Journal of Accountancy

Volume 45 | Issue 4 Article 2

4-1928

Value of the Balance-sheet to the Executive

Michael H. Sigafoos

Value of the Balance-sheet to the Executive*

By Michael H. Sigafoos

The value of the balance-sheet to the executive depends on two things: careful preparation by one who is skilled in assembling statistics concerning the operations of a business, and ability on the part of the executive to understand what these figures mean when applied to his own business.

The balance-sheet, no matter how comprehensive, is no better or more useful to the executive than his fitness to analyze it and to apply the good he gains from it, his fund of information necessarily being limited to the confines of his own preparatory training and study of plant operations. If schooled, he is able to trace and recognize the operations of the business reflected in the assets—current, invested and otherwise—as well as in the liabilities of the company.

The executive of today must be a man of many parts, able to face facts and grapple with realities. He should have a practical as well as an analytical mind, able to sense situations from a natural, physical viewpoint as they exist in the running of the plant and should recognize them when presented in condensed statistical form, as he reads the balance-sheet.

The first item to engage his attention is the cash in bank—the most liquid asset of all. If the balance is heavy or unusually large, he wants to know how much of this amount is represented in loans from banks and, moreover, how much more cash will be needed to meet current requirements for payroll, vendors' bills due on a certain date, temporary bank loans maturing, which he wishes to avoid renewing, if possible, or to increase, if necessary. He may also require funds for interest due on the funded debt or sinking-fund requirements, if any, and perhaps for the much coveted dividend declared, the payment of which is due within a fortnight.

Having satisfied himself as to cash requirements, he directs his attention to accounts receivable. He desires to know the estimated or expected receipts from this as well as other sources. There is always more or less speculation as to the actual, dependable revenue from this item on the balance-sheet and,

*Address delivered at a meeting of the Philadelphia chapter, Pennsylvania Institute of Certified Public Accountants.

therefore, the accountant has prepared a supplementary statement, showing the age and collectability of the accounts. There are certain accounts delinquent and others on which definite promises to pay have been made. The executive knows from the information gained from his credit man that certain customers, not having discounted, which is seasonal with them, do not fail in their full-time remittances. Moreover, he may be able to obtain a trade acceptance or, better still, notes which can be discounted. He has now at least a starting point. He may have to take a deep breath, several of them in fact, before he can see his way clear to the next step—that of repairing his inventory of raw materials which is below the normal line and, in view of market conditions, does not warrant his waiting to buy the required material for orders carrying a definite delivery date; whereas, thirty days prior to this time, he could have covered his needs possibly at less than he can today—a penalty for gambling against the market. His ability to analyze the balance-sheet for a way to successful financing is his one refuge.

Of necessity, the executive must have a running knowledge of market fluctuations peculiar to the class of merchandise used in his particular line of manufacture. He consults with his purchasing agent, learns of deliveries due, immediately confers with the plant foreman as to the floating inventory set forth in the inventory analyses and inquires if there is any surplus of raw material assigned for fabrication on stock orders, possibly a little long, on which he can borrow, replacing it as soon as he is covered for promised deliveries. In some instances, the concerns he buys from guarantee prices against decline; in others he is not so fortunate.

He summons his sales manager and learns the details of orders booked, for some of which the goods have been partly processed or finished, ready for shipment. His problem is not wholly solved. Again he consults the analysis of inventory in process and otherwise. On some of the large orders under way a cash deposit is required. As the processing of the goods progresses, more deposits are received and by the date of shipment as much as 50 or 75 per cent. is remitted by the buyer, the balance due being paid on arrival of the goods at destination after examination, approval and acceptance.

By the statistics furnished in this schedule, the executive is able to determine from the balance-sheet to what extent he may look for relief from this source and gauges fairly definitely the amount of dependable cash coming in within the next week or ten days. The reason for requiring advance payments on large orders as they progress, which may take six months' time or more to complete, is to cover the outlay of direct and indirect labor and overhead, as well as material. This is not a usual practice, but its occasional occurrence is known from personal experience, and it is a condition which helps illustrate the value of the balance-sheet to the reader thereof.

The executive, having satisfied himself that he can reasonably meet the requirements for orders promised, in order to determine further his financing plan next proceeds to analyze the amount of unfilled orders with regard to quantities of materials necessary to complete them, matching this against the amount of purchases he must make for future delivery and balancing this with any surplus he may have over mill-level requirements—another supplement to the balance-sheet.

There is one serious feature with which every executive is confronted, i.e., the amount of inventory, raw, in process and semi-finished, necessary to balance the requirements of his mill. He dislikes to disturb this balance except in the most extreme instances as the financing of his company naturally depends upon the fluctuation of orders received and deliveries promised. This inventory should always be carried at the lowest possible quantity and cost, and although it may turn over and change any number of times during the year there is always required a certain amount of floating inventory to balance the run of the mill and also "time in" with departments having continuous operations. We speak of "priming a pump." As the amount of water or other liquid carried at the valve level is to the pump, so is the floating inventory to a well balanced factory flow of production. This inventory should be the minimum quantity valued and carried at the lowest possible cost. If it can be replaced at a lower figure, it should assume this value, but never should be rated at a current cost of replacement. It is a most certain conclusion that low market levels return from time to time and the manufacturer should protect himself against such periods to the extent that when the market does drop, he is reasonably sure his mill-balance inventory needs little if any writing down, at any rate none resulting from appreciation over original cost.

Where investments are carried by corporations whose surplus cash has been temporarily converted until certain requirements are due, the executive determines whether the investment has increased or decreased, in comparison with the previous month or possibly as far back as its inception. He also scrutinizes the plant investment and looks for changes in it. If it has increased by reason of improved machinery purchased, he desires to meassure the value of the investment by the returns estimated by his engineers. He must know if the resultant economy is from greater speed with corresponding output and with the same amount of labor or with less labor—power consumption considered.

The executive passes on to the sales for the month reflected in accounts receivable, having before him an analysis of both. We speak of sales as the finished product—actually delivered and charged to the customers on the books of account. With some concerns, of one of which I have intimate knowledge, the classification of sales shows the profit or loss of each class of product manufactured, together with the percentage, and also a calculation of the total. The executive may find some surprises in this analysis compared with the original estimate when the business was undertaken. The surprises will be both ways. He realizes that he can not intelligently operate the business if he does not know which line of output shows a loss, splits even or yields a profit. It is beyond peradventure that the average manufacturer, large or small, guesses or has the wrong information entirely as to whether he is making or losing money. In many instances the product pushed the hardest, in the belief that it is the most profitable, is a losing proposition. A well regulated set of books—condensed in the form of a comprehensive balance-sheet—will serve well. The concern that knows its profits every month on each class of output sold is likely to be successful but, as far as such information is concerned, possibly is the exception.

Before the executive is through with the analysis of his sales, he confers with his sales manager to ascertain whether or not the figures reflected on the papers before him seem correct according to the judgment and intimate personal knowledge of the sales manager, who must have at command a comprehensive digest of the various selling branches and know beyond a reasonable doubt whether or not the executive is informed on generalities and thinking in terms on a par with his own line of reasoning.

It is an old story, but one, I believe, appropriate to this discussion, that while selling is the big game the buying makes for the selling and that conservative purchases on a carefully studied market, due consideration being given to orders in hand and to prospective business, will always bring good results to the executive who is wide awake, well informed and endowed with a good bump of common "horse sense."

The executive turns to his record of statistics to study the turnover of his inventory with regard to sales, and his net investment of capital and surplus, whichever way he chooses to figure it, compared with previous periods. He times this turnover with the business, not only in volume and tonnage, but also as to periods, which have special significance. The volume of sales must be compared not only with that of the same month of a past year, but with a similar period, whether two, three, six or more months or a year ago. Volume, however, is more or less a misnomer at times. Therefore, consideration must be given to tonnage and price fluctuations must be compared, so that the volume of a given period may be reconciled with the current volume, to the end that judgment, after consideration of facts reflected in the sales department, may be fair to all concerned when driving hard for increased volume in sales.

Another glance at his statistical record, prompted by the balance-sheet, shows the executive the amount of money spent for obtaining new business and for the maintenance of long-standing trade relations. The executive who thinks the proverbial "John Doe," who has been his customer for five, ten or more years, does not need calling upon is much mistaken. Old customers, large and small buyers, are harder to hold than new trade is to obtain. The former require attention and must be given consideration occasionally. New customers must not be accorded all the favors and attention.

Just how much money is being spent by the general sales manager and his corps of salesmen is reflected in another supplement to the balance-sheet. Every dollar of sales value should show a percentage of cost and, naturally, an expected profit. This dollar must be tied in with tonnage, footage or otherwise, whichever is the determining factor to gauge volume, and from the results shown the executive must resolve by good judgment whether or not increases or decreases in percentages mean anything more than arithmetical determinations, comparative, attractive and interesting. He must seek out and determine (and here is where his training and natural fitness come in, together with ability to read and analyze his balance-sheet and operating statements) whether or not the actual physical conditions correspond with the statistical facts before him. The figures can not be changed, but the conditions may be governed and directed to spell better results on capital invested.

The executive, having completed his reading and study of the balance-sheet, compares his cash, accounts receivable, inventories, plant investment and liabilities and sums up in his own mind a conclusive picture of the status of the business at the period conforming to the date of the figures before him. The balance-sheet is an aid and is valuable, he realizes, only as he is able to utilize its information in the successful movement of the entire working force under his personal direction. It is not a panacea for all ills. It bespeaks that which has happened, is a guide to the future, and, if coupled with practical experience and clear foresight, it enables the executive to arrive at some constructive conclusions whereby he may determine just what course is the best to pursue.

Those of the accountancy profession, who have had opportunity to study through actual experience the rôle of an executive, find that should places be exchanged they would swallow lots of their own medicine, the doses not always being in homeopathic proportions. It is one thing to advise; it is another to execute the same advice.

One of the principal items causing the executive much concern is the variation of consumed, unconsumed and also overconsumed mill overhead. This is reflected indirectly on the balance-sheet and is supplementary to it. He must be careful that the customers derive the benefit from the overconsumed overhead. It is not fair to the customer, much less to the company, to charge in the cost set-up when bidding for business the unconsumed overhead of the mill and move this on to the "good customer" who gives the order.

The admission of this practice refutes the argument that overhead in any factory is the hardest problem to contend with and that in many instances it is cheaper to operate with an overhead loss than to shut down a department, if not the entire works, for a season. If the plant is shut down, trade of long standing is neglected and labor will naturally drift away to other employment.

The balance-sheet is only a partial aid to the executive in assisting him in matters of importance, and the schedules supplementary to it, setting forth certain vital detail, are factors to be considered. It is the small fox that destroys the grapes, the small leak that sinks big ships, and the time to remedy all matters in a large manufacturing plant is when they are discovered—this by exhaustive analyses. They must not be allowed to drag along indefinitely with the idea, which is false economy, that too much money is being spent for repairs and upkeep and that things will "shift" for a time. One must always be ready for marching orders.

In conclusion and with a last reference to the time-honored and often-much-abused balance-sheet, with its supplementary pages of information—it is of great value and indispensable to the executive. Conversely, if improperly prepared or not carefully studied, or if it is placed in the hands of an executive not possessing the proper qualifications or natural fitness, it is a dangerous instrument. Its greatest value is at a time nearest to the closing of the month's business. It is of no value, beyond possibly interesting reading, when it comes to the executive and his board of directors thirty days, and sometimes later, after the date of periodic closing of operations. In many instances, financial statements of corporations are available by the 10th and 12th of the succeeding month. Where this condition exists one may look for prosperity and a well managed corporation.

Knowledge and power are twin factors. Each depends upon the other and, when unevenly teamed, they leave the loaded vehicle, industry, stranded by the wayside, surpassed by concerns equipped with a better balance of power.