Woman C.P.A.

Volume 20 | Issue 3 Article 3

4-1958

Closely Held Corporation: A Challenge to the Industrial Accountant

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THE CLOSELY HELD CORPORATION A CHALLENGE TO THE INDUSTRIAL ACCOUNTANT

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It was pointed out in a recently published technical article that the closely held corporation is of vital interest to the small and medium size public accounting firms because the majority of their corporate clients fall in the closely held category. However, not all closely held corporations are of small or medium size; many are quite large. But, regardless of size, certainly all of them can benefit from the services of a competent private accountant, as well as from the services of the public accountant. So, we can say that the closely held corporation is of vital interest to the industrial accountant as well as to the public accountant.

A close corporation can be viewed for some purposes as an incorporated partnership. The owners have adopted the corporate form of organization for the sake of legal entity, limited liability, easy division and transmission of ownership interests, and perhaps for other reasons.

In many respects, the closely held corporation resembles the widely held corporation. For both, the powers, duties, and liabilities of corporate management are the same. The laws apply equally to the officers and directors of all corporations, and it makes no difference if the corporation is closely held.

Both types of corporation have similar problems, of varying degree, concerning general management and administration, finance, production, sales, purchasing, personnel, and office management. We shall try to consider the variances and the part the industrial accountant plays in them.

The close corporation most often begins operations on a very small scale, then later develops into a larger, more complex organization. Some farsighted stockholders employ the aid of competent management consultants at the time of organization or before, but too few avail themselves of this service. In the beginning, the owners may not realize the need for a qualified accountant and in many instances are not able to afford one. One day they may awaken to find their records deeply involved and their bookkeeper unable to cope with ever-increasing financial problems.

Many of these corporations are prompted to seek professional assistance by reason of tax deficiencies, embezzlement, or a need to increase capitalization; while others continue on and on until their records are in a hopeless state of confusion.

From these situations, and others, arise the opportunities for qualified industrial accountants to assume a vital role in closely held corporate management. When an accountant assumes one of these positions, he is confronted with special challenges not always apparent in the publicly held corporate setup.

If the business has been operated primarily by a majority stockholder, as so many of them are, the owner may be reluctant to change his old routine. He has been accustomed to making mental notes of important data, and he doesn't like to put things in writing. He is apt to begin a new operation without advance accounting preparation. He may intermingle transactions among several subsidiaries already in existence. He can probably forecast the net income of any one of his companies without ever looking at the books but is not too concerned with the recognized standards of accounting by which the results are ascertained. He may even be resentful of being goaded for one reason or another to utilize the services of a skilled accountant. Added to this, his long-time employees, accustomed to a free hand in the company's sales, purchasing, and cash transactions, may be hostile to suggested controls and internal auditing procedures.

This is fertile ground to test the executive accountant's ingenuity, diplomacy, salesmanship, and perseverance, in addition to his knowledge. If he is truly well qualified and has over-all perspective, there are no limitations as to his usefulness in contributing to the financial welfare of his company.

As an initiatory procedure to identify himself with management in the closely held corporation, the executive accountant must gain the confidence of the stockholders, who are usually related and active in all phases of operations. They, many times, are uneasy about the proficient, administrative accountant, who is, in their scheme of things, an outsider. They may be fearful that he will exceed his responsibilities and seek to make policy decisions for them. They are frequently self-conscious about accepting recommendations or advice from him. They may not understand his accounting principles and for that reason may be scornful of them. To merit confidence, these issues must be patiently and successfully resolved.

As a part of management we are considering the accountant in the broadest sense of his vocation, but primarily the basic duties of accounting lead directly to analytical and reporting services related to past, present, and future operations of the business.

As to past operations, a very revealing and interesting report which is easily understood by the closely held corporation executive is the SOURCE AND DISPOSITION OF WORKING CAPITAL. This statement, as a supplement to the usual monthly financial statements, presents a wealth of information in capsule form.

In the performance of his task in recording current financial data, the accountant must sometimes resist stubborn efforts on the part of the close corporation executive to prescribe incorrect accounting entries. The executive, unacquainted with accepted standards of accounting and tax refinements, may attach little importance to them. He may ask why these things are significant, and one should be ready and able to give a comprehensive answer.

In connection with future business dealings, the accountant should discuss the merits of a budgeting program. A budget is an aid to eliminating problems in connection with too much inventory, or not enough; planning for and meeting payrolls; and preparing for tax and debt retirement outlays. The average small and medium size business is sometimes in greater need of a budget than the large corporation.

After the accountant has induced the close corporation executive to utilize and rely on accounting analyses and reports in the operation of the business, he should explain to the executive the value of proper internal control. It is, after all, a fundamental responsibility of the accountant to control property such as cash, receivables, inventories, and plant and equipment. The accountant is in a logical position to establish an accountability under which management is assured of the proper usage of these assets.

The close corporation accountant surely must guide the management in tax matters. The closely held corporation is sometimes inclined to ignore proper tax accounting.

For example, in matters of taxation the accountant could point out the importance of accurate records with regard to officers' travel and entertainment expenses for business purposes which are reimbursed by the corporation. The executive may be prone to disregard notations showing the places traveled, individuals visited, and detailed expenses incurred. Extreme effort should be made to exclude personal expenses of officer-stockholders from the corporation books.

The corporate president should be advised as to the reasonableness of his salary and the salaries of other officers in relation to duties performed and value to the business.

The accumulated earnings tax should be discussed. For closely held companies in particular, it may be better to pay the penalty surtax than to pay out after-tax earnings as dividends to stockholders in high tax brackets. Payment of the penalty surtax means keeping the balance of the earnings in the corporation, which earnings then will be reflected in the value of the stock and taken at the capital gain rate if the stockholder sells out. The situation should be studied from both angles and the best course determined.

The future plans of the corporation should be examined carefully to determine what portion of the retained earnings will be needed to finance anticipated expansion or replacement of property. A study of working capital requirements should be made and advice given as to dividend policy. All financial plans of the corporation should be meticulously detailed in the corporate minutes.

Problems, such as amount of debt that can be supported in relation to the shareholders' equity, forgiveness of debt by a shareholder, receivables from officer-stockholders, multiple corporation structure, and changes in corporate structure, should be discussed and analyzed with a view to tax consequences.

Once the accountant has gained the confidence of management and begun his instructive program concerning records, reports, systems, and taxes, he should encourage the management to have a certified audit of its records, if it has never had one, and to continue having one if it has. An audit can serve as a starting point and authority for a fair valuation of accounts in the books. If the close corporation has never had an audit, it may indeed be a revelation to the stockholders. The management may be astounded to learn how many inaccuracies have accumulated in the records. It may suddenly discover that the book value of its stock has skyrocketed, or is worthless.

Once the audit report is in the hands of management, the accountant may be called upon to explain the changes made in valuation of balance sheet accounts, or to explain why an account is now shown under a different section of the balance sheet from what it was before. This can be quite a challenging experience.

For example, have you ever tried to explain to a highly successful business man why cash segregated for the future replacement of property assets should not be shown as a current asset when he considers that cash is cash no matter how you look at it?

Or have you ever tried to explain why the value of insurance on the lives of officers should be stated at the cash surrender value rather than the premium cost, and why we just don't show this value as a current asset?

And have you ever tried to explain the difference between a prepaid expense and a deferred charge to a man who is merely amused by the accounting profession's intent concern with such definitive matters?

We have considered the importance of confidence, the value of an educational program in accounting and taxes, and the usefulness of encouraging a certified audit as part of the accountant's role in the closely held corporation. Along with this are the usual demands on the accountant. He is expected to be a one-man specialist in systems, internal controls, costs, taxes, budgeting, auditing, analyzing financial statements and the stock market, investigating employee pension and profit-sharing plans, and in general is trusted to be a living business encyclopedia.

This presents quite a contrast as compared to the very large corporation which usually has a specialist for each phase of its financial operations. Too, the corporation whose capital stock is traded on the stock exchange is required to have a certified audit of its records, and by reason thereof, its accounting procedures normally conform to the principles of accounting as set forth by the American Institute of Certified Public Accountants. The officers of these corporations, therefore, have been indoctrinated to these standards and have learned to accept them.

In summarization, it is apparent that the industrial accountant with the closely held corporation has three general challenges:

1. To satisfy management that it has a continuing need for a full-time, high-level accounting executive.
2. To realize the favorable conclusion of an educational and informative program designed to bring about management's complete understanding of why accounting and tax techniques are as they are.
3. To induce management to have an annual certified audit of its records.

The accountant who successfully brings these challenges to a satisfactory conclusion earns for himself a well-defined part in the management of the closely held corporation. Every closely held corporation executive won over to the cause of high standards of performance in accounting represents a great stride forward for our profession, and this should be the aim of every professional industrial accountant.

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Accounting department should be completely separated from sales, manufacturing, purchasing, cash receipts and disbursements and insurance.

Employees in position of trust should be bonded.

Employees should be required to take vacations.

Internal reports to the management should be adequate and frequent.

Insurance should be periodically reviewed.

Journal vouchers should be explained in detail, supported by substantiating data, and approved by a responsible employee.

From the Editor's Desk

A most cordial welcome to our new readers—the members of Tampa Bay Chapter No. 55 and New Orleans Chapter No. 56, as well as nearly five hundred new subscribers: women who are studying accounting through the International Accountants Society. All are invited to participate in the publication—not only to draw from it inspiration and technical information but to contribute their thinking and experience.