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# What Industrial Accounting Should Mean to the Executive*

By STANLEY G. H. FITCH

The title selected for this address suggests two relative thoughts; first, What is industrial accounting? second, What classes of executives are concerned with industrial accounting? Industrial accounting includes general financial accounts, subsidiary but coördinated cost accounts, production and sales records and business statistics. The executives concerned with industrial accounts comprise not only business executives who formulate the policies and direct the operations of manufacturing and merchandising enterprises, but also the executives of banks that lend their depositors' money for borrowers' current requirements, and the heads of banking firms that finance borrowers' permanent capital requirements through the sale to investors of corporate securities. Consequently industrial accounting will not be restricted in its application to any single phase of business operations, but will be approached from the viewpoint of those business executives who are directly interested in the results disclosed through such accounting, and also from the viewpoint of other executives acting on behalf of those indirectly interested, who may be widely diversified, yet vitally concerned in such results.

## SCOPE OF INDUSTRIAL ACCOUNTING

A well-rounded system of industrial accounts furnishes the best barometer of business and should embrace records which may be generally classified under three main divisions, viz:

(1) General books of account from which condensed financial statements may be prepared periodically, showing the financial condition and operating results. The bal-

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ance-sheet, which sets forth the status of the company's financial condition at stated dates, and the profit-and-loss statement, which accounts for the changes in financial condition between two balance-sheet dates, are the standard financial statements which do not require extended comment at this time.

(2) Cost accounts under the control of the general books, together with relative production records. The cost accounts should be designed to make available comparisons (such as by units of product), in such detail as may be necessary to disclose the causes for variations upward or downward. Standard costs in comparison with actual costs frequently give more significant information than a mere examination of actual costs which may have been incurred under abnormal conditions.

(3) Subsidiary books and records coördinated with the general books and under their control, from which statements containing analytical and comparative information in support of the major statements may be prepared. The analytical statements should be designed to show such information as may be required to set forth in detail the essential and significant facts of the business operations. For example, a comparative analysis of sales classified according to lines of product by territories, or by salesmen, reflects the trend of the business as affected by local or national conditions, seasons, variations in energy or efficiency of the sales force, etc. A similar analysis of selling expenses in conjunction with the sales analysis indicates whether or not variations in such expenses follow the variations in business done and permit the necessary investigations in case the results appear to be doubtful or illogical. Statistics of production should also be developed upon similar lines.

In every branch of industrial accounting coördination should be the watch-word. This is particularly true of cost accounting. Mere statistics, which are not reconcilable with nor controlled by the financial books, are unreliable and frequently lead to erroneous conclusions which inevitably result in disappointment or disaster. The value of a cost accounting system may be measured directly in terms of the quality of information furnished, the clarity with which it is presented and the speed with which it is made available. The study of ancient history may be of some interest to posterity, but in relation to present results of business operations it is of little value to an inquiring executive.

### Coöperation in Business Based on Confidence

With reference to the subject of this paper, a successful manufacturer was asked the question, "What does industrial accounting mean to you, a manufacturing executive?" His immediate reply was, "A well-rounded system of industrial accounts forms the foundation of that confidence in the soundness of the business which is essential to the success of any enterprise. That confidence must be shared by the general manager and his directors; by the factory manager, the sales manager, and the banker."

In order that a general manager may be assured that his confidence is not misplaced, he must satisfy himself as to the ability and integrity of his accounting personnel, entrusted with the development of accounts and the compilation of statements submitted to him for guidance. He must satisfy himself, either by personal insight or by assurance from authoritative quarters, that the methods of accounting followed are sound in principle and efficient in operation, and, having in mind the thought that costs submitted to him will determine to a large extent his selling policy for the ensuing fiscal period, he must know the basis upon which the costs have been computed.

To be specific with regard to data submitted relating to costs and cost estimates, the executive should know the basis upon which materials included therein have been charged, that is, whether at cost or at market, and whether materials consumed show on that basis a profit or a loss. In times of unsettled labor conditions, he must know whether labor charges included in the cost computation represent current rates of pay or rates anticipated as payable at the date when the product is to be manufactured. In respect to overhead expenses included in cost, he must understand whether such overhead represents a normal charge arrived at on the basis of normal production in a period of normal business, or whether the amount so charged represents an abnormal overhead under abnormal conditions.

Once having assured himself that his accounting methods and the resulting financial statements are fundamentally sound, a general manager is enabled to deal confidently with other members of his organization on the basis of the results reported. The production manager, if called to account for an apparent shrinkage in production and consequent increase in production costs, cannot then fall back upon the time-worn excuse that he believes

the figures are not correct, because from past experience he must share the general manager's confidence in the accuracy of the production and cost reports and must undertake wholeheartedly to improve the operating efficiency of the factory.

A sales manager knows that the product of the factory must be sold at a fair margin of profit if a business is to succeed in the long run. But sales managers, too often, are prone to believe that factory costs reported to them have been inflated for the purpose of forcing up selling prices, so they claim they cannot meet competition, based on rival manufacturers' alleged costs which may be wholly inaccurate. Therefore, confidence of the general manager in his accounts begets confidence on the part of his salesmen, who, in adopting a new viewpoint, go out to sell on the basis of quality rather than on that of price alone.

Another phase of this subject is presented in the case of proprietor-managers, who own or control substantially all of a corporation's stock, as distinct from those executives whose individual financial interests lie chiefly in their salaries, plus, possibly, a percentage of profits. In the former instance a proprietor-manager may be satisfied with general information supplemented by his own intimate knowledge of the business acquired through years of close contact. In the second instance, however, much greater detail in statements and reports may be required for submission to directors and stockholders to whom the executives are ultimately responsible.

In his relations with banks, the treasurer of a corporation usually lays before the banker an annual statement of financial condition and profit and loss. If he also presents monthly statements of operations, the banker is immediately inspired with confidence in the conduct of that business, for he sees that its executives know currently the trend of the business and have information upon which to act promptly in the conduct of its affairs. The banker sees that in the case of such a borrower the antiquated system of determining profits and financial condition annually or semi-annually through a physical inventory, with the consequent possibility of continued losses remaining undetected for many months, has given way to progressive and efficient methods of currently accounting for profits or losses so that little is left to chance or guess-work.

While a business executive may be expected to know the details of his own particular line better than any outsider, neverthe-

less a banker is in position to ascertain in a broad way the general trend of the market for basic materials and commodities. The banker knows that in periods of depression enormous inventory losses have to be taken if merchandise is to be marked down to "market," and he well knows the significance of the familiar phrase "cost or market, whichever is lower," as applied to inventory valuations. When under such conditions, he sees that a borrower's balance-sheet clearly shows that such losses have been taken courageously, his confidence in the sound business judgment of the borrower remains unshaken. But if he finds that a borrower's inventory has been valued at cost in the face of a falling market, a doubt at once arises in his mind regarding the wisdom of the manager.

Consideration must also be given to the banking-house executive who is charged with the responsibility of recommending to his customers the securities of the enterprise which he finances. Such an executive cannot usually examine minutely the accounting methods and the details supporting the financial statements presented to him, but he does scrutinize the periodical or monthly statements of operations which are placed upon his desk and his decisions result from the confidence, or lack of it, which he may feel with respect to the officers of such companies and their organizations.

In the structure of mutual confidence upon which sound business relations are built, it may not be out of place to refer to the increasing need for public accountants as advisors of their clients. The progressive executive requires not only audits and certification of annual statements, but he also welcomes unbiased investigation of his accounting methods and systems. Expressed in other words, such an executive has his methods as well as his accounts audited, and while he may not have opportunity for close personal contact with the details of his accounting system, he comes to rely with confidence upon his accounting adviser in order that efficiency and economy, and the application of correct principles, may continue to characterize the work of his accounting organization.

### COÖRDINATION OF COST ACCOUNTING WITH CONTROL OF INVENTORIES AND PRODUCTION

The significance of industrial accounting is perhaps well reflected in recent comments by the head of a prominent manufac-

turing concern. He stressed particularly the value of cost accounting when accompanied by adequate physical control of raw materials, work in process and finished product; and it must be admitted that cost-accounting systems, otherwise carefully planned, have proved deficient because they failed to provide control over physical stocks through the medium of adequate storerooms, store records and production records.

In an admirable booklet on *Perpetual Inventory and Stores Control* recently published by the fabricated production department of the Chamber of Commerce of the United States, the conclusion, amply supported in detail, is irresistibly drawn that an efficient stores or perpetual-inventory system, and that alone, will provide for—

1. Sufficient material to meet production requirements so that production shall at least not be checked by a lack of necessary material.
2. A minimum investment in inventories, which is of importance.
3. An orderly and accessible arrangement of material and the physical safeguarding of material from the elements and from theft.
4. The elimination of the burdensome and inaccurate annual physical inventory.
5. A monthly closing by giving the amount and value of material on hand at any time.
6. An invaluable record in case of fire loss.
7. A safeguard against the accumulation of obsolescent material.

A perpetual inventory will show the past and present consumption of material, will allow for a revision of the quantities of material carried in meeting fluctuating market and production conditions, and will indicate the items that are slow moving, overstocked or non-standard.

A statement sometimes made, that "detailed costs cannot be obtained, the operations are too complicated and the shop would be swamped with clerical work," is always a challenge to the man who knows he must have accurate costs; and he usually can obtain what he needs as the result of simplified and more efficient factory operation. For example, in planning a cost system where costs distinguishing separate operations had to be ascertained

for articles involving continuous flow through successive departments, it was alleged to be impracticable to determine such costs owing to the involved routing of the articles produced. However, it was amply demonstrated in such instances that an analysis of the manufacturing operations showed useless and inefficient movements of stock, so that through re-routing of orders, or rearrangement of departments, the movements of stock were simplified, while efficiency in manufacturing operations was attained, quite incidental to the development of an intelligent cost-accounting system.

Another significant fact has developed in the experience of manufacturers, viz., the dominance of the sales manager in certain organizations. He often feels that he alone knows what can be sold to the company's greatest advantage and bases his opinion upon demands by the trade, even though his policy involves the manufacture and sale of an excessive variety of goods. He fails to remember that quantity production in a few lines spells profits, while production widely diversified in many lines may result in small profits or even losses. In the face of a predominant sales manager, the wise general manager must rely upon his cost accounts, which should unerringly show the lines that should be pushed in the interest of profitable business; but the general manager who lacks the fundamental support of adequate and complete accounts is often unable to maintain a position which he intuitively knows is best for the company's welfare and may have to acquiesce in unsound manufacturing and selling policies.

## Fundamental Knowledge of Cost Factors Essential To Interpretation of Results

It is not within the scope of this article to discuss in detail the relative merits of various methods of cost finding and of overhead distribution but it seems pertinent to draw attention to the fact that, in reviewing cost statements laid before him, an executive requires a fundamental understanding of the factors of cost and especially of the nature of the charges designated as overhead expenses.

Reference to the history of the development of industrial accounting reveals the primitive methods of cost finding which have been used up to comparatively recent days, and in too many instances may still be found in use. Too frequently the time-worn formula "material, labor and overhead" has been contracted

until it becomes merely "material and labor," while overhead is not recognized as a cost factor or is roughly included in the "margin" added for profit in fixing the selling price.

The modern development of cost finding has been along the lines of cost analysis, the allocation directly to the operation or the production unit of all possible charges and the further analysis of overhead expenses for the purpose of applying such charges to the cost of operations or production units in such a way that they may be borne by the product to which they really apply—as opposed to the rule-of-thumb methods of overhead distribution by the addition of approximate percentages of labor or material charges. A cursory review of current publications dealing with cost finding, emphasizes the importance, now recognized by cost accountants and engineers, of exact knowledge of the elements of cost and especially of the charges included in overhead and their proper allocation to the cost of the product. In contrast with this recognition of the need for exact knowledge of the factors upon which true costs are built is the practice, still followed by some accountants and executives, of tabulating figures of alleged cost which ought not to be accepted at their face value if sound conclusions are to be drawn therefrom in determining questions of administrative policy.

In numerous instances, depreciation of plant and equipment has been entirely disregarded as an element of cost but has been dealt with annually as a charge to profit-and-loss, after the operating results for the year, exclusive of such charges have been ascertained. The depreciation charge has thus been determined, not on the basis of what constitutes a fair allowance for wear and tear not made good by maintenance charges, but rather in the light of what the earnings statement can bear and still show a balance to the credit of profit-and-loss. This procedure usually results in excessive charges during profitable years, while little or nothing is charged for depreciation in lean years; although it is a fact that nearly all depreciation of fixed assets continues to accrue regardless of the results of business operations. There would, therefore, seem to be an opportunity to bring home to some executives the thought that costs should be true costs, uncolored by the desires of individual persons to make them reflect conditions which are contrary to the facts. Depreciation is not an imaginary charge against operations merely because it is commonly expressed by bookkeeping entries which do not for the

moment express immediate and actual outlay in cash. On the other hand if provision is not made for the recovery (through the medium of depreciation charges to cost of operations over a period of years) of the amount invested in plant and equipment, the ultimate result will be disastrous.

Many cost systems provide for the inclusion in cost of interest on investment as an item of overhead expense. By interest on investment is meant a charge, at an arbitrary rate, computed on the amount of capital locked up in plant or inventories. Such a charge, when placed upon the books, represents a fictitious or imaginary transaction, as a charge against cost or production and as a credit to profit-and-loss. At no time does interest on investment represent an actual outlay, but it has been argued that it does measure the expected or normal return on the capital invested before ascertaining the profit from manufacturing or trading. In other words, costs computed on such a basis are inflated to the extent that they include charges representing unrealized profits.

The foregoing comments indicate how cost figures, according to the methods followed, may understate or overstate actual costs which are the only safe guide to the executive in interpreting his operating results and in planning future policies. It is apparent, therefore, that the executive in considering statements of operating results and statements of costs should not only have entire confidence in the figures submitted to him but also should have a knowledge of the fundamental methods followed in their compilation.

### Cost Accounting Necessary to Business Success

Successful executives have long realized that cost keeping, or cost finding, is essential to business success and that it is not a theory, advanced by professional accountants for their own particular aggrandizement, although to the untrained man cost accounting has long been shrouded in deepest mystery. Perhaps such a mental attitude accounts for the fact that according to statistics compiled by the government, more than half of the 250,000 business corporations in this country operate without profit, while not more than 5% of the total number record what it actually costs them to make their goods. In many cases, of course, profits earned are merely the result of good luck rather than of good management.

The following extract is taken from a recent government survey:

> It is the belief of the commission that the small margin of profit existing in so many of our industries is due to the ignorance on the part of manufacturers of what their goods actually cost to produce. This ignorance causes them to make unprofitable prices, which the manufacturer who does know his cost is forced to meet to a large extent.
>
> Formerly the necessity for the determination of true manufacturing costs was not as imperative as it is today. Margins between cost and selling price in most lines were larger. Costs could be ignored except in a general way and a good return still be made on the investment; but, today, margins of profit in most lines of trade are very much more narrowed than formerly, and the necessity for the most efficient management and closest analysis is felt as never before.
>
> It is necessary today for the business man's success, that he know on what articles he is making a profit, and on what articles he is incurring a loss. Competitive conditions are seriously disturbed where losses on one or more articles are recovered by profits on other articles. It is obvious that a manufacturer should not only know the cost of each article he manufactures but that he should see that every article manufactured bears its proper share of factory and general overhead.
>
> Most manufacturing plants have grown to a size which renders personal supervision impossible. The only reliable way, therefore, by which an executive can judge the efficiency of an organization is through a system of periodical statistical reports. These reports can be accurately obtained only when a good cost system is in operation.
>
> New methods are being introduced and improved machinery installed in the factory every day with a view of reducing costs either by the elimination of waste or by increasing efficiency. It is impossible to know whether the introduction of these improvements will reduce costs unless the manufacturer knows not only what his total cost is but exactly what items make up the total. Items of cost are frequently lost track of when the total only is considered, while if these items were properly segregated so as to show what they were, they could be materially reduced and in some instances eliminated altogether.

Not only does accurate cost accounting give to the manufacturer complete information for establishing selling prices, but it also assists him in meeting new industrial conditions as they arise from time to time. While statistics show that the peak in prices of basic commodities and labor was passed some time since, yet the recent decline in prices has been checked to a large extent and the manufacturer is again confronted with demands for higher wages and better labor conditions and these in the face of keen competition in marketing his product.

The real function of a cost system is not merely to record the cost of operation but to assemble data which can be used with a clear and correct understanding to reduce costs. Only then does it perform its full duty and become a most valuable agent for the promotion of factory efficiency. A logical conclusion,

therefore, is that every industrial plant needs a reliable cost system to present regularly in an orderly manner the vital facts relating to the business and to tell the story, week by week, of the actual current business conditions, including exact costs of operations by divisions and departments of the business.

An authority on manufacturing costs very aptly says:

> The aim and object of every cost system should be to afford true and accurate information as to facts. It is based on facts; it should embody and present facts and naught else. To exaggerate facts and to show fictitious profits and values is not worse than to depreciate facts and to conceal true profits and values. The creation of a correct science of industrial accounting and costs should be the desire and aim of all who are concerned with industrial management. To accomplish this, three things at least are needed:
>
> (a) Clear understanding of fundamental principles.
>
> (b) Definite terminology generally understood and accepted.
>
> (c) Frequent interchange of the data of practice, whereby the adoption of sound principles may be promoted, the experience of each may be available to all, the best methods may become established, and above all, a standard system may ultimately be created.
>
> The accomplishment of these results, by affording complete and accurate knowledge of the facts pertaining to industrial efficiency, and to the costs of production, will tend greatly and permanently to promote the development of American industry.

In order to devise an adequate and effective cost system, the cost accountant at the outset must study the evolution of the product or products manufactured; he must become intimately acquainted with the manufacturing processes, the flow of materials through the works, the physical layout of the plant, and the practical problems to be solved in the course of production, as well as in arriving at the cost of the product. In every new undertaking he must act as a scientist engaged in research work, in the quest for exact knowledge upon which to found his cost accounting structure; and frequently he must explore the mysteries of the chemistry of manufacturing processes. The cost accountant who fully grasps his opportunities in this manner acquires a clearer vision and broader intellectual outlook in meeting the problems in industrial accounting.

Leading executives in many lines of business have recognized the value of uniform methods of accounting as a means of bringing together for intelligent discussion manufacturers who have common problems and common interest. Statistics compiled by the fabricated production department of the United States Chamber of Commerce show that in more than one hundred commodity

lines uniformity in accounting methods already has been established or attempted. The progress varies from the initial steps, involving the preliminary work of investigation, to the adoption and installation of completed cost systems on standard lines. The use of uniform cost-accounting methods will go far toward the elimination of unintelligent competition resulting from incomplete or unreliable costs.

Moreover, certain trades have established bureaus for the tabulation and distribution of trade statistics relating to business conditions of especial value to the respective trades. When the executive studies the trend of business as evidenced by his own comparative statements and sees, perhaps, that his own business is falling off, he is also able to view his results in comparison with those of the trade as a whole. If he finds that his own business has been maintained as to volume at a relatively higher ratio to normal than general business has been maintained in his line, he may have reasonable grounds for satisfaction in believing that he has continued to secure at least his share of the available orders, provided of course that he has not sacrificed profits in obtaining the business; but, if he finds that he has not maintained his relative proportion of business done, he has a compelling reason for searching inquiry in order to ascertain the cause of such a condition.

### Budgetary Control of Business Operations

A budget system has been defined as an accounting and statistical organization whose function is (1) to gather information from the past; (2) to formulate on that basis plans for the future; and (3) to report subsequently how these plans have been executed.

Budgetary control of business operations is of comparatively recent development but in many organizations is a fact. A budget for a given period embraces careful estimates of the volume of business expected; of the expenditures necessary in manufacturing or purchasing and in marketing the goods; and finally of the cash requirements necessary to finance the production and sale of the goods. In preparing such a budget, the estimates must be made in detail by departments; and the department heads must be held accountable for any variations. The far-sighted executive, in carrying out his business campaign according to the budget, should have at his command all necessary informa-

tion in relation to the past, through the medium of the accounts upon which he relies without question.

The business highway is strewn with business wrecks which came to grief through plunging into the unexplored regions of new business ventures without the guiding and restraining influence of a budget. In the early days of the development of the automobile industry, many corporations found themselves at the end of their resources because they attempted to expand too fast. It is true that they were operating in a new field where the outcome could not well be foreseen, but a limit upon expenditure, established through the medium of a carefully planned budget, would have gone far toward preventing financial disaster. Today, some manufacturers, in the search for business to fill their plants that were lavishly extended for war activities, have undertaken the production of radio outfits, expecting to reap quick and large profits in supplying the popular demand. A few of these manufacturers have found already that they are over-extended financially because they did not budget their campaign and did not hold their investment in a new enterprise within reasonable bounds. In periods like the present, characterized by keen competition, or in times of business depression like those through which we have recently passed, when economy and retrenchment are the watchwords, the executive comes to rely upon a careful budget and in its planning turns instinctively and confidently for help to the cost accountant.

The day of the sellers' market and of easy profits is gone, perhaps never to return in our generation, and the budget has become the guide of the executive. The cost accountant's help in budget-building is indispensable. A well-known writer has well said that there is perhaps no greater service the cost accountant can perform at this time for the general manager than to help him formulate a budget which will yield a reasonable profit on a normal year's business and will set a standard that if not maintained will mean less than a fair return on investment and if much exceeded will involve financial risks incommensurate with the possible additional return. This budget should be framed in such a way as to provide for balanced production and continuity of operation. In other words, it should allow for full utilization of production facilities; and to that end cost accountants should check and condemn any tendency to manufacture anything and everything for which there is a possible demand and

should bring to bear cost figures that will disclose the expensiveness and wastefulness of such a practice.

It is perhaps unnecessary to emphasize the importance of organizing the work of budget preparation within the accounting department so that those department heads who are to be held accountable under the budget plan for production, sales, expenses and costs may have no control over the reporting of the results of the operations. Such department heads, of course, should be freely supplied with all detailed information regarding the operations and expenses of their departments that may be required in reviewing their achievements or failures when measured by the budget standards, but under no conditions should the man whose output is under test be permitted to select the gauge by which his performance is to be measured.

### The Executive and the Accountant—The Personal Relation

In his relations with his accounting department, the busy executive may find that the accountants in his organization do not always rise to the full height of their opportunities. The executive, of course, may not be a trained accountant but his mind is trained to grasp quickly the essentials of any problem and to determine its solution when presented to him. Sometimes he has to analyze a statement which contains all the facts but may not be helpful because it lacks significant arrangement or display. It is then that he wonders, quite naturally, if his accountants ever pause to ask themselves a few pertinent questions such as the following (recently propounded by a thoughtful student of this subject): "Do accountants realize that executives are busy men with no time, patience nor inclination to wade through a mass of details?" "Do accountants therefore make their cost reports simple and concise, featuring the essential facts?" "Do they try to interpret the financial statements they prepare, or do they leave the executive to draw his own conclusions as best he can?" "Do they use graphic charts and comparisons of percentages, wherever possible, and do they submit comparisons with past, or standard performance?" Until accountants can answer such questions in the affirmative, they have yet far to go in order adequately to fulfill their obvious duties in their respective organizations.

While it is true that accountants, both in public practice and private employ, can not be infallible, there is much to be said on behalf of the hard-pressed executive who fails to find always the desired degree of initiative, vision, and energy in the personnel of his accounting department. But on the other hand, where can be found a higher degree of conscientious service in any department of his organization? With the right kind of leadership on the part of the executive—inspiration through personal encouragement of good work, suitable reward for conscientious and intelligent effort—accountants as a class will not fail to meet any emergency that may arise and call for unflinching loyalty and hard work. And here it may not be out of place to recall that it is a common occurrence in the business world for the accountant to rise rapidly beyond his immediate surroundings and through sheer force of character and ability to become the executive head of even a great organization.

### The Solution of Daily Problems in Industrial Accounting

Taxation has affected the pocket nerve in an unmistakable fashion, and sound and efficient accounting methods admittedly contribute toward the attainment of business success, yet their influence may not be of the headline variety and their importance may often be minimized by an executive. In practically every business organization may be found an accountant more or less qualified to solve daily problems without outside help, but, in the writer's experience, such accountants are somewhat reluctant to call for assistance upon questions relating to the accounts of a business about which they believe they know more than any outsider knows. Nevertheless, they often lose sight of the fact that questions of principle frequently arise involving in their solution the application of sound accounting theory and practice, so that professional accountants, qualified by years of study and practical experience along broad general lines, could undoubtedly render valuable assistance without detracting from the prestige of the corporation accountant.