintaining the same percentage of earnings on sales and increasing the earnings on capital.

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* The really significant ideas related to this formula originated in H. L. Lammie's article, "Return on Capital Employed", The Journal of Accountancy, August, 1958.

Of course, the application of this formula to a real situation is much more complicated than this simple application to a hypothetical example like the Acme Box Factory.

In the first place, what do we mean by "capital employed"? Naturally, we mean the permanent capital -- the fixed plant, property, and equipment. And ordinarily, we mean the working capital too -- cash, accounts receivable, and inventories. This question isn't hard to answer, but we must be clear what "capital employed" includes if we are going to use it as a component in a formula.

A second question is more difficult. What is the basis for valuation of the capital employed? Are we valuing our capital in terms of original costs, cost less depreciation, or estimated replacement value? The pros and cons of using one basis or another are lengthy. In general, choice depends upon a number of factors -- particularly in the use of the ratio, the company organization, and the nature of the assets.

Proper valuation requires a high order of accounting judgment.

But we don't need to be overawed. Even the layman as well as the professional accountant can use a handy rule of thumb in measuring how "high order" it is. This handy rule is summed up in the word <u>consistency</u>. Whatever basis for valuing capital is used, the formula is a dependable management tool only if we are consistent about the basis for our valuations, or analyze properly the effect of inconsistencies -- where for one reason or another they cannot be avoided.

There are also pitfalls in the proper determination of what the profit figure is, if it is to be used in such a formula.

However, once its components are properly determined, this formula can be useful to management in a number of critical ways. It can measure performance at the company level, or at the division level -- or it can measure the profitability of products. It can be used in planning capital appropriations, inventory and manufacturing requirements, product pricing, and budgeting.

But it is not my purpose at the moment to sell the virtues of just one formula. I cite this concept of return on capital employed as merely one example of how modern accounting does more than provide "inside details" -- as in Carnegie's day; in addition to this, it now provides techniques for their interpretation. By using them, any businessman -- whether he is a budding Carnegie or not -- can be better assured of making sound decisions.*

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* Other illustrations of this point might be used if the speaker prefers them. A useful case history that could easily be incorporated in this speech in place of the concept of return on capital employed is developed by Robert M. Trueblood: "Accounting and New Management Attitudes", The Journal of Accountancy, October, 1958. Trueblood cites as an example of the new interest of business in the scientific method the use of probability sampling and electronic data processing in accounting for a widely scattered and hetrogeneous inventory.

Another example that might be useful in this context is the model working capital forecast developed by Richard M. Rothschild and Paul Kircher in "Projecting Capital Needs", The Journal of Accountancy, September, 1955.

Or -- particularly if the speech is delivered before a group of small businessmen to whom the concept of return on capital employed is much too advanced -- the speaker might wish to substitute an anecdote from personal experience. Perhaps a story of a businessman who improved performance through employee testing or market research might be in order.

III. The scope of accounting as a management tool -- two areas in which a small businessman can easily make a start toward more scientific management.)

Now we have seen that nearly all businessmen need a specialized and somewhat scientific approach in order to maximize profits.

Of course I am aware that this kind of approach may be easier for big businesses, although I suspect many big businesses have adopted the new accounting techniques more rapidly than small business simply because the need was more apparent. The complexity of their operations is such that decision-making on a basis of inadequate accounting information and interpretation becomes unbearable. In the smaller businesses, the need for new techniques is apt to creep up on management.

At any rate, it now seems in order to raise this question: where can a business -- and particularly a small business -- begin to make use of the specialized techniques that he needs?

I think that the experience of a very large number of certified public accountants suggests that many small businesses can improve their performance quite rapidly by budgeting properly.*

My national professional society, the American Institute of Certified Public Accountants, recently reported in one of its bulletins** on the results of a survey of small business procedures in New England. Over 65 per cent of the small businesses interviewed for this survey had no

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* For further details, see John Carey's column, "From the Executive Director's Desk", The CPA, July-August, 1958; and Wayne Keller's article, "An Approach to Budgeting -- Particularly for Small Business", The Journal of Accountancy, November, 1958.

** Number 2 in the series, Economics of Accounting Practice.

budget. That meant, of course, that their planning and control -- if they had any -- was by guess and by feel; and they certainly were accepting an unnecessary disadvantage in competition with other companies.

Sometimes the disadvantage is disastrous. Analyses of business failures usually develop reasons such as inadequate capital, excessive granting of credit, overstocking of merchandise, and high costs of operations. All of these can be reduced to a common denominator -- inadequate planning and lack of controls. And the first step in remedying this defect is a proper budget.

Why, then, don't more companies have proper budgets?

The reasons seem to be historical. It takes a little time for anything good to "catch on." And frequently, small businesses do not have budgets because there are still a number of common misconceptions about them: It is often thought that a budget is quite complicated. Actually, for a small business it is quite simple, and cannot run ahead of the existing system of accounts and records.

Second, it is sometimes thought that a budget substantially increases accounting costs. Actually, costs of accounting and statistical processes go up about 10 to 20 per cent when a budget is instituted. This added cost is ordinarily recovered many times over in increased operational efficiency.

Third, a budget is often regarded as a spending limit, as budgets for governments used to be considered. However, the fundamental purpose of a budget is really to provide a basis for evaluating the probable results before they are made and the actual results after they are made. Thus a budget <u>helps</u> management decision, and does not hinder it.

And finally, it is sometimes thought that a budget is just a "guessing game" anyway because the goals set forth in the budget are so often missed. Of course, this kind of argument can be used against any kind of planning.

As an example, take football. On a well-drilled team, all eleven men know exactly what they hope to do on every play. For obvious reasons they don't always do it. I think it was Knute Rockne who first made a kind of slogan out of the idea that every perfect play ends in a touchdown. Yet his teams, which did not make a touchdown on every play, did not for this reason give up trying to execute perfect plays.

For comparable reasons, a business that does not make a complete success out of every operation in terms of its budget probably needs to give more rather than less attention to budgeting. Sand-lot football teams and "seat-of-the pants" businesses without pre-arranged plays and budgets don't belong on the same field with football teams and businesses <u>with</u> them.

After a businessman prepares a budget, he can compare performance with a reasonable goal. Then he is in a better position to answer a number of questions on which his success may depend. Such questions as these:

Where should I cut costs?

Am I getting all my costs into my overhead account?

Am I giving too much credit? or too little?

Am I taking too much credit? or too little?

How does my inventory shape up? (While it's an asset, the only way to pay a bill with an asset is the way the sheriff does it -- by turning it into cash.)

Of course, for small businesses in particular, it is important that a budget be simple and useful, answering the questions that naturally arise and cause difficulty. Accounting as a management tool is apt to begin with the budget, and then broaden out as the business gets bigger, and as more information is required in specialized areas for management to make intelligent decisions on the basis of reasonably adequate information and interpretation.

I would like to talk about a number of these specialized areas if your durability and mine had no limit. There are a number of them where I believe a large number of businessmen are losing money. Proper employee testing and evaluation, wage evaluation, and cost analyses are three areas that come quickly to mind.

However, I will pass them by and say only a few words about another specialized area, because almost every businessman who begins to broaden out at all runs into it.

This area is paperwork -- or records management.

Recently, a program was set up by Columbia University and the Records Management Institute for analyzing this problem nationally. They uncovered some rather startling situations.

They found that the average manufacturing company with 100 employees maintains at least 2,000 pieces of paper for every person on the payroll. That the paperwork for every man on the payroll costs about $400 a year. (Some $2,000 for men on government payrolls.) And that, in this average manufacturing concern with 100 employees, 65 cents out of every dollar spent for paperwork is wasted!*

When you compare controls of most businesses in production and in the offices, you appreciate how this problem arises. Few manufacturers would dream of letting a $5,000 factory worker determine how to make a product. Yet a $4,000 office worker often creates his or her own files, procedures, and paperwork operations.

Then what happens?

Typically, the cost of creating one letter eats up the profit of $18 worth of business. The cost of maintaining one office file drawer for a year eats up the profit on $727 worth of business. By making decisions which he or she is not competent to make, a clerk may easily cost a seemingly insignificant extra $500 to $1,000 a year. Yet this $500 to $1,000 requires $10,000 to $20,000 worth of business to pay for it.

In brief, you need the same scrupulous control over your paperwork that you need over your production.

The Records Management Institute has developed some general standards. While these naturally must be modified in being applied to individual companies, quoting them may give you at least a rough idea whether more birth-control of documents is needed in your company. Their analysis showed that the average manufacturing concern with 100 employees should:

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* The ideas in this section came from Arthur Barcan's article, "Frontiers in Records Management", The Journal of Accountancy, November, 1956.

1. Have no more than the equivalent of 62 file drawers of records in the office and storage. (The average has over 103 drawers, a surplus of 40 -- with 131,000 unnecessary pieces of paper.)
2. This concern should retain only 29 of these in the office. (As against an average of 70.)
3. It should store the less active records at $27.20 a year.
4. This average concern with 100 employees should limit the vital company records to less than one file drawer. (Instead of about twice as much space in square footage and about five times as much in cubic footage.)
5. It should protect the vital records at a cost of about a half-cent per document.

If you find that you are comparable to this average in keeping down paperwork, rather than in line with the standard devised by the Records Management Institute, it may be that you have not realized how much your paper work is costing you; it may be that management of your records could be improved; or it may be that you have no objective guide for evaluating your paperwork.

I have singled out this specialized area as one of many in which accounting as a management tool is saving money for some progressive firms, because this particular area is important to almost all kinds of businesses. And it is often overlooked.

(IV. <u>Conclusion.</u>)

I have now finished my attempt to describe the general nature and scope of modern accountancy's services to business management. Of course, I have only skimmed the surface.

Recently, the library of the American Institute of Certified Public Accountants suggested a selected list of over a hundred books for an accountant's library. Nineteen of these were entirely about accounting as a management tool. At least 30 more dealt quite extensively with some aspect of accounting as a management tool. Almost all the books at least touched on the subject.

So I hope you will understand why -- in some 30 minutes -- I have chosen to be illustrative instead of comprehensive.

However, I hope that I have suggested areas for fruitful analysis of your own business operations. And perhaps ideas about how you may find solutions to problems.

If we now add all of this up to make one meaningful point, I think we may state this: we live in a business climate today in which any enterprise may easily be swept off course by technological, economic, and political cross-currents; in accounting the businessman has some of the instruments for knowing where he is, so that he can act accordingly.

SAMPLE NEWS RELEASE

John Doe, certified public accountant of Emporia, Iowa, spoke to the Emporia Rotary Club at its weekly Thursday luncheon on "Accounting -- a Tool for Business Success."

The accounting procedures of many small businesses today are more complex than those used by Big Steel when Andrew Carnegie made notable use of accounting as a management tool over fifty years ago, Mr. Doe pointed out. Taxes are one factor among many that make the modern businessman's life more complicated. Mr. Doe cited as an example some chicken farmers who by financial reorganization saved a million dollars in tax money in five or six years.

Mr. Doe recommended that most small businesses should improve their use of accounting for management purposes by installing proper budgets and making a critical examination of how their paper work is done. He is a member (or partner) of the Emporia accounting firm of Doe and Brown.