University of Mississippi

eGrove

Haskins and Sells Publications

Deloitte Collection

1922

Accounting statements and the natural year

Edmund Canby Gause

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Bulletin, Vol. 05, no. 07 (1922 July 15), p. 50-52

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Accounting Statements and the Natural Year

By Edmund Canby Gause

(A paper read before the Ohio Society of Certified Public Accountants, June 17, 1922)

A FEW months ago a large proportion of the business concerns in this country were closing, or had just finished closing, their books of account for the calendar year 1921. For various reasons, financial statements were prepared which, if prepared properly and correctly, showed, first, the financial condition of the business at December 31, 1921, and second, the details of the operations for the year ended that date which led up to the financial condition. The former statement is termed a general balance sheet and the latter a statement of income and profit and loss.

In the case of large corporations where the capital stock is widely owned, financial statements are included in a printed annual report which is furnished to the stockholders, and there is also usually included therein a certificate of public accountants in respect of the correctness of the financial statements. A frequent reason for preparing financial statements is to furnish information to banks and to credit agencies such as Dun and Bradstreet. Such statements may or may not be certified by public accountants, although it is obvious that, if they are, their value has been materially increased. But, regardless of the particular reason for preparing these statements, it is a fact that they are prepared in one form or another at the end of the fiscal year of practically every business concern—corporation, firm or individual.

The duty of preparing the statements is usually delegated to the individual who has charge of the accounting or bookkeeping. In the case of large corporations this individual is the comptroller or auditor, or perhaps the public accountants who audit the books, while in the case of smaller concerns the bookkeeper is usually required to do this work.

While the two statements mentioned are the ones which are prepared in practically every case, there are variations in their form. In one case they may represent a small business where the stockholders are all directly interested and it is therefore unnecessary to show much detail. In another case they may represent a larger corporation where there are outside stockholders and it is necessary to furnish considerable information. In still another case they may represent a group of companies—such as the United States Steel Corporation—in which event consolidated statements with elimination of inter-company items and accounts are included in the annual report, together with supporting schedules containing the detail of property, inventories, funded debt, sales, cost of sales, etc.

The form of a general balance sheet which is more generally used is one which shows property first under assets, and capital stock first under liabilities. Another form, and one which bankers usually prefer, shows current assets first under assets, and current liabilities first under liabilities. The particular form of a statement is not as important as it is to be sure that all the necessary information is shown therein and that no items of any consequence are hidden or covered up in such a manner as not to be readily identified. For example, if there was a small amount of cash, it might be included with accounts receivable and called "Cash and accounts receivable," and in that way the reader of

the balance sheet would not know that there was very little cash unless he made inquiry. A method of covering up advances to officers and employes or to subsidiary companies is to include the amount thereof in accounts receivable, without making any separation in the balance sheet between such items and the regular trade accounts receivable. There are many ways of covering up unfavorable items in financial statements without actually falsifying them.

Occasionally one sees a published report of a corporation which includes a general balance sheet and a statement of net income for the year; but the latter statement omits the link which connects it with the general balance sheet because it ends with net income and does not include the surplus at the beginning of the year nor any direct charges or credits to profit and loss made during the year. In such a case there is always a possibility that there may be items carried direct to profit and loss which, if shown in detail in the profit and loss statement, might arouse the suspicion or unfavorable comment of stockholders. An example of this is where the book value of property has been arbitrarily appreciated and the amount of the appreciation carried direct to the credit of profit and loss, which has the effect of increasing both the book value of property and the amount of the surplus and is very favorable when so reflected in the balance sheet, but is not so favorable when shown as such in the profit and loss statement.

In a general balance sheet which has been properly and correctly prepared, ratios can be used very effectively to bring out important and interesting facts and information. The ratio of current liabilities to current assets is of value and is the one most frequently seen in a balance sheet. Some mortgages securing bond issues and some issues of preferred capital stock have a condition in respect of the company maintaining a certain ratio of current assets to current liabilities, such as 2 to 1, and dividends on common capital stock cannot be paid if the current assets are reduced thereby so that the stipulated ratio is not maintained. The ratio of sales for the year to uncollected accounts receivable at the end of the year, when compared with similar ratios for previous years, is a gauge as to the promptness in the collection of the accounts. The ratio of cost of sales or cost of manufacture to net sales is valuable when compared with similar ratios for previous years. In some cases the ratio of net liquid assets to total liquid assets is used, and there are other ratios which are used for various reasons, such as the ratio of net worth or capital to fixed assets, to show the proportion of capital invested in plant; the ratio of sales to merchandise, to ascertain the turnover; the ratio of sales to net worth or capital, to show the turnover of capital, etc.

Stockholders, bankers and credit agencies are all interested in comparing the financial statements for the current year with those for previous years and noting the changes therein. It is therefore an advantage to show a comparison at least with the previous year and prepare the statements in three-column form—this year, last year, and the differences. The differences can be shown in one column by using black for increases and red for decreases.

No financial statement is complete or correct without some reference therein to contingent liabilities, if there should be any at the date of the balance sheet. Such reference is usually in the form of notes on the bottom of the sheet and is not incorporated in the body of the statement. Contingent liabilities include such items as discounted notes receivable or trade acceptances, accommodation endorsements on notes, guarantees of bond principal and interest, and other items of a similar nature for which there is no direct liability at the

date of the balance sheet, but the possibility that there may be such at a subsequent date.

Comments are generally used by public accountants in reports on audits and examinations in order to explain certain items shown in the accompanying statements, to set forth detail which may be too voluminous to incorporate in the statements, to describe the procedure followed in the verification of assets or the confirmation of liabilities, to qualify certain work done or explain why other work was not done, etc. Comments are also frequently included in the annual printed reports issued by the larger corporations for some of the reasons already mentioned.

This seems to be an appropriate time to bring to your attention the fact that the calendar year is not always the natural business year, and that there may be some date other than December 31 which is the logical time to take the inventory and close the books. For generations it has been the custom of a large part of the business world to take the annual inventory at December 31 without, in a great many cases, any good reason for so doing except custom. The proper time for taking the inventory and for closing the books is at the end of the natural business year, which means at a time when stocks of merchandise are at their lowest and when the liquid condition of the business is most favorable.

In the case of the inventory, it means a saving of time, money and energy to take it when the stocks are small, and when, possibly, employes are less employed and can co-operate more effectively than they could if there were heavy demands for production. When the liquid condition of the business is most favorable, that is undoubtedly the time to present yearly financial statements to banks and credit agencies, as it is then that the amounts of cash and accounts receivable are large and those of inventories and accounts payable are small. This question is of sufficient importance to merit the consideration of all business executives in order that they may determine if they are using their natural business year for inventory taking and for closing their books of accounts, and there is none more interested in bringing this question to the attention of the executives than the professional accountant.

Judgment Guiding Financial Statements

(Continued)

THE significance of the term "financial strength" depends on the point of view. The person who looks at a balance sheet from the ranks of money lenders considers the amount of capital and surplus which must be lost before his claim is endangered. The stockholder has only the surplus between him and his investment. There is every chance then that as he looks at the balance sheet of a corporation in which he is financially interested his eye will first seek the amount of the surplus.

The word surplus is subject to various interpretations. Legally, or as usually interpreted by the courts, surplus is the excess of assets over liabilities and capital. As generally understood, it means that which has been earned as a result of operations; the accumulation of profit or margin of selling price over cost.

Surplus may also be derived from a revaluation of assets; from assets acquired without any corresponding liabilities; from a decrease in liabilities without a corresponding decrease in assets; or from the acquisition of net assets taken up at a