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Accounting Trilogy

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THE ACCOUNTING TRILOGY

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Since the early origin of accounting in Babylon and Assyria, people of various nationalities have seen the need of accumulating and making intelligent interpretations of facts relating to business. To trace the progress of accountancy would be to trace the advancement of commerce, with our present day concepts of double entry accounting dating from 1494 with Pacilol's *Summa de Arithmetics, Geometria, Proportioni et Proportionalita.* The progress from that day forward has been overwhelming, the greatest part taking place within the last 35 years. Accountants were the "little men with the green eye shades" who sat at desks day after day recording historical costs. Today, this type person is called an office clerk or bookkeeper, not an accountant. Accounting has developed to a professional status worthy of its place among the other great professions.

Accounting interpretations have changed also. Prior to the industrial revolution business was carried on primarily on a small, individual basis. As long as this was the case, the owner was in close touch with every phase of his business so there was little need for records except for records of indebtedness. But as business grew, more records were required and annual financial statements became necessary in order to show all interested persons the status of the business. For many years there was only one accounting statement prepared for the annual report and that was, of course, the balance sheet. This practice was prevalent during the 1920's. Even as late as 1935 some of the very large companies included only the balance sheet in their annual reports to stockholders. However, a change had started and some companies began showing both a Profit and Loss Statement and a Balance Sheet (with a Surplus analysis).

Another change is taking place now. That is the inclusion of a Statement of Sources and Application of Funds along with the statements already mentioned. This statement fills a gap in financial analysis. So often the owner of a business looks at the net profit figure with amazement for it seems incredible that he could have had such a large net profit figure with no corresponding increase in his cash account. The Funds Statement shows what resources were made available during the accounting period and how such resources were used. It is more than a flow of cash statement; it shows a flow of working capital.

It cannot be said the Funds Statement has the extensive use that the Profit and Loss and Balance Sheet have but a recent survey made by the author has given evidence that it is being used by some companies in their published annual reports.

The survey included an analysis of 100 annual reports to stockholders of corporations, for the fiscal year 1955. The 100 reports were picked at random. Of the reports examined, twelve were found to have included a Statement of Sources and Application of Funds, appearing under the following names:

NAMES	*USED BY*
Changes in Working Capital	4
Sources and Application of Funds	4
Summary of Financial Operations	1
Statement of Application of Funds	1
Changes in Net Working Capital	1
Source-Use-of-Funds-Statement	1

These twelve reports were made by six different national auditing firms. This seems to indicate that the inclusion of the Funds Statement is acceptable practice of many of the national auditing firms and not just the practice of one firm.

The relatively short statements included such items as:

Source:
- Profit for year.
- Add: Charges not requiring cash outlay —Depreciation, depletion, amortization
  - Sale of capital assets
  - Sale of capital stock
  - Sale of bonds
  - Bank loans

Application:
- Capital outlays on: Land, building, etc.
- Founded debt retirement
- Payment on long-term notes
- Investments
- Dividends
- Increase in working capital
- Redemption of preferred stock
- Increase in holdings of treasury stock for corporate purposes

No company used all of these classifications; in fact, most companies used only about three in each of the two groups above. However, three of the companies made their statements more meaningful by giving the

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and labor to produce maximum profit to the owners, service to the community and satisfaction to the workers.

Adequate stock control results in that amount and kind of merchandise being used which will make the greatest possible contribution to the net profit of the business. It is the basis of sound purchasing and merchandising practice. An efficient system of inventory control permits a firm to keep its stock on hand as small as possible and, at the same time, avoid shortages of materials which cause interruptions in the productive process or which dangerously limit the sales opportunities. As a result of these two advantages, stock control permits a firm to operate with less capital. Storage charges, price declines due to falling market, and loss due to obsolescence are additional economies effected by adequate stock control.

Skillful scheduling of raw materials, work-in-process, and finished goods is based on the formula for inventory turn-over, the schedule that may be expected for deliveries of raw materials, the anticipated requisitions during production and the orders expected for finished goods. It is not necessary for the alert manager to know all of these facts and schedules, but he must have information and must know how to use the facts reported to him by the various departments.

Inventory may be handled through periodic or through perpetual methods. The method is determined primarily by the type of articles involved and convenience in record-keeping. Management will determine the system which is most efficient in adequately recording this asset.

Finally, it seems logical that competent control of inventory is not only reflected in increased capital, but also observed in labor, the third element which is essential to complete operation. Reduced confusion in the purchasing department, adequate service on requisitions and prompt deliveries in the shipping room are some of the results which reduce friction among the personnel. This guidance affecting the workers is assuming increasing importance in the success of an organization. This is that intangible something which makes the workers feel that "the show must go on." Pride in the job automatically follows such a spirit.

It seems axiomatic that a proud and happy personnel working with adequate inventory to create added capital which in turn will benefit the personnel is a circle that approaches perfection. This is the type of "show" that investors might call "The Blue Chips." The college student in the audience watches in amazement the perfection of the acting, the plot, the coordination, the props, the scenery, and the director. If this student will accept intelligent changes and criticisms, he may have talent and acquire sufficient training to be one of the great actors in industry some day. Furthermore, America can furnish the stage and props for this same lowly student to become the conductor of a great opera, "Industrial Excellencia," because the possibilities are infinite in the fields of tomorrow.

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countant this industry offers some of the greatest opportunities for success and leadership in production, sales, research and finance.

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sidered:

1. Internal check and control should be most detailed where most needed. This determination is based on the probability of loss and the cost of control in relation to the accuracy to be gained. This requires careful evaluation of both procedures and personnel. There is a danger of a false sense of security where the control set up does not meet the specific situations, or is not adapted to the abilities of those who are expected to operate it.
2. Any system of control is only effective insofar as it is understood and followed.

Constant attention is needed to see that these two essentials are being met.

REFERENCES

1. BRINK, Victor Z., *Internal Auditing.* New York: The Ronald Press Company, 1941.
2. MONEGAN, Woodside V., "Auditing," *C.P.A. Review Manual.* New York: Prentice-Hall, Inc., 1951.

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report on a five-year comparative basis. One company had its Funds Statement on a ten-year comparative basis.

The Funds Statement was not born in the 1950's as its present growth might indicate. Around 1930-35, the statement was often referred to as the "Where Got" and "Where Gone" Statement wherein was presented a summary of balance sheet changes. The statements took various forms but one of the often used forms followed a balance sheet arrangement where the balance sheets for two consecutive years were compared and the net change for each balance sheet account put in either the "Where Got" or the "Where Gone" column. Any debit changes indicated applications of funds (where gone) and the credit changes indicated sources (where got). However, it was readily seen that just an analysis of the balance sheet would not give a clear picture of what had happened and that it was really necessary to go back to the accounts and analyze the changes that had taken place in order to show the effects on working capital. This led to the present concepts regarding the steps to be followed in preparing a Funds Statement.

A detailed discussion of the preparation of a Funds Statement would be too lengthy for a report of this type. Only a few of the basic steps will be discussed.

Working papers are needed where the accounts to be considered are numerous and involve several different types of transactions which may or may not have affected working capital. An illustration of a common worksheet is given at the end of this article. If a worksheet of this type is used, it is necessary to have balance sheets for the two years being considered. The balance sheet data is entered in the first two columns of the worksheet. A comparison is then made of the balances of each account and the net change entered as a debit or as a credit, as the case may be, in the "Net Changes" column. The debit and credit columns are then footed and should be equal.

What happens from here on in the working papers may be simple or it may be complex. If no adjustments are necessary, the steps are fairly simple. Each "Net Change" item is carried across to the Funds (Non-Current) or Working Capital column. If the net change of a current asset or a current liability shows a debit change, this amount is carried across to the working capital increase (debit) column. If the net change is a credit instead of a debit, the amount is carried across to the working capital decrease (credit) column. On the other hand, the net changes in non-current accounts are carried across to the Funds (Non-Current) columns; if it is a debit in the net change column, it is carried across to the funds applied (debit) column or if it is a credit, it is carried across to the Funds Provided (credit) column. If the total credits exceed the total debits (that is, if the funds provided exceed funds applied) working capital has increased. Thus the difference between the two funds columns shows the change in working capital and is the amount necessary to equate the last pair of columns.

The Funds Statement can then be made from the working papers. The type of Funds Statement found in published annual reports is often a condensed form. A more detailed statement is usually valuable to management.

Before completing working papers for a Funds Statement, however, it is often necessary to add a pair of columns for "adjustments" after the net change columns. Adjustment may be necessary for several reasons: some account changes may have had no effect on the movement of funds; some account changes may be the result of several separate types of transactions wherein funds may have been provided and also applied; and, too, several account changes may have resulted from one transaction and an adjustment is desired in order to summarize the change.

As one studies the present day concepts regarding the Statement of Sources and Application of Funds, it is soon apparent that there is no unanimity on what should be shown in the statement nor on how such information is to be obtained. There is, however, sufficient evidence shown through the amount of material available on the subject and the actual use made of the statement to justify the conjecture that soon accountants may be adding the Statement of Sources and Application of Funds as the third major financial statement along with the Statement of Profit and Loss and the Balance Sheet (with related Surplus Analysis). Then there will be *The Accounting Trilogy*).

CEM COMPANY

Working Papers for Statement of Sources and Application of Funds
For the Year Ended December 31, 1956.

Account	Balances		Net Changes		Funds (Non-Current)		Working Capital	
	12-31-55	12-31-56	Dr.	Cr.	Dr. Applied	Cr. Provided	Dr. (Inc.)	Cr. (Dec.)