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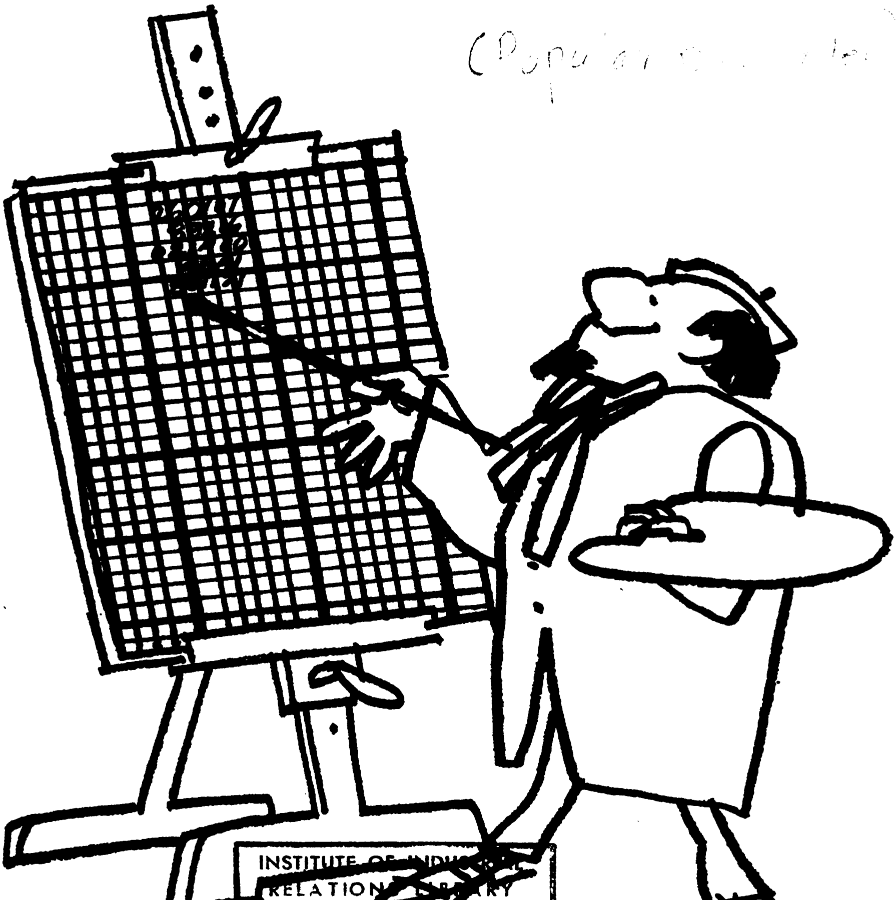
THE USES OF ACCOUNTING IN COLLECTIVE BARGAINING

by Harry C. Fischer, C.P.A.

(Popular ...)



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THE USES OF ACCOUNTING IN COLLECTIVE BARGAINING

The Uses of Accounting in Collective Bargaining

By HARRY C. FISCHER, C.P.A.

Edited by Irving Bernstein
Drawings by Bill Tara

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Foreword

THE INSTITUTE OF INDUSTRIAL RELATIONS of the University of California was created for the purpose, among others, of conducting research in industrial relations. A basic problem is to reach as large an audience as possible. Hence, through this series of popular pamphlets the Institute seeks to disseminate research beyond the professional academic group. Pamphlets like this one are designed for the use of management, labor organizations, government officials, schools and universities, and the general public. Those pamphlets already published (a list appears on the preceding page) have achieved a wide distribution among these groups. The Institute research program includes, as well, a substantial number of books, monographs, and journal articles, a list of which is available to interested persons upon request.

A collective bargain is in substantial part a money "package," an assemblage of wage rates and fringe benefits that the employer offers his employees over a prospective period of time. Its negotiation involves a subtle process of balancing equities. The union and the workers must satisfy themselves that the bargain is fair according to the standards they apply to their particular situation. The employer must be persuaded that he can afford to pay the costs of the bargain. In the conduct of the bargaining each side must be aware of and give consideration to the other's equity. Thus, both the employer and the union must weigh the former's ability to pay. The language in which this is expressed is accounting. This pamphlet is intended to serve as an introduction to that language.

The author of *The Uses of Accounting in Collective Bargaining* is well fitted to write such a pamphlet. Harry C. Fischer holds the B.B.A. from the Baruch School of Business of the City College of the University of the City of New York. Both the states of New York and California have certified him to practice as a Certified Public Accountant. He has, in fact, practiced for many years in California in the firm of Sunderman, Miller, Fischer & Co., specializing in health, welfare, and pension funds. He is a member of the American Institute of Certified Public Accountants and of its Committee on Health, Welfare, and Pension Funds. He is also a member of the Accountants Advisory Committee of the National Foundation of Health, Welfare, and Pension Plans, Inc. He is the author of *Accounting and Office Manual for Labor Unions,* published by the Bureau of National Affairs, as well as of many articles on accounting and tax problems.

The Institute wishes to express its gratitude to the following persons from the University of California, Los Angeles, who reviewed the manuscript: Paul Prasow,

Ted Ellsworth, and John W. Buckley. Bill Tara designed the cover and drew the illustrations. Mrs. Felicitas Hinman assisted with the editing.

The viewpoint is that of the author and is not necessarily that of the Institute of Industrial Relations or of the University of California.

BENJAMIN AARON, *Director*
Southern Division

LLOYD ULMAN, *Director*
Northern Division

Preface

THE INTRODUCTION TO *The Uses of Accounting in Collective Bargaining* points out the need for an understanding of accounting terminology and the interpretation of items in financial statements for those engaged in collective bargaining.

Members of negotiating teams may have had little formal education in accounting. Therefore, the presentation of certain material must of necessity be on an elementary level. This booklet is not an accounting text. It emphasizes comprehension of accounting procedures, the way accountants differ in their treatment of them, and the effect of such procedures on reported profits. It is the reported profits figure that features in a discussion of ability to pay, and an understanding of the accounting procedures followed will also afford a basis for comparison of operating results with other companies.

The chapter on suggestions for further reading should prove helpful for continued study. For those desiring proficiency in accounting, a more formal course of study is recommended.

HARRY C. FISCHER, C.P.A.

Contents

I. Introduction

COLLECTIVE BARGAINING has been established as the accepted means by which representatives of organized labor and of management reach agreement as to wages, fringe benefits, hours of work, and working conditions. Labor's immediate objective is an adequate return for its work and thereby improvement of the worker's standard of living. To management it is vital that the terms concluded permit the continued profitability of the enterprise and a return on the investment of stockholders.

Union representatives in a bargaining role are familiar with the desires of their members and have acquired some working knowledge of the industry. The assumption of this booklet, however, is that they also need to make use of available and pertinent financial information as an additional tool in collective bargaining. Sources of financial information discussed later in this book make such data available.

Such financial information will not only be of interest as an indication of the employers' ability to pay, but it may also show the rate of growth of the enterprise and its standing as compared to other firms in its field.

Recent emphasis by labor unions on participation of their members in the results of increased productivity requires the assembling and analysis of financial data. From time to time, the government has suggested "guidelines" or "guideposts" of percentage wage increases that would not upset the stability of the economy as a whole, another need for unions to use financial data in their attempt to equate such "guideposts" with the results to the industry of labor's increased productivity.

It may be argued that because labor negotiators may be assisted by professional advisers, they need not be proficient in understanding of financial statements and accounting terminology. However, since accounting deals with financial transactions, it is in effect the language of business, and the representatives of labor should have a knowledge of accounting terminology in order to properly communicate with management should such references be brought up during the course of the negotiations.

Negotiations with smaller enterprises may not entail the use of professional advisers, and here the individual negotiator should indeed be conversant with accounting terminology. Furthermore, the decision-making process and the requirement to report to the union members places the burden on the negotiating committee for a clear understanding of all financial matters involved.

From management's viewpoint one would think that it would expedite negotiations and simplify communication if both sides in the negotiating process understood the meaning of any financial terms that may arise.

In subsequent chapters of this booklet the reader will note that accountants differ in their treatment of financial data which is reflected on the "bottom line" or profit figure of the operating statement. An understanding of the makeup of the items in that statement is therefore of importance. Certain financial ratios will provide a measure of the earnings and productivity of the enterprise. Of significance too is the effect of income tax provisions on the results shown in the operating statement.

Analysis of the Balance Sheet or Statement of Financial Condition will provide significant ratios, those showing the utilization of plant and equipment and the liquidity of the organization among them.

It will be of some help to the negotiator if he has a general understanding of the structure of the business organization with which he is dealing and its accounting processes and records. This may be particularly useful should management offer to "open its books" on a claim of inability to pay. True, the union negotiating committee may call upon an accountant for this purpose, but again the committee will have a clearer understanding of what is done when it reports back to the members.

In matters of contract enforcement of wage, pension, and health benefit provisions, the collective bargaining agreement often provides for inspection of records. Such use of the accounting records will be reviewed in some detail.

To summarize, the entire focus of this booklet is to provide a general understanding of the uses of accounting in collective bargaining for whatever help it may offer to those directly concerned with the main task of negotiations.

II. The Meaning of Accounting

IN THIS AGE OF scientific achievement it may be popularly assumed that accounting too has developed to become an exact science. However, it will be seen that by its very nature accounting is unfortunately not an exact science. In fact, it is not a science at all, but an art that requires judgment in its practice. Therefore, it is necessary to know what to expect from its application in industry. The task is not too difficult and its understanding will be rewarding for those who are confronted with its use in a collective bargaining situation.

1. DEFINITION OF ACCOUNTING

An accounting bulletin of the American Institute of Certified Public Accountants sets forth the following definition of accounting developed by its committee on terminology:

Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transac-

tions and events which are, in part at least, of a financial character, and interpreting the results thereof.
(Accounting Terminology Bulletins, No. 1, *Review and Resume* (New York: The American Institute of Certified Public Accountants, 1953) p. 9.)

Accounting may be called the language of business and it is used to control operations and to arrive at a report of the financial accomplishments of the business organization. Trained persons make use of record systems and procedures to maintain internal control and develop the financial data required for reporting. Reports are required for management, stockholders, taxing authorities, and for many public and private agencies, dependent upon the nature of the enterprise. Such agencies may include the Securities and Exchange Commission, Utility Commissions, the Interstate Commerce Commission, and credit agencies. Dun & Bradstreet, Inc. is an example of a private agency requiring financial information.

For further clarification and in the light of continuing business development, the preceding definition of accounting has been expanded in a later accounting research study to read as follows:

Accounting is the body of knowledge and functions concerned with systematic originating, authenticating, recording, classifying, processing, summarizing, analyzing, interpreting, and supplying of dependable and significant information covering transactions and events which are, in part at least, of a financial character, required for the management and operation of an entity and for the reports that

have to be submitted thereon to meet fiduciary and other responsibilities.

(Paul Grady, *Accounting Research Study No. 7*, "Inventory of Generally Accepted Accounting Principles for Business Enterprises" (New York: The American Institute of Certified Public Accountants, Inc., 1965) p. 4.)

2. ACCOUNTING PRINCIPLES

Accounting principles refer to the development of a body of applicable rules derived through usage and practice, but subject to the judgment of the skilled accountant in their application in each instance. It is the variation in treatment of accounting procedures under these rules to which the reader of a financial statement must be alerted.

Differences in treatment of certain items by accountants will markedly affect reported earnings. For example, research and development costs may be charged off to expense during the current year or spread over several years. Methods and rates of depreciating plant and equipment, and methods of computing the inventories of merchandise may differ between companies in the same industry.

It is an accounting principle that a provision for depreciation of plant and equipment should be set up in the accounts of the enterprise by a charge to expense in order to provide for its decline in value through use. However, someone must exercise judgment as to whether, for example, a 5-year or 10-year useful life should be assigned to a piece of equipment. If the original cost is $55,000 and assuming a salvage value of $5,000, then the amount to be depreciated is $50,000. Use of a 5-year life results in an annual expense of $10,000 (1/5 of $50,000). Use of a 10-year life results in an annual expense of $5,000 (1/10 of $50,000).

Here we see that the exercise of judgment to use a 5-year life rather than a 10-year life has increased reported expense by $5,000 with a consequent decrease in reported earnings by a like amount. Tax considerations may influence judgment on how depreciation, inventories, research and development costs, and certain other items are to be treated. These will be touched upon later on.

When the independent public accountant retained for the annual audit examines the financial statements, he renders an "accountants opinion" with the report. The first part of his letter states the nature of the examination made "in accordance with generally accepted auditing standards." The opinion portion of the letter reads "In our opinion, the accompanying balance sheet and statement of income and earnings retained for use in the business present fairly the consolidated financial position of the . . . . . Company and its subsidiaries at . . . . . (date), and the consolidated results of their operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

The significant phraseology is that the statements were prepared in conformity with generally accepted accounting principles, and that such principles are consistently applied each year for that company. The applicable body of accounting rules is not only generally accepted by the accounting profession, but its usage has been generally accepted by the business and the financial world.

Where conflicts in accounting treatment have arisen, Accounting Research Bulletins have been issued by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants for purposes of clarification of procedures to be followed. More recently, an Accounting Principles Board has been established by the American Institute of Certified Public Accountants to review the need for uniformity in accounting treatment. The American Accounting Association is another organization that has spoken out on accounting principles.

The Securities and Exchange Commission has issued rules and regulations regarding financial statements that have had an effect on accounting practice and financial reporting.

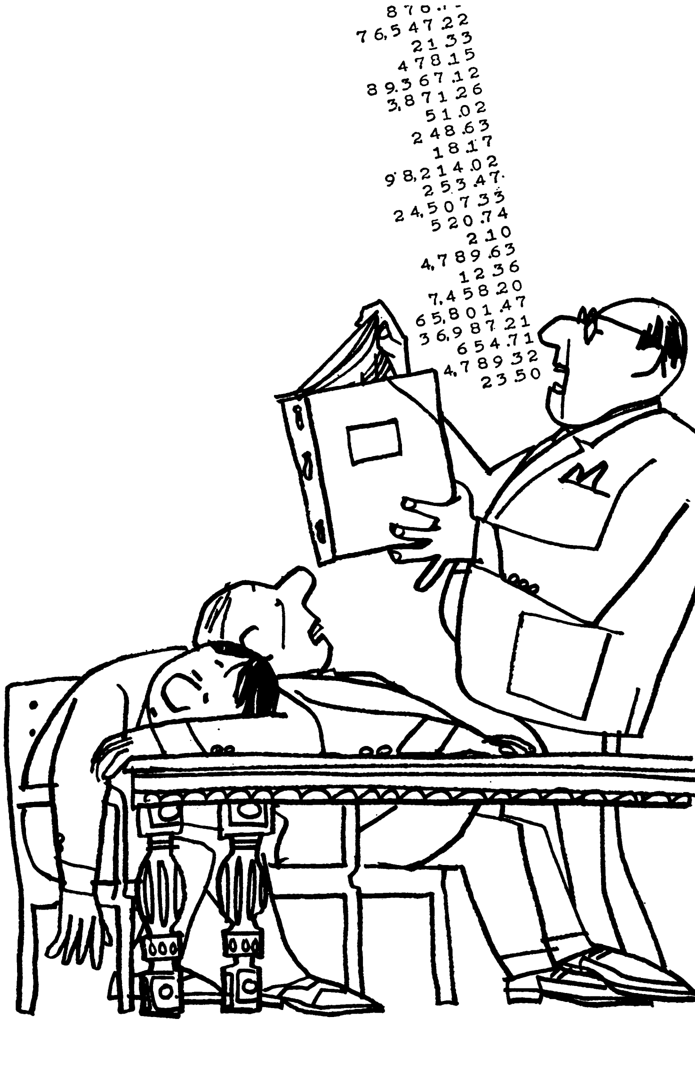
Variation in accounting treatment will affect only a limited number of items in the operating statement, but it may have great impact on the net earnings reported. This is covered in Chapter V on the Statement of Income and Expense.

3. FINANCIAL STATEMENTS

The accounting process includes preparation of the two principal financial statements: the Balance Sheet or Statement of Financial Condition, and the Operating Statement or Statement of Income and Expense.

Basically the Balance Sheet lists the resources of the organization as of the statement date. By inspection of the statement we can observe such matters as ability to pay outstanding obligations, working capital, and investment in plant and equipment.

The Operating Statement relates in summary form the financial results of the past period. It will show the volume of business, costs and expenses, and the earnings remaining for shareholders. Comparison can be made with past periods for trends in sales volume, labor costs in relation to sales, net income, and other data.



III. Financial Statements Illustrated

Financial statements are prepared by the accounting department of the business organization at regular intervals in order to provide information as to its resources and profitability. These statements reflect in summary form financial transactions, which have taken place during the accounting period. Statements of one accounting period may be compared with those of a previous one in order to determine what changes have taken place in financial resources and in operating activity and net profits.

A corporation may own the capital stock of other companies or "subsidiary corporations." These companies may be in allied enterprises, or they may be in completely unrelated businesses. An example of the former is a parts supplier owned by an automobile manufacturer, and an example of the latter is an appliance manufacturing subsidiary owned by the same automobile manufacturer. At the end of the fiscal year, the financial statements of the subsidiary corporations are combined with the statements of the parent corporation to form "consolidated" financial statements.

Financial reports are prepared at least annually, but they may be supplemented by monthly, quarterly, or semiannual statements. An organization may prepare these reports at the end of each calendar year, or it may adopt a natural business year as its fiscal year. In the latter event, the annual financial statements will cover a complete seasonal cycle of its business activity, ending when its inventories are at their lowest point of the year. For example, many department stores adopt a fiscal year which ends on January 31. This offers them an opportunity to complete the Christmas season and to clear out additional merchandise in January pre-inventory sales. By the end of its natural business year on January 31, more merchandise has been converted into sales, the work entailed in taking stock is reduced, and net profits can be more accurately determined.

1. PRINCIPAL FINANCIAL STATEMENTS

Chapters IV and V explain in detail the items making up the two principal financial statements, namely the Balance Sheet and the Statement of Income and Expense. Figures 1 and 1a provide an illustration of the former and Figure 2 illustrates the latter statement.

Most annual financial reports also include a Statement of Retained Earnings (Figure 3) and a Statement of Application of Funds (Figure 4). Additional financial information for management's use may include schedules furnishing a detailed breakdown of items summarized in the principal financial statements. Examples are a Schedule of Cost of Products Sold (Figure 5) and a Schedule of Cost of Goods Manufactured (Figure 6).

2. STATEMENT OF RETAINED EARNINGS

It is normal for the business enterprise to retain part of its profits for its continued growth and in order to cover possible future losses. Therefore, only a portion of the annual earnings are paid to stockholders as dividends.

The Statement of Earnings retained for use in the business (Figure 3) sets forth the balance of retained earnings at the beginning of the year, is increased by the addition of the net income for the year, and is reduced by the amount of dividends declared. The balance at the end of the accounting period is part of the stockholders' equity (Figure 1a).

Extraordinary gains and losses, not derived from normal operations of the business, are also shown in this statement. For example, an award by a court as the result of a patent infringement suit would be shown here rather than in the Statement of Income and Expense.

3. STATEMENT OF SOURCE AND APPLICATION OF FUNDS

In recent years it has become customary for companies to include as part of the annual report a

Statement of Application of Funds (Figure 4). This statement summarizes the source of all cash funds received during the fiscal year and indicates how the funds so obtained were applied. It sets forth the changes occurring in financial resources between reporting periods.

Amounts shown in the illustration were derived from a comparison of the Balance Sheet amounts at the beginning of the fiscal year with those of the end of the fiscal year (Figures 1, 1a). The year's increases or decreases in assets, liabilities, and capital are the items summarized in the Statement of Application of Funds.

From this statement can be obtained the "Cash Flow" for the year (net income plus charges that did not involve an actual cash outlay). It can be observed whether additional funds were obtained from the sale of securities and what use was made of funds derived from profits and from other sources. For example, the statement illustrated in Figure 4 shows total expenditures for new plant and equipment of $640,320, and an increase in working capital of $519,220. Comparison of the current assets and current liabilities between the beginning and end of the periods furnishes the increase or decrease in "working capital."

A working capital increase may represent a net increase in cash, accounts receivable, and inventories. Comparison of amounts in the fiscal year's beginning and ending Balance Sheets will indicate changes that may be a key to future developments. For example, a large increase in the finished goods inventory without an accompanying increase in volume of business for the

year may point towards a forthcoming slack in production until an inventory reduction is achieved.

4. SUPPORTING SCHEDULES

The Schedule of Cost of Products Sold (Figure 5) provides the detail relating to the amount shown in the Statement of Income and Expense (Figure 2). The provision for depreciation is often shown separately for statement purposes because it does not entail the expenditure of cash.

The Schedule of Cost of Goods Manufactured (Figure 6) provides a further breakdown of the total shown under this caption in the Schedule of Products Sold (Figure 5). In a wholesale or retail business the Schedule of Cost of Products Sold would show the total cost of merchandise acquired by purchase, eliminating the need for a supporting Schedule of Manufacturing Costs.

FIGURE 1

MANUFACTURING COMPANY OF AMERICA

CONSOLIDATED BALANCE SHEET

ASSETS

	Years Ended September 30, 1967	*1966*
Current Assets		
Cash	$ 1,135,580	$ 957,490
Short-Term Securities—At Cost .... (Approximates Market)	841,120	596,450
Trade Accounts Receivable, Less Allowances of $61,400 (1966—$51,000) .	2,977,280	2,625,890
Inventories—At Lower of Cost or Market		
Raw Materials and Work in Process	2,465,830	2,305,240
Finished Products	3,069,170	2,939,630
Total Current Assets	$10,488,980	$ 9,424,700
Property, Plant, and Equipment		
Buildings and Equipment—At Cost..	$10,642,590	$10,002,270
Less: Accumulated Depreciation ..	5,270,130	4,596,540
	$ 5,372,460	$ 5,405,730
Land—At Cost	560,100	560,100
Total Property, Plant and Equipment—Net	$ 5,932,560	$ 5,965,830
Other Assets		
Prepaid Expenses and Deferred Charges	$ 370,170	$ 365,780
Investments—At Cost	137,830	132,810
Total Other Assets	$ 508,000	$ 498,590
	$16,929,540	$15,889,120

FIGURE 1A

MANUFACTURING COMPANY OF AMERICA
CONSOLIDATED BALANCE SHEET
LIABILITIES AND STOCKHOLDERS' EQUITY

	Years Ended September 30, 1967	*1966*
Current Liabilities		
Accounts Payable	$ 1,296,290	$ 1,085,320
Accrued Taxes, Interest and Other Expenses	264,310	224,900
Loans Payable to Banks	142,270	134,300
Dividends Payable	117,430	116,620
Income Taxes Payable	663,540	527,640
Long-Term Debt Due Within One Year	150,000	-0-
Total Current Liabilities	$ 2,633,840	$ 2,088,780
Long-Term Liabilities		
5% Sinking Fund Debentures Payable $150,000 Annually 1967–1968, Less Amount Called For Redemption November 1, 1967	$2,850,000	$ 3,000,000
Deferred Federal Income Taxes	335,500	261,300
Total Long-Term Liabilities	$ 3,185,500	$ 3,261,300
Stockholders' Equity		
6% Cumulative Preferred Stock		
Authorized 50,000 Shares at $100.00 Par Value		
Outstanding 8,010 Shares (1966—7,170)	$ 801,000	$ 717,000
Common Stock		
Authorized 350,000 Shares at $10.00 Par Value		
Outstanding 234,757 Shares (1966—233,248)	2,347,570	2,332,480
Capital Surplus		
Additional Capital Paid In	969,500	887,580
Earned Surplus		
Earnings Retained For Use in the Business	6,992,130	$ 6,601.980
Total Stockholders' Equity	$11,110,200	$10,539,040
	$16,929,540	$15,889,120

FIGURE 2

MANUFACTURING COMPANY OF AMERICA
CONSOLIDATED STATEMENT OF INCOME AND EXPENSE

	Years Ended September 30, 1967	1966
Income		
Net Sales	$25,766,050	$24,095,480
Other Earnings	123,830	115,630
Total	$25,889,880	$24,211,110
Costs and Expenses		
Cost of Products Sold, Exclusive of Depreciation	$17,404,840	$16,450,960
Depreciation	673,590	675,040
Selling, General and Administrative Expenses	5,223,230	4,893,490
Taxes—Exclusive of Taxes on Income	644,150	602,390
Interest Expense	142,500	142,500
Total	$24,088,310	$22,764,380
Earnings Before Income Taxes	$ 1,801,570	$ 1,446,730
Provision For Income Taxes		
Current Year	$ 820,900	$ 557,700
Deferred	74,200	139,600
Total	$ 895,100	$ 697,300
Net Income For the Year	$ 906,470	$ 749,430

FIGURE 3

STATEMENT OF EARNINGS RETAINED FOR USE IN THE BUSINESS

Balance At Beginning of Year	$ 6,601,980	$ 6,360,840
Net Income for the Year	906,470	749,430
Total	$ 7,508,450	$ 7,110,270
Cash Dividends Declared		
Preferred Stock—$6.00 A Share	$ 48,070	$ 42,000
Common Stock—$2.00 A Share	468,250	466,290
Total	$ 516,320	$ 508,290
Balance At End of Year	$ 6,992,130	$ 6,601,980

FIGURE 4

MANUFACTURING COMPANY OF AMERICA
CONSOLIDATED STATEMENT OF SOURCE AND APPLICATION OF FUNDS

YEAR ENDED SEPTEMBER 30, 1967

Source of Funds	
From Operations:	
Net Income	$ 906,470
Charges Which Did Not Involve Current Expenditures	
Provision for Depreciation and Depletion	673,590
Provision for Deferred Income Taxes	74,200
Total From Operations ("Cash Flow")	$1,654,260
Sale of Preferred Stock	84,000
Sale of Common Stock Under Option Plans—1,509 Shares	
Credit to Common Stock	15,090
Credit to Capital Surplus	81,920
Total	$1,835,270
Application of Funds	
Dividends Declared	
Preferred Stock	$ 48,070
Common Stock	468,250
Expenditures for Property, Plant and Equipment	640,320
Sinking Fund Debentures Called for Redemption	150,000
Deferred Charges	4,390
Investments	5,020
Increase in Working Capital	519,220
Total	$1,835,270

FIGURE 5

MANUFACTURING COMPANY OF AMERICA
SCHEDULE OF COST OF PRODUCTS SOLD

YEAR ENDED SEPTEMBER 30, 1967

	1967	*1966*
Finished Goods Inventory, October 1 ..	$ 2,939,630	$ 2,762,500
Add: Cost of Goods Manufactured	18,207,970	17,303,130
Merchandise Available for Sale	$21,147,600	$20,065,630
Less: Finished Goods Inventory, September 30	3,069,170	2,939,630
Cost of Products Sold	$18,078,430	$17,126,000
Cost of Products Sold, Excluding Depreciation	$17,404,840	$16,450,960
Depreciation	673,590	675,040
Total	$18,078,430	$17,126,000

FIGURE 6

MANUFACTURING COMPANY OF AMERICA
SCHEDULE OF COST OF GOODS MANUFACTURED

YEAR ENDED SEPTEMBER 30, 1967

			Percentage of Total Cost
Raw Materials			
Inventory, October 1, 1966.	$ 1,845,100		
Purchases	11,500,220		
Freight in	828,150		
Total	$14,173,470		
Less: Inventory, September 30, 1967	1,975,630		
Raw Materials Used .		$12,197,840	67.0%
Direct Labor Costs			
Factory Wages	$ 3,760,000		
Fringe Benefits	376,000		
Payroll Taxes	253,700		
Compensation Insurance ...	18,800		
Total Direct Labor Costs		4,408,500	24.2%

Manufacturing Overhead			
Factory Superintendents ...	$ 36,000		
Indirect Labor	162,000		
Fringe Benefits, Taxes and Other Indirect Labor Costs	46,900		
Light, Heat and Power.....	230,000		
Factory Supplies Used	175,000		
Repairs and Maintenance ..	240,000		
Depreciation—Buildings and Equipment	673,590		
Other Factory Overhead ...	68,200		
Total Manufacturing Overhead		1,631,690	9.0%
Total Materials, Labor and Overhead Costs		$18,238,030	100.2%
Deduct: Increase in Costs Allocated to Work in Process			
Inventory, September 30, 1967	$ 490,200		
Inventory, October 1, 1966	460,140	30,060	0.2%
Cost of Goods Manufactured..		$18,207,970	100.0%

IV. The Balance Sheet

THE FIRST STATEMENT to be examined is the Balance Sheet, sometimes called the Statement of Financial Condition. Listed in summary form are the Assets, Liabilities, and Net Worth or Capital of an organization as of a given date.

An asset is a thing of value, such as cash or merchandise. On the other hand, a liability is an amount of money owed or due to others, such as for merchandise purchased or for money borrowed.

Net Worth or Capital may be determined from the fundamental equation, viz:

Assets minus *Liabilities* equal *Net Worth.* Stated another way, this equation may read:

Assets equal *Liabilities* plus *Net Worth.*

As an example, assume total assets of $30,000 and total liabilities of $20,000, and insert the figures for the equation as follows:

Assets $30,000 minus *Liabilities* $20,000 equal *Net Worth* $10,000

Assets $30,000 equal *Liabilities* $20,000 plus *Net Worth* $10,000

Presenting this information in outline Balance Sheet form results in the following financial statement:

Assets	$30,000	Liabilities	$20,000
		Net Worth (Capital)	10,000
	$30,000		$30,000

The Balance Sheet may list separately such assets as cash on hand, cash in checking account, and cash in savings accounts, or these items may be classified under the one heading of "Cash." Business financial statements avoid an excess of detail and combine items of assets under standardized headings such as Cash, Accounts Receivable, and Merchandise Inventory.

Assets are further classified on the Balance Sheet under group headings in accordance with their liquidity (the rate at which they may be converted to cash) and their nature. Liabilities are usually classified in the order that payment will be due, viz: those due currently within one year and those due after one year. A classified Balance Sheet is illustrated in Chapter III, Figures 1, 1a.

1. ASSETS

1a. Current Assets

Items classified as Current Assets are in the first grouping of Assets on the Balance Sheet because they are the most liquid. Current Assets include, cash, short-term securities, trade accounts receivable, notes receivable, and merchandise inventories. The accepted

usage of the classification refers to cash or assets that will be converted into cash within a period of one year.

The cycle of business activity is one in which raw material inventory is converted into work in process and then into finished goods. The sale of finished goods results in charge accounts to customers. Collection of these charge accounts (accounts receivable) results in the receipt of checks deposited to cash accounts.

These current assets are in constant use and turn over in operating the business. For this reason, after deduction of the current liabilities of the business, these assets are called the working capital.

Cash: Included are cash on hand for deposit, cash in checking accounts, and cash in savings and savings and loan accounts.

Short-Term Securities: Treasury Bills and listed stocks and bonds used for temporary investment of excess cash are shown under this category. However, long-term investments are shown under a separate classification, not as current assets.

Accounts Receivable: This represents the total on the statement date of amounts due from customers arising from the sales of goods or services. It is usual in most businesses, under the terms of sale, to allow the customer a certain number of days before payment is due. For example, the manufacturer may sell to the wholesaler under terms of 2/10, net 30. This means that he may deduct a discount of 2 percent if he pays the bill within ten days, and he must pay the full amount if he pays in 30 days when the bill is finally due.

Notes Receivable: Arrangements may be made with certain customers, permitting them to extend the period of payment by converting their open account receivable into a longer term written promissory note receivable, payable on a certain date for the amount due and including a rate of interest. The amount due will no longer appear under the heading of accounts receivable, but will be shown under the notes receivable heading instead.

This is a usual practice in certain industries, and in others it is done only as a special accommodation. In any event, receipt of a note permits the seller to "discount" it or borrow money from his own bank with the note as collateral. When due it is presented by the bank to the customer for payment. If not paid, or "dishonored," the seller must make good and then proceed against the customer for payment.

A note receivable may also arise out of a cash loan to customers or to others. If the due date is more than one year from the date of the Balance Sheet, such notes are not shown under the heading of Current Assets, but are classified separately or as Other Assets.

Allowance for Doubtful Accounts: Despite the careful extension of credit, most businesses cannot avoid some bad debts arising from nonpayment of accounts receivable. To provide for this contingency, an estimated percentage of credit sales is recorded in an account on the books as a reserve to allow for possible doubtful accounts. When the Balance Sheet is prepared, this allowance, or reserve, is deducted from the totals of

Accounts Receivable and Notes Receivable, leaving the net estimated collectible amount as the Balance Sheet Asset.

Should a bad debt occur at a subsequent date, the amount is charged against the Reserve Account, reducing both the Accounts Receivable and the Reserve Account, and having no effect on profit or loss at that time. Profits are reduced in the year when the reserve is originally provided for in the accounts.

Inventories

Inventories are quantities of merchandise on hand at the statement date to which a dollar value has been assigned, usually the lower of cost or market. Quantities are determined by physical count or listed from perpetual inventory records, and checked against the actual stock. Inventory totals are usually listed under the subheadings of raw materials, goods in process, finished goods, and factory supplies.

Raw Materials on hand refer to materials entering directly into the manufacture of the finished product and include the cost of freight, import duties, and other incidental costs required to bring such materials into the factory.

Goods in Process (or work in process) include the cost of raw materials, direct labor, and factory overhead up to the unfinished stage of manufacture of such items on the inventory date. Factory overhead includes fixed charges such as depreciation and property taxes, and variable charges such as supervisory and indirect labor.

Factory overhead may be allocated on some unit basis such as a percentage of raw materials, or of direct labor, or of both.

A "standard cost" method of pricing goods may be used for the various stages of production. Such standard unit costs are derived from raw material cost studies, labor time and motion studies, and unit overhead cost allocations.

Finished Goods refer to merchandise in stock, ready for shipment to customers.

Factory Supplies refer to unused items on hand not directly becoming a part of the finished product, but required in the factory during the course of its manufacture, such as machine oil for the equipment or cleaning supplies for the plant.

Valuation of Inventories

Inventories are generally valued at purchase price or cost of manufacturing, not at selling price to customers. If the purchase price of raw materials has dropped since the acquisition of the raw materials on hand, the government permits the use of the lower market price for income tax purposes. However, a problem appears when costs are constantly rising. At what prices should items remaining in the inventory on the statement date be valued: Costs of the first lot? Cost of the last lot? The average cost?

Using a *First-In-First-Out Valuation* (FIFO), costs are assigned in order of acquisition of the merchandise so that in a market of rising costs the lower priced merchandise is assumed to have been used first, and the higher priced merchandise (the current market price) is assumed to remain in the inventory. This method has a favorable effect on profits.

Using a *Last-In-First-Out Valuation* (LIFO) assumes that the most recently acquired merchandise is used up first, with the oldest merchandise acquired still remaining in inventory at the lower acquisition price. In a period of rising prices, this results in the most recently acquired merchandise being charged to current costs at the highest cost .

Use of this method of inventory valuation may result in an understatement of the value of the inventory carried in the Balance Sheet and an understatement of net worth. Assigning the most recent cost to the merchandise sold results in a lower net profit than would be the case if the earlier cost had been charged.

The *Weighted Average Valuation* is another method of pricing the inventory to determine the cost of the items remaining on hand. It consists of totalling the number of units purchased during the period and the total dollar cost of all these units. Dividing the total dollar cost by the total number of units purchased gives the average cost per unit purchased. The quantities remaining in the inventory are then priced at this average cost.

Retail stores may use the retail inventory method, which provides for listing the inventory at retail selling prices and then reducing the total to cost by application of an average gross profit percentage.

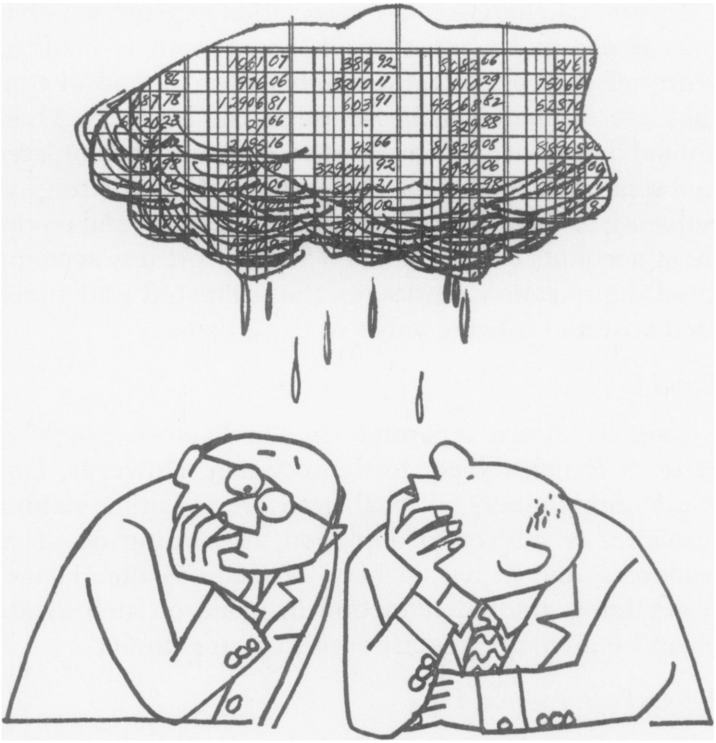
Construction companies engaged in long-term uncompleted contracts may value construction in progress at cost and add a percentage of profit based on the *Degree of Completion.*

Knowledge of the method of inventorying used is of the utmost importance to the reader of the financial statements. The government permits any of the above methods, provided they are consistently followed. When comparing the financial statements of several companies in the same industry, the method of inventory pricing should be noted for its effect on profits of each company.

1b. Property, Plant and Equipment

This classification, sometimes called "fixed assets," represents the total of assets that are long lasting and necessary in the operation of the business. Included are office and warehouse buildings, factory buildings, machinery and equipment, trucks and automobiles, and office furniture. Land is shown separately under this classification.

These assets are carried at their original cost of acquisition, which includes freight and installation costs necessary to put machinery in place. Interest and property taxes incurred during the course of construction of new buildings may be included in building costs or may be charged off as an expense of operations in the year incurred. If charged to expense before the plant is productive, such interest and taxes may have a marked effect on current year's profits.



Accumulated Depreciation

Buildings, machinery and equipment, trucks and automobiles, and office furniture are all subject to a gradual wearing out through use and action of the elements. Machinery and equipment may also become obsolescent (out of date) because of the invention of new machines or a new process which makes the old ones uneconomic to use and noncompetitive with the new ones.

By annual charges to a depreciation expense which in turn is charged against profit, an attempt is made to write off the cost of these assets over a period of time they are estimated to be of use in the business. These annual depreciation charges to expense are accumulated in a separate account for the purpose of "evaluating" or reducing to "book value" the cost of the plant and equipment accounts on the Balance Sheet. Cost less accumulated depreciation represents the estimated undepreciated cost and salvage value of these assets.

Land

Land is shown separately in the Balance Sheet because it is not subject to depreciation. However, land containing timber, oil, coal, iron ore, or other natural resources is subject to depletion, or a using up of its resources, and provision may be made in the Balance Sheet for a gradual reduction in value of such assets, offset by a charge against current year's profits.

Tools, Patterns and Dies

These assets may be included in the totals of plant and equipment shown in annual reports. At other times they may be grouped as a separate asset under the general classification of property, plant and equipment. Tools, patterns and dies have only short useful lives, sometimes for merely one model year. For that reason at the end of the accounting period the remaining useful items are inventoried at cost less depreciation. The excess over this amount is charged to manufacturing expense. Any salvage value realized is offset against such expense.

A policy of too fast "amortization" (write-off to expense) of these assets may result in both an understatement of assets and of profits for the year.

1c. Intangible Assets

Buildings and equipment are "tangible" items which can be physically seen. "Intangible assets," on the other hand, exist only on paper. Examples are patents and copyrights, costs of leases, etc. Where these items represent actual costs incurred, they may be amortized (charged off to expense) over the time remaining before their expiration.

Goodwill may represent the cost of acquisition of the assets of a business over their market value and is a price paid for acquiring access to customers or earning power of a business. Financial analysts will ignore this item if it appears on the Balance Sheet. It may be eliminated by a charge against capital and surplus, but not against current year's profits.

1d. Prepaid Expenses and Deferred Charges

This classification of assets refers to expenses incurred during one accounting period that are chargeable to operating expense of subsequent accounting periods. Examples are prepaid insurance premiums, prepaid interest, and prepaid rent. The cost of a three-year insurance premium will be allocated over the period covered; prepaid interest will be charged to expense over the life of the loan, etc.

Current accounting practice permits prepaid accounts to be shown under the Current Asset classification or that of other assets. Either method results in no reduction of profits until the prepaid item is charged off to expense of the appropriate period.

Research and Development Expense is another example of an account that may be carried as a deferred charge asset on the Balance Sheet when incurred, and subsequently charged to operating expense over the accounting periods directly benefiting from the research. Income tax laws permit the company an alternative method of charging research and development expense to operating expense as such charges are incurred. This may have a depressing effect on profits one year, while subsequent years will reap the benefit of higher profits should the research result in new products at lower costs.

2. LIABILITIES

2a. Current Liabilities

Most business activity is carried on by credit, evidenced by bills submitted for merchandise purchased on open account or notes given to cover open accounts or money borrowed from banks and other agencies. In the normal operating cycle of business activity, materials are purchased and labor is applied to convert the raw materials into finished goods. These finished goods are sold on open account; later collections are received in cash and the cash is used to pay liabilities due.

Liabilities for merchandise, payrolls, taxes, loans, etc., arising out of the operating cycle are classified as current liabilities. The portion of long-term debt due within one year is also classified this way.

Accounts Payable: Amounts due to trade suppliers for such items as raw materials and factory supplies are summarized under this heading on the Balance Sheet.

Accrued Taxes, Interest and Other Expenses: As of the close of the accounting period, amounts may be unpaid for such items as manufacturer's excise taxes, employees' payroll taxes, or for interest on loans.

Similarly, employees may have earned all or part of a week's pay with payment not due until a date following the end of the fiscal year. These items are added to liabilities or "accrued" as due in the Balance Sheet. They are also reflected as expenses in the operating accounts for the accounting period in which they were incurred.

Loans Payable to Banks: This classification represents short-term (less than one year) loans from banks made to supplement cash need.

Dividends Payable: The Board of Directors meets and "declares a dividend" to stockholders of record on a certain date, payment to be made at a subsequent date. Thus, Dividends Payable represents the liability for dividends already declared but unpaid. It is offset by a charge against the retained earnings account and does not affect the income statement.

Income Taxes Payable: Federal and state income taxes unpaid on prior year's profits and estimated due on current profits to date are included under this heading.

Long-Term Debt Due Within One Year: Debt installments due within a one-year period are classified as current liabilities on the Balance Sheet, and the balance is shown below under Long-Term Liabilities.

2b. Long-Term Liabilities

Amounts due on corporation bonds, mortgages, and other long-term loans are classified as long-term liabilities. From such total is deducted the amount due within one year for inclusion under the heading of current liabilities.

Debentures or *Bonds* are represented by certificates issued in amounts of $1,000 or more by the corporation and represent the written promise of the corporation to pay the principal amount on or before a specified date with interest at a fixed rate payable semiannually. The bonds may be "registered" to a named individual, or they may be "coupon" bonds, payable to bearer. Bonds are covered by a group contract or "trust indenture" held by a trustee and may be secured by property of the corporation or unsecured.

A "sinking fund" provision requires the corporation to deposit an amount annually with the trustee in order to establish a fund to retire the bonds. Each year a number of bonds may be "callable" by the trustee and the cash in the sinking fund is used to pay those bondholders presenting their bond certificates for payment.

Certain series of bond numbers may be payable at stated intervals and are called "serial bonds." Other bonds may be "convertible" (exchangeable) into a stated number of common shares of stock of the corporation in lieu of payment in cash.

Cash obtained from issuance of bonds will have an indirect effect on profits by providing working capital or machinery and equipment to expand the business and hopefully increase revenue. The direct effect on the operating statement will be an annual fixed charge for interest, which is a deduction from profits.

2c. Contingent Liabilities

Normally liabilities represent amounts determined as of the statement date to be obligations of the organization.

However, sometimes there is an element of doubt as to whether an obligation exists. An example is a pending lawsuit against the corporation for damages. In such case a contingent liability may be shown on the Balance Sheet to cover the amount payable if the lawsuit is lost. This provision would be offset by an appropriation or tentative reduction of retained earnings or surplus. Tax laws do not permit deduction of contingent liabilities as a charge against current profits.

2d. Deferred Federal Income Taxes

In order to reduce the current liability for corporation income taxes, certain adjustments may be made which will have the effect of postponing income taxes to a later period. For example, a greater charge for depreciation may be taken on the tax return than that shown on the Statement of Income and Expense. The deferred federal income tax account accumulates the temporary savings in income tax which theoretically will be paid at some later date.

It should be noted that an increase in the deferred federal income tax account has been offset by a charge against the current year's profits. (This so-called "conservative accounting" concept may be difficult for the layman to grasp. The net effect is to charge current year's profits with the greater income tax that would have been paid if the depreciation reported in the income statement had been reported on the corporation tax return. The day of reckoning is supposed to come when the greater depreciation charges taken on the tax return have been exhausted and there is no further depreciation on the equipment in question necessitating payment of a larger tax at that time. But with constantly increasing investment in plant and use of group or class accounts to record acquisitions, the variation in corporation income tax may be deferred for a long time. In the meantime profits have been understated by the excess tax charge and the cash is retained in the business. Not all accountants agree with this concept of deferred income taxes.)

3. STOCKHOLDERS' EQUITY

The capital required to operate a business is made up of two parts: investment of the stockholders or owners in the business, increased by accumulated earnings retained in the business, and borrowed capital or long-term debt. (Short-term borrowings are part of the trading cycle and are constantly being paid off as collections are made on sales.)

When a business is operated on a great proportion of long-term debt as compared to the stockholders' investment, it is said that the business has good "leverage," meaning that it is earning profits with money other than that of its owners. However, at the same time net profits are being reduced by the amount of the interest charge, which is also deductible from corporation income taxes. Payment of dividends to stockholders is made *after* the net profit figure has been determined and is not a deduction for tax purposes.

Given two competing companies making an equal profit on sales (before deduction for interest), the company operating with the greater long-term debt will usually show a greater percentage return on stockholders' equity. Preferred stock, common stock, capital surplus, and earnings retained in the business make up the stockholders' equity or ownership.

3a. Preferred Stock

The preferred stockholders have a prior claim against dividends and assets than do the common stockholders. The stock is "senior" to the common stock. The preferred stock is said to be "cumulative" when dividends are payable in later years if unpaid and skipped in any year. The preferred stock may also be "participating" if the stockholders share in dividends paid to common stockholders in addition to their preferred dividends. The shares may be "convertible" or exchangeable into a predetermined number of common shares.

3b. Common Stock

The common stockholders bear the greatest risk, but are entitled to share in all of the remaining profits after satisfying the prior claim of the preferred stockholders. Common stock may have a stated face value or "par value" or may be of "no par value" shares with no value stated. However, this is only an arbitrary matter for the purpose of complying with state corporation laws, and such values have no relation to the actual asset value per share of stock or to the values at which stocks are traded on the Stock Exchanges.

When the stock is originally issued by the corporation, amounts received over the par value of the stock are credited to Capital Surplus.

Treasury stock represents stock repurchased by the corporation after it has been issued. Corporations with excess cash may later reacquire some of their stock when the price is favorable. This has the effect of reducing the capital, but it also increases the per share earnings since fewer shares are now outstanding.

Stock splits have no effect on the dollar capitalization except that the number of shares in the hands of the stockholders has been increased, thus usually making it easier for the shareholder to dispose of part of his stock.

Stock dividends, representing shares of stock given to stockholders as opposed to cash dividends, increase the number of shares in the hands of stockholders. A book transfer is made from retained earnings to the more permanent common stock and/or capital surplus accounts.

Stock options grant officers and others the right to purchase stock at a present or later date at a predetermined price. Thus, if the market price rises, the officer "exercises his option" and pays the corporation the option price per share and can later sell his stock and realize a gain.

3c. Capital Surplus

The amount paid in by common stockholders over the par value or stated price of the stock is credited to capital surplus. Transfers are sometimes made to this account from retained earnings in order to restrict the amount of earnings available for cash dividends.

3d. Earned Surplus or Retained Earnings

Annual profits are credited to this account and accumulated in the business from year to year as additional stockholders' equity. Dividends paid to stockholders are charged against retained earnings (Figure 3). Extraordinary gains and losses (other than from current operations) are also added to or deducted from this total. For example, a large sum obtained through a court suit against another company for patent infringements would be credited directly to retained earnings, as the amount was not obtained from the normal revenue of the business.

V. The Statement of Income and Expense

THE STATEMENT OF Income and Expense summarizes items of revenue, cost, and expenses to arrive at the net profit or loss for the accounting period. Since it shows the results of operations for the period, the report is also called the Statement of Operations. Other commonly used descriptions for this report are Statement of Earnings or Statement of Profit and Loss, or merely Statement of Income.

This report should be distinguished from a Statement of Cash Receipts and Disbursements, which summarizes all cash received and all cash disbursed during the period. However, cash receipts will include collection of the prior year's sales, and cash disbursements will include payment of the prior year's bills but will exclude bills of the current year not yet paid. Furthermore a cash statement will include such items as money borrowed or loans repaid which are not income from sales. Therefore, a Statement of Cash Receipts and Disbursements is inadequate for purposes of stating the results of operations.

The Statement of Income and Expense is prepared on the "accrual basis." Sales of the accounting period are included as income, whether collected or not. Unpaid merchandise or expense bills are accrued or included in costs and expenses as they are incurred, regardless of the time of payment. Merchandise remaining in inventory is deducted from cost of goods sold during the period.

The interrelationship of the Balance Sheet and the Statement of Income and Expense may be better understood by noting how accrued items affect each. For example, uncollected income from sales is shown on the Balance Sheet as accounts receivable and included in income from sales on the Statement of Income and Expense. Unpaid expense bills are included in accounts payable on the Balance Sheet and added to Selling, General and Administrative Expenses on the Statement of Income and Expense.

The year-end merchandise inventory deducted from the cost of products sold in the Income Statement is shown as an asset on the Balance Sheet. The net income for the year is included in the accumulated retained earnings shown in the Balance Sheet.

By means of a consolidated Statement of Income and Expense, the parent corporation and solely owned subsidiary corporations combine their individual operating statements into one summary statement for the fiscal year. For comparative purposes, the current year and prior year's figures are usually listed. (See Chapter III, Figure 2.)

1. INCOME

Net Sales refer to total billings for the fiscal year, less sales returned, allowances made, and sales discounts deducted by customers in accordance with the terms. Sales taxes and excise taxes where applicable are excluded from sales and shown as a liability to the taxing agency. Freight charges are excluded and offset against the expense. A separate schedule showing the breakdown of dollar sales and number of units sold by product is of interest for comparative purposes and is included in some published annual reports.

Other Earnings include such items as interest and dividends received on cash temporarily invested. Sales of supplies and used equipment (not part of the product normally sold) would be included in other earnings.

2. COST OF GOODS SOLD

Included in cost of goods sold are all costs allocated to the merchandise that was sold. (See Chapter III, Figures 5 and 6.) The cost of raw materials, labor and fringe benefit costs, and overhead costs, adjusted for the beginning and ending inventories of raw materials and work in process, make up the cost of goods manufactured. Adding the inventory of finished goods at the beginning of the accounting period and deducting the inventory of finished goods at the end of the accounting period gives us the cost of goods sold.

Overhead costs entering into the cost of goods manufactured refer only to factory expenses such as indirect labor, heat and power, factory supplies, etc. (See Chapter III, Figure 6.)

In a wholesale or retail business, where no manufacturing is done, the cost of goods sold is the cost of acquiring the merchandise for sale, adjusted for the variation in beginning and ending inventories.

In accounting usage, the term "costs" generally refers to items entering into the cost of goods sold. The term "expenses" generally refers to such items as selling and administrative expenses. However, the terms are sometimes used interchangeably.

3. DEPRECIATION CHARGES

Depreciation is the estimated amount added to costs and expenses during the accounting period representing the wearing out, or increasing inadequacy through obsolescence, of the buildings and equipment. Equipment declines in value due to age and use. An invention of a new machine or process may make the old equipment obsolete.

Depreciation is often shown as a separate item in the Statement of Income and Expense. However, depreciation of plant and equipment used in a manufacturing business is properly chargeable to factory overhead.

It is expected by means of these annual depreciation charges to ultimately write off to costs and expenses the entire cost of buildings and equipment, less an estimated salvage value. (See discussion of accumulated depreciation in the Balance Sheet in Chapter IV.)

One should note carefully that these annual charges for depreciation are only *estimates* of additions to costs and expenses made on the books and in the financial statements. But the effect is to reduce reported profits by the amount of the depreciation. Charges for depreciation do not as such represent cash outlays. Cash is expended only when the equipment is acquired.

Therefore, the charge against profit for depreciation has the effect of retaining cash in the business until expended for replacement equipment. In fact, unless a separate fund is set up for the purchase of new equipment when the old is worn out, the cash so retained may in the meantime be used for other purposes.

The term "cash flow" is used to designate net profits plus depreciation. Cash flow per share is often indicated in annual financial reports, as well as the reported earnings per share.

3a. Methods of Computing Depreciation

Variation in the method of computing depreciation and the estimated useful life of the asset will affect the charge for depreciation and stated net profits.

The most commonly used method of computing depreciation is the *Straight Line Method* which allocates the depreciation equally over the estimated life. Assume a machine costs $12,000, the estimated salvage value is $2,000, and the cost to be depreciated is $10,000. Estimating a useful life of ten years, one-tenth of $10,000, or $1,000, is charged to depreciation each year. However, note that if the estimated useful life is five years, the annual charge to depreciation would be $2,000. In the first example the resulting net profit would be more than in that of the second.

In manufacturing plants, a *Service Life* method may be used by estimating useful life on the basis of machine hours used, or on the basis of units of production.

Tax laws may permit "accelerated" methods of depreciation such as the "declining-balance method" and the "sum of years' digits" method.

Under the *Declining-Balance Method* the amount to be depreciated each year is based on cost reduced by each year's depreciation. Under the *Double Declining-Balance Method,* taking as an example an amount to be depreciated of $10,000 and a 10-year life, twice 10 percent or 20 percent may be deducted or $2,000 the first year. In the second year the deduction is 20 percent of $8,000 ($10,000 less the first year's depreciation) or $1,600. Under this accelerated method greater amounts of depreciation are charged in the early years of the machine's acquisition. As a result of a greater depreciation charge in the early years, the stated profit is reduced in the early years of the life of the equipment.

The *Sum of Years' Digits* method is also an accelerated depreciation method whereby the annual depreciation deduction is figured by applying a changing fraction to the cost of the property. The result is also higher depreciation charged in the early years. For example, assume the cost less salvage value of the equipment is $10,000 and the useful life is five years. The first year's depreciation is 5/15 or 1/3 of $10,000 or $3,333. (The denominator 15 is arrived at by adding the sum of the remaining years—5 plus 4 plus 3 plus 2 plus 1.)

An accelerated method of depreciation may be used for purposes of preparing the corporation income tax returns, while the financial statement may show a lower straight line depreciation deduction. To properly understand the net operating income of a company and to be able to compare the results with companies in similar lines of business, the reader of the financial statements should know the depreciation method used. In fact, management often contends that the depreciation charge should be on the basis of replacement cost and not original cost. In periods of rising costs for equipment, such a practice would increase the charge for depreciation and reduce stated profits. At this time neither government tax laws nor conservative accounting practice permits depreciation based on replacement cost.

4. DEPLETION CHARGES

Depletion Charges is the term used for the gradual using up of what is called a wasting asset, representing a natural resource such as gas, oil, coal, iron ore, timber, etc. Just as for depreciation of equipment, a charge is made against profits for the estimated using up of this resource. The charge may be made on the basis of an estimated unit cost of the resource to be obtained from the land. Each year the charge for depletion is made on the number of units (or volume) produced.

Current tax laws permit a continuous depletion rate of 27½ percent of gross receipts from oil sales, regardless of the actual unit cost, with a limitation that the depletion charge cannot exceed 50 percent of the taxable income realized each year from the oil property, calculated without regard for the charge for depletion. Other rates for minerals are set forth in the tax laws.

Where a provision for depletion is deducted from net profits, the "cash flow" is arrived at by adding the depletion and depreciation charges back to net profits.

5. SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

The expenses included in this grouping are all of the operating expenses, except those included in factory overhead as part of the cost of goods manufactured. There may be a further breakdown, with supporting schedules showing a detailed listing of categories of selling expenses, shipping expenses, and office and administrative expenses. Other operating expense items such as taxes and interest expense may be shown separately in order to emphasize what is being paid to taxing agencies and to lenders for the use of borrowed funds.

Selling expenses include such items as advertising expenses, salesmen's salaries, commissions, traveling expenses, and entertaining and sales promotion expenses. Office expenses include office salaries and fringe benefits, telephone, stationery, postage, office occupancy expenses. Administrative expenses include officers' salaries, bonuses and fringe benefits, and officers' traveling and entertaining expenses.

Financial statements prepared for management and credit agency reports will usually furnish a greater breakdown of detailed expenses than will the annual published reports to stockholders. Stockholders usually receive, with the notice for the annual meeting, a list of the directors of the corporation and their stockholdings and a list of the principal officers and their annual salaries, bonuses, and retirement benefit information. Indirectly then, this will furnish some breakdown of the charges to administrative expenses for officers' accounts.

6. RESEARCH AND DEVELOPMENT EXPENSES

With federal and state corporation income taxes taking in excess of 50 cents of each dollar earned, and in view of the highly competitive nature of industry, many corporations are expending increasing amounts for research and development in their search for new products.

Such expenses may not be shown separately in the financial report, but may be included in costs charged to the cost of goods manufactured. It is important to determine whether such charges have been abnormally high in the current fiscal year, with a depressing effect on current profits. The full benefits of new products and new processes discovered through research often may not increase profits until put to use in subsequent years.

7. NET INCOME FOR THE YEAR

Deducting costs and expenses from gross receipts will show the company's earnings before income taxes. After deducting estimated federal and state income taxes, the remainder is the net income for the year. This net income is added to earnings retained in the business from which stockholders' dividends are paid (Figure 3). (See also the note in Chapter IV relative to charges for deferred income taxes.)

VI. Effect of Income Tax Provisions on Reported Earnings

BEFORE EXAMINING how income tax provisions affect reported income in financial statements, it is well to understand how taxes on wage and fringe benefits affect employees and employers.

The employee's "take home pay" is reduced by deductions for social security taxes and withholding taxes, for which the employer acts as a collecting agent for the federal government. In California, employees' take home pay is further reduced by the 1 percent tax for disability benefits administered by the Department of Employment. Deductions for contributory pension plans and vacation benefits would further reduce take home pay.

The employee pays no income taxes on employer pension and health insurance contributions made to approved plans for his benefit. The employee is subject to income taxes when he retires and receives his pension, but at that time if he has little other income his tax will be negligible.

The employer must match the social security tax deduction from wages with an equal payment to the Internal Revenue Service. He must make quarterly payments of unemployment taxes on wages to states where he has employees, and a small annual payment for federal unemployment tax. Wages, payroll taxes, and fringe benefits such as pension and health contributions are all deductible by the employer from his gross income in determining his taxable income.

If the employer's effective federal and state income tax rate is 50 percent, then for every dollar paid in wage costs he is out of pocket 50 cents. (This is true because every dollar of deduction from gross income reduces the income to be taxed at the 50 percent rate, if that happens to be his effective rate.) The rates will vary between employers operating as sole proprietors and between corporations operating in different states, but the principle remains the same.

Taxable income and rates for corporations and for individuals are determined in accordance with the Internal Revenue Code of 1954 and subsequent amendments by Acts of Congress. Regulations and rulings are issued by the Commissioner of Internal Revenue within the Treasury Department of the United States.

Most states and some cities also have income tax laws. These laws usually follow closely the provisions of the Internal Revenue Code for the determination of taxable income. However, tax rates are much lower than federal rates and vary from one state to the other.

1. INDIVIDUAL INCOME TAXES

Income from business enterprises operated as single proprietorships is reported on Form 1040, Schedule C, of the owner's individual income tax return. Net profits from the business are added to his other income or offset against losses from other sources in arriving at his taxable income subject to individual income tax rates.

Individual income tax rates are subject to periodic changes by act of Congress. However, 1967 is illustrative with rates ranging on a graduated basis from 14 percent of the first $500 to 70 percent on taxable income over $200,000. According to the tax table, the tax on the first $200,000 of taxable income on a joint return amounts to $110,980, or an effective rate of 55 percent ($110,980 divided by $200,000 = 55 percent).

Self-employed individuals are also subject to a self-employment tax to cover social security and Medicare provisions of the law, comparable to the tax paid by employees. For 1968 the maximum self-employment tax is $499.20 (self-employment income of $7,800 at a rate of 6.4 percent).

For a comprehension of how certain corporate transactions will affect individual income taxes, it is well to understand how dividends received and capital gains from sales of securities are taxed to individuals.

Individuals exclude the first $100 of dividends received in cash, and include the balance in their income subject to individual income tax rates. On a joint return,

$200 may be excluded. Distribution by a corporation of shares of its own stock as a stock dividend results in no tax to the shareholder until the stock is sold.

Profits from sales of securities and from sales of capital assets such as land and buildings are called capital gains. Capital gains and losses receive special tax treatment. Individuals having capital gains from sales of securities and other capital assets held for more than six months are taxed on only one-half of the amount of those gains at their regular income tax rates. Or as an alternative, if more favorable to them, they may compute their tax without capital gain and add 25 percent of the capital gain to arrive at their total tax. Capital losses are deducted from capital gains, and if the losses exceed the gains, $1,000 may be deducted from current year's income and the balance carried forward to be taken as a deduction in subsequent years until exhausted.

A special provision of the Internal Revenue Code, applicable to individuals only, permits income to be taxed at lower rates where there is a marked increase of taxable income in one year compared to the preceding four years. To use this method, averagable income must exceed $3,000, and adjusted taxable income must be more than one-third higher than a base period of the preceding four years. Long-term capital gains are excluded from averaging.

2. PARTNERSHIPS

Partnerships report their income at the close of their fiscal years on Form 1065. However, this is only an information return, showing gross income, deductions, net income, and the distribution to partners. No tax is paid with a partnership return. Each partner's share of income is included with his other income on his individual income tax return Form 1040. Tax rates vary with the individual's income tax bracket for his total taxable income.

3. CORPORATIONS

Corporations report their income and deductions at the close of their fiscal years on Form 1120. Their net taxable incomes are taxed at corporation tax rates. Those with subsidiary corporations may file consolidated returns.

Corporation income tax rates are also subject to periodic changes by Congress. The basic pattern of normal tax and surtax has remained the same, varied by small rate changes up or down. Small business is encouraged by a normal tax of only 22 percent on the first $25,000 of taxable income. Income above $25,000 is taxed at the normal tax rate of 22 percent plus an added surtax of 26 percent, or a total rate of 48 percent.

Since the taxable income of most large corporations is above $25,000, the lower rate on the first $25,000 has little effect on the total tax which is largely computed at the 48 percent rate. (At the time this is written, the Administration requested an additional surcharge of 10 percent of the total tax. Tax Amendment adding a surcharge of 10 percent to the tax as computed under prior law became effective retroactive to January 1, 1968 for corporations and April 1, 1968 for individuals. The surcharge expires July 1, 1969 unless extended by act of Congress.)

State income tax rates should also be taken into account in computing the total effective tax rate to be paid by the business organization. For the larger corporation, the state income tax will bring the effective rate over the 50 percent mark when added to the federal normal tax and surtax rates. This is clearly illustrated in the State of California where the corporation tax rate is 7 percent.

All ordinary and necessary business expenses must be deducted from gross income in arriving at taxable income. Gross income includes such items as sales of merchandise or services, rents collected, and interest received. Deductions include cost of merchandise sold, salaries and wages, overhead expenses, taxes paid, interest paid, and depreciation. Interest received on state and municipal bonds is exempt from taxation by the federal government. These provisions are similar to those affecting individual proprietorships and partnerships.

3a. Capital Gains

Corporations do not exclude half of their long-term capital gains as do individuals. However, they may compute an alternative tax, paying a maximum tax of 25 percent on long-term capital gains rather than the regular corporation rates. Losses from sale of capital assets used in the business, such as land, buildings, and equipment may be deducted from ordinary income. Other capital losses are only deductible from capital gains, but may be carried forward to the five subsequent years if they cannot be deducted in the current year.

3b. Dividends Received

Corporations receiving dividends from other U. S. corporations in which they have made investments generally exclude 85 percent of such dividends from their taxable income. This can result in considerable tax savings when surplus funds are invested in stock of other corporations.

3c. Dividends Paid

The corporation tax is computed on taxable income before payment of cash dividends to their stockholders. Dividends paid by corporations are not deductible from their taxable income.

3d. Interest Paid

The corporation raising additional capital from the sale of bonds rather than from sale of shares of stock has the tax advantage of the interest deduction. Generally, all interest paid by a taxpayer, whether in business or not, is allowed as a deduction under the Internal Revenue Code.

3e. Depreciation and Depletion

Deductions for depreciation and depletion are allowable from gross income in computing taxable income.

Such deductions are allowed according to law, regulations, rulings, and applicable court decisions. (See discussion under depreciation and depletion in Chapter V. See also the discussion under deferred federal income taxes in Chapter IV.)

3f. Taxes Paid

All taxes paid as an expense of doing business are deductible with the exception of the U. S. income tax, which is never allowed as a deductible expense in computing taxable income for federal returns. However, state income taxes are deductible on federal returns in computing taxable income. Therefore, to ascertain the overall combined effective state and federal corporation income tax rate, this fact should be taken into consideration.

This is illustrated as follows:

Assume the maximum current U. S. corporate tax rate of		48.00%
Take into account the California corporation income tax rate of	7.00%	
Give effect to the tax saving due to the deduction allowed on the U. S. return for the California tax paid 48% of 7%	3.36	
Net effective cost of the California tax..........		3.64
Combined effective corporation tax rate for U. S. and California before imposition of any temporary surcharge		51.64%

4. NET OPERATING LOSS—CARRYBACK AND CARRYOVER

In view of the high corporation tax rates, a provision of the federal law can lead to a large tax refund in a year of an operating loss or reduce the income tax in subsequent years. This will ease the financial impact of reported losses.

The U. S. Internal Revenue Code allows a loss from operations of business to be carried back three years and forward to each of the following five years until used up by an offset against income. This is a means of averaging losses of one year against profits of another for purposes of computing the tax liability. The California tax law has no such provision.

The following example illustrates how effective this tax provision can be:

	Year	*Amount of Net Profit*	*Amount of Loss*	*Total Tax Paid*	*Normal Tax*[1]	*Surtax*[1]
	1967		$1,200,000	None		
	1966	$ 200,000		$ 89,500	$ 44,000	$ 45,500
	1965	300,000		137,500	66,000	71,500
	1964	500,000		243,000	110,000	133,000
Totals		$1,000,000	$1,200,000	$470,000	$220,000	$250,000

[1] Computed on the basis of a normal tax rate of 22 percent for each year and a surtax rate of 28 percent in 1964 and 26 percent in 1965 and 1966.

The 1967 loss of $1,200,000 is first carried back three years to 1964. Since it exceeds the profit of $500,000 in that year, the tax of $243,000 paid for 1964 is refunded. The same procedure is followed for the year 1965 for which the tax paid of $137,500 is refunded, and for 1966 for which $89,500 is refunded. The 1967 loss of $1,200,000 has thus offset $1,000,000 of prior years' profits, and the total taxes of $470,000 paid for the years 1964, 1965 and 1966 are refunded by the United States Treasury Department shortly after the end of the 1967 fiscal year. The remaining $200,000 of the loss ($1,200,000 less $1,000,000) will be carried over to the year 1968. If there is a profit in the year 1968 exceeding $200,000, the entire amount will be deducted in that year, reducing the corporation income tax to be paid. If the profit is less, any unused amount can be carried to 1969, 1970, 1971 and 1972, in that order. Additional losses will be carried forward five years in the same manner.

5. INVESTMENT CREDIT

To encourage the acquisition of machinery and equipment as a business stimulant, the Internal Revenue Code provides for a credit against the tax of 7 percent of the cost of machinery and equipment acquired. This differs from other provisions of the Code in that it provides for a direct reduction of the tax to be paid rather than a deduction from taxable income.

As an illustration, assume that the business (individual proprietorship, partnership, or corporation) during its fiscal year acquires machinery totalling $100,000 with a useful life of more than 8 years. When the individual or corporation tax returns are filed, $7,000 (7 percent of $100,000) is deducted from the tax due.

Certain limitations should be noted. To be eligible for the investment credit, the equipment should have a useful life of 4 years or more. If the useful life is 4 to 5 years, one-third of the cost is taken into account in computing the 7 percent credit. If the useful life is 6 to 7 years, only two-thirds of the cost is taken into account, and if the useful life is 8 or more years, the 7 percent is computed on the full cost. A further limitation is that the investment credit against the tax in any one year is limited to $25,000 plus one-half of the tax in excess of $25,000.

If any portion of the investment credit cannot be used in any tax year because of the limitation, then the unused investment credit may be carried back and deducted against taxes paid in the previous 3 years to obtain a tax refund, and if still unused, can be carried over to the succeeding 7 years. Large corporations purchasing millions in labor-saving machinery thus receive a substantial credit against taxes.

In addition, depreciation may be taken on the full cost of the machinery and equipment, resulting in further tax savings.

VII. Analysis of Financial Statements

An understanding of accounting terminology and of the composition of the financial statements of an enterprise provides the background information for communication in the language of business. To make effective use of such information in collective bargaining, it is also necessary to understand the relationship between items in the financial statements. This is accomplished through statement analysis and comparison and intepretation of financial data.

Analysis of financial statements provides a measure of the earnings and productivity of an enterprise as well as a measure of its financial management. Additional analysis provides key financial information vital to investors, but also of general interest to those associated with the corporation. Financial statements emphasize past performance of the enterprise. Changes in management, changes in production methods due to the acquisition of new equipment, changes in the product manufactured, and changes in the economic climate need also to be taken into account in interpreting the results summarized in the financial statements.

A difficulty is encountered in statement analysis by the lack of uniformity shown in annual reports to stockholders. Some companies provide detailed data on product sales classified by type and stated in dollars and numbers of units; others provide a consolidated sales figure only, showing dollar volume. It is especially necessary for thorough analysis of annual financial reports of "conglomerates" or merged corporations that they present a breakdown of income and expenses for each separate component business activity. This is true because bargaining may apply to separate divisions of the corporation. However, this information has often not been made available in the past. Despite this shortcoming, the financial reports as presented do afford some basis for statement analysis.

Webster's Dictionary defines "ratio" as "Fixed or appropriate relation, as between things, or to another thing, in number, quantity or degree; rate; proportion." By reducing financial statement figures to percentage relationships, it becomes a simple task to compare one year's results with those of a preceding year. Percentage relationships can also be used to compare results with other companies in a similar industry.

The ratios set forth in this chapter are illustrative of the type of comparisons reported in financial publications. Other ratios can be used to suit the purposes of statement analysis. The figures used in the examples are taken from the financial statements illustrated in a preceding chapter. Results vary widely among industries and among companies within an industry. Illustrations are presented in order to show the method of computation.

1. FINANCIAL STATEMENT RATIOS—MEASURE OF EARNINGS AND PRODUCTIVITY

1a. Ratio of Net Earnings to Stockholders' Equity

This ratio is a measure of the overall profitability of the enterprise based on capital invested in the business by its owners. The profit figure used in the illustration is the net profit after all provisions for depreciation and income taxes have been deducted. The stockholders' equity, or invested capital, includes preferred stock, common stock, capital surplus, and earnings retained in the business. (Chapter III, Figure 1a.) In computing this ratio, the stockholders' equity basis may be that at the beginning of the year, the end of the year, or an average of the beginning and ending amounts.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Net Income for the Year	$ 906,470	$ 749,430
Divided by Stockholders' Equity	$11,110,200	$10,539,040
Percentage of Earnings on Stockholders' Equity	8.2%	7.1%

1b. Ratio of Net Earnings to Sales

Another measure of profitability of the enterprise is to state the net profit in terms of its relationship to net sales. The net profit may be expressed as a percentage of the net sales or in cents per dollar of sales. In the illustration below, the percentage of net profit to sales for 1967 is 3.5 percent. Each sales dollar results in 3½ cents of net profit.

The significance of the percentage depends on its comparison with prior years, as well as on the nature of the industry. In a high volume business, where the profit per dollar of sales is low, the total net profit may still result in an adequate return on stockholders' equity.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Net Income for the Year	$ 906,470	$ 749,430
Divided by Net Sales	$25,766,050	$24,095,480
Percentage of Net Profit to Sales	3.5%	3.1%

1c. Ratio of Operating Profit to Net Sales

Companies differ in their capital structure. Some depend on large bond issues to raise capital, others may raise capital through sale of shares of stock. The net profit figures of each will vary, because interest is a tax-deductible expense while dividends are not. In order to place the operating results of these companies on an equal basis for comparison, operating profit is computed before deductions for interest expense and income tax. Some analysts also eliminate the depreciation deduction before making this computation, so that comparison can be made regardless of differing depreciation methods.

This ratio is variously called the "profit margin" or "pre-tax profit margin" or "operating profit."

	Fiscal Year Ended September 30, 1967	Fiscal Year Ended September 30, 1966
Operating Profit to Sales		
Earnings Before Deducting Income Taxes	$ 1,801,570	$ 1,446,730
Add Back the Deduction for Interest Expense	142,500	142,500
Operating Profit Before Interest and Income Taxes	$ 1,944,070	$ 1,589,230
Operating Profit	$ 1,944,070	$ 1,589,320
Divided by Sales	$25,766,050	$24,095,480
Percentage of Operating Profit	7.5%	6.6%

1d. Percentage of Direct Labor Cost to Total Cost of Goods Manufactured

Raw materials, direct labor, and factory overhead are the components of the cost of goods manufactured. (See Figure 6 in Chapter III.) The percentages of each component making up the total will vary with the nature of the product manufactured. However, there should be similar relationships within the same industry.

A comparison of the percentage of direct labor cost to total cost of goods manufactured over a period of years may be significant of the trend in the productivity of labor. A decrease in the percentage of labor cost in the current year compared to prior years indicates that labor costs are declining compared to the other cost components and may be a measure of increasing productivity. On the other hand, the ratio may indicate that other cost components are increasing at a greater rate than the cost of labor. Therefore, each financial statement ratio must be examined in the light of all other known factors affecting the industry.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Direct Labor Costs	$ 4,408,500	$ 4,350,600
Divided by Cost of Goods Manufactured	$18,207,970	$17,303,130
Percentage of Direct Labor Cost to Total Cost of Goods Manufactured ..	24.2%	25.1%

1e. Percentage of Direct Labor Cost to Sales

Another indication of productivity and of labor's share of the sales dollar is the percentage of direct labor cost to net sales. Again it is important to make the comparison over a period of years, and with other companies in the industry. In the illustration below 18 cents of every sales dollar were expended for direct labor costs in 1966 as compared to 17 cents in 1967. This decrease in ratio could result from an increase in selling price, the acquisition of labor-saving machinery, new methods of production, increased labor efficiency, or a combination of these factors.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Direct Labor Costs	$ 4,408,500	$ 4,350,600
Divided by Sales	$25,766,050	$24,095,480
Percentage of Direct Labor Cost to Sales	17.1%	18.1%

1f. Sales Per Employee

Some financial analysts find a comparison of dollar sales per employee of significance as a measure of efficiency and productivity when examined for a period of years and compared with like companies. An equivalent result could be obtained by making the comparison with unit sales per employee, if the data on the number of units sold is available.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Sales	$25,766,050	$24,095,480
Divided by Number of Employees	780	772
Dollar Sales Per Employee	$ 33,030	$ 31,210

1g. Assets per Employee

Another comparison made by financial analysts is that of total assets per employee. Perhaps a better measure would be total plant and equipment per employee. This is an indication of the resources required by the enterprise to keep each employee gainfully employed. An increase in sales per employee accompanied by an increase in plant and equipment per employee may be indicative of an increase in productivity per employee due to the increased investment in labor-saving machinery.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Total Assets	$16,929,540	$15,889,120
Divided by Number of Employees	780	772
Assets Per Employee	$ 21,700	$ 20,580

2. FINANCIAL STATEMENT RATIOS—MEASURE OF FINANCIAL MANAGEMENT

2a. Working Capital

By definition, the term "working capital" means the current assets used in the normal trading cycle of the business, less the current liabilities. Classified as current assets are cash, short-term securities, trade accounts receivable, and inventories. Included in current liabilities are accounts and expenses payable, taxes payable, and other liabilities due within a one-year period. The increase or decrease in working capital is determined as follows:

	Fiscal Year Ended *September 30, 1967*	*September 30, 1966*	*Increase*
Current Assets	$10,488,980	$9,424,700	$1,064,280
Less: Current Liabilities.	2,633,840	2,088,780	545,060
Working Capital	$ 7,855,140	$7,335,924	$ 519,220

2b. Current Ratio (Working Capital Ratio)

The ratio of current assets to current liabilities is called the current ratio. It is significant in Balance Sheet analysis as indicative of the financial health of the business. For most enterprises, bankers look for a 2 to 1 ratio, which means that the business should have two dollars of current assets for every dollar of current liabilities. This is a sign that the enterprise has adequate working capital and can meet its current obligations as they come due. However, the nature of the business should be taken into consideration when assessing the significance of this ratio. For example, electrical utilities with a large investment in plant and equipment but little investment in inventories do not have the same working capital requirements as a manufacturing concern with a large investment in raw material and finished goods inventories.

A high, current ratio as in the following illustration, while offering no doubt that the business can meet its obligations, may also serve to indicate that the enterprise is not as actively engaged as its financial sources would permit. The illustration shows that as of September 30, 1967, $4.00 was available to meet each $1.00 of current debt, which is a high ratio.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Current Assets	$10,488,980	$ 9,424,700
Divided by Current Liabilities	$ 2,633,840	$ 2,088,780
Current Ratio	4 to 1	4.5 to 1

2c. Liquidity Ratio

The liquidity ratio, sometimes called the "acid test," is the ratio of "quick assets" to current liabilities. Quick assets are cash and current assets readily convertible into cash, such as short-term securities and trade accounts receivable. Inventories are excluded because of the time factor required to manufacture raw materials and sell the finished product. The liquidity ratio shows the quick assets available to meet current obligations.

The illustration shows that as of September 30, 1967, the enterprise had $1.90 of quick assets for each $1.00 of current debt.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Cash	$ 1,135,580	$ 957,490
Short-Term Securities	841,120	596,450
Trade Accounts Receivable	2,977,280	$ 2,625,890
Total Quick Assets	$ 4,953,980	$ 4,179,830
Divided by Current Liabilities	$ 2,633,840	$ 2,088,780
Liquidity Ratio	1.9 to 1	2. to 1

2d. Collection Ratio

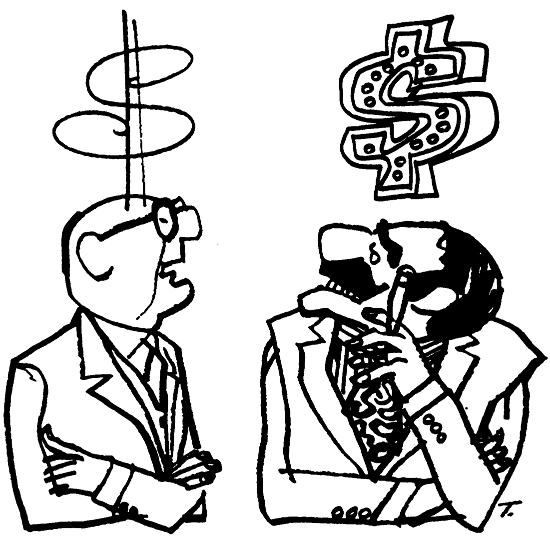
The collection ratio, or "accounts receivable turnover," is a measure of efficiency in collection of amounts due from customers. For example, if the terms of sale are 30 days, then ideally only one month's sales should be uncollected, and the accounts receivable should be turned over 12 times for the 12 months of the year. If three months' sales were uncollected, or a turnover of 4 times during the year, a slowness in collections would be evident.

In the illustration below, the accounts receivable turnover is 8.7 times a year. Dividing 365 days of the year by 8.7 shows approximately 42 calendar days of sales uncollected, which indicates a good collection ratio if the terms were 30 days. Obviously time must be allowed for delays in shipments and remittances in transit in the mails.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Sales	$25,766,050	$24,095,480
Divided by Accounts Receivable	$ 2,977,280	$ 2,625,890
Accounts Receivable Turnover	8.7	9.2
Approximate Number of Days Sales Uncollected	42	40

2e. Inventory Turnover

The ratio of merchandise inventories to cost of goods sold, or inventory turnover, is a measure of the efficient use of working capital in inventory accumulation. A low turnover ratio indicates that the raw materials and finished goods inventories are being built up faster than the goods are being sold. It may indicate the necessity for a production slowdown until the inventories are sold



off. Where model or style is a factor, excess inventories may have to be disposed of at lower prices.

A high turnover ratio, on the other hand, indicates effective use of working capital in inventories and continued production to meet demand. Where there are wide fluctuations in inventories, the average of inventories at the beginning and end of the year should be used in computing the ratio. Some analysts compare the inventories against sales in determining turnover.

Dividing the ratio of inventory turnover into 12 months of the year provides information as to the number of months required for the inventory to turn over or be sold off.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Cost of Goods Sold	$18,078,430	$17,126,000
Divided by Merchandise Inventory	$ 5,535,000	$ 5,244,870
Inventory Turnover Ratio	3.3	3.3
Approximate Number of Months Required for Inventory Turnover	3⅝	3⅝

2f. Ratio of Plant and Equipment to Net Sales

The ratio of plant and equipment to sales, or plant turnover, is a measure of the efficient utilization of capital invested in machinery and equipment. Increased investment in machinery and equipment normally has a favorable effect on volume of production when plant additions are put to use. The higher the ratio of turnover the greater is the utilization of plant indicated. To complete the analysis this ratio should be compared with competitive companies.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Sales	$25,766,050	$24,095,480
Divided by Plant and Equipment	$ 5,932,560	$ 5,965,830
Net Plant Turnover	4.3	4

2g. Sales Per Dollar of Invested Capital

Another measurer of the efficient use of capital is the amount of sales per dollar of stockholders' equity. Comparison with the results shown by other companies in the industry will measure relative effectiveness, provided the net earnings ratio (see Section 1a) is also considered in the analysis.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Sales	$25,766,050	$24,095,480
Divided by Stockholders' Equity	$11,110,200	$10,539,040
Sales Per Dollar of Invested Capital	$2.32	$2.29

2h. Capitalization Ratios

What percentage of the total capitalization represents common stockholders' equity? What percentage of the total capitalization was provided by bondholders' long-term debt? By preferred stock? Computation of the proportion of each type of investment to the total capitalization provides this information. These ratios indicate the "leverage" or use of borrowed funds in the total capitalization. The use of bonds in the capitalization reduces the quantity of common shares to be issued and therefore provides for division of profits among fewer shareholders. Effective use of the borrowed funds will therefore result in a greater per share profit.

	Fiscal Year Ended September 30, 1967		Fiscal Year Ended September 30, 1966	
Long-Term Debt	$ 2,850,000	20.4%	$ 3,000,000	22.2%
Preferred Stock	801,000	5.7	717,000	5.3
Common Stock and Surplus	10,309,200	73.9	9,822,040	72.5
Total	$13,960,000	100.0%	$13,539,040	100.0%

3. RATIOS OF SPECIAL IMPORTANCE TO INVESTORS

3a. Reported Earnings per Common Share

In order to evaluate investment potential, an investor inquires as to the amount of earnings on each share of common stock issued and outstanding. To compute this figure, it is first necessary to deduct from reported earnings the amount of dividends payable to the preferred stockholders. The remaining earnings are allocated to the holders of the common stock and are divided by the average number of common shares outstanding in order to obtain the earnings per common share:

	Fiscal Year Ended September 30, 1967	Fiscal Year Ended September 30, 1966
Reported Net Income for Fiscal Year...	$ 906,470	$ 749,430
Less: Dividends on Preferred Stock..	48,070	42,000
Remaining Earnings	$ 858,400	$ 707,430
Average Number of Common Shares—Outstanding	234,002	233,000
Divide Remaining Earnings by the Average Number of Shares Outstanding in Order to Obtain the Earnings per **Common Share**	**$3.67**	**$3.04**

3b. Cash Flow per Common Share

In accounting terminology the term "cash flow" refers to net profit plus certain charges against profit that do not require a direct outlay of cash. Deductions from earnings not requiring an outlay of cash relate to bookkeeping adjustments only, such as that for depreciation and deferred income taxes. These deductions are reversed and added back to net profit in order to compute the cash flow.

The cash flow figure pinpoints the amount of cash being generated from operations which will cover dividend commitments, requirements for plant expansion without outside financing, and increases in working capital.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Reported Net Income for Fiscal Year (After Deduction for Income Taxes)	$ 906,470	$ 749,430
Add: Reversal of Charges for Depreciation and Depletion	673,590	675,040
Add: Reversal of Charge for Deferred Income Taxes	74,200	139,600
Total Cash Flow	$ 1,654,260	$ 1,564,070
Average Number of Common Shares—Outstanding	234,002	233,000
Divide Cash Flow by the Average Number of Shares Outstanding in Order to Obtain the Cash Flow per Common Share	$7.07	$6.71

3c. Dividends per Share of Common Stock

The board of directors meets periodically to declare an amount of dividends payable per share of common stock to stockholders of record as of a certain date. If dividends are paid quarterly the annual dividend rate can be obtained by adding together the four quarterly per share dividends paid. However, if the dividend rate is not known, but the financial statements are available, the dividend rate can be computed by dividing the total dividends declared shown in the Statement of Retained Earnings by the average number of shares outstanding, which may be indicated in the stockholders' equity section of the Balance Sheet.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Dividends Declared	$ 468,250	$ 466,290
Average Number of Common Shares Outstanding	234,002	233,000
Divide Total Dividends Declared for the Fiscal Year by the Average Number of Shares Outstanding in Order to Obtain the Dividend per Share	$2.00	$2.00

3d. Dividend Payout Ratio on Common Stock

A corporation may follow an informal policy of paying out as dividends a fairly uniform percentage of its per share earnings. The balance remains in the corporation as retained earnings for further growth. To obtain the "dividend payout ratio" on common stock, divide dividends per share by earnings per common share. The dividend payout ratio is the percentage of net earnings paid to common shareholders.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Dividends per Common Share........	$2.00	$2.00
Earnings per Common Share (After Deducting Preferred Dividends)	3.67	3.04
Divide Dividends by Earnings per Common Share to Obtain the Payout Ratio	54.5%	65.8%

3e. Dividend Yield on Common Stock

The percentage of dividend yield or earnings on common stock is computed on the market price of the stock. If the stock is listed on one of the stock exchanges, the closing market price may be obtained from newspaper stock listings. If the stock is not available to the public and not listed on either an exchange or "over the counter" by a broker, then the "book value" per share of stock may be used as the basis for computing the dividend yield. (See Section 3g for computation of book value.) The dividend yield per share shows the direct return on an investment if the stock was acquired at current prices.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Assume that the Stock is Listed on the New York Stock Exchange		
Assume a September 30th Closing Price of	$40.00	$36.50
Amount of Dividend Paid per Common Share	2.00	2.00
Divide the Dividend by the Market Price to Obtain the Dividend Yield per Share	5%	5½%

3f. Price-Earnings Ratio

The "price-earnings ratio," or "price-earnings multiple" as it is also called, is the number of times earnings is included in the market price of the share of common stock. In the illustration below, with earnings at $3.67 per share and a market price of $40.00, the stock is selling at eleven times its annual earnings. This ratio is of help in evaluating the market price of the stock over a number of years in relation to its earnings for those years.

Investors will often pay a "high multiple" of earnings because of the future "growth" potential of the company.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Closing Market Price September 30th ..	$40.00	$36.50
Earnings per Common Share	3.67	3.04
Divide Closing Market Price by Earnings per Share to Obtain the Price-Earnings Ratio	11	12

3g. Book Value per Common Share of Stock

The "book value" or net asset value per common share is obtained by dividing the common shareholders' equity by the number of common shares outstanding at the Balance Sheet date. To obtain the common shareholders' equity, the amount of the preferred stock must be subtracted from the total stockholders' equity.

The market price of the stock may be more or less than the book value at any given time. The market price is affected by earnings, by economic conditions, and by factors of supply and demand for the shares.

	Fiscal Year Ended	
	September 30, 1967	*September 30, 1966*
Total Stockholders' Equity	$11,110,200	$10,539,040
Less: Preferred Stock	801,000	717,000
Common Shareholders' Equity	$10,309,200	$ 9,822,040
Number of Common Shares—Outstanding	234,757	233,248
Divide the Common Shareholders' Equity by the Number of Common Shares Outstanding in Order to Obtain the Book Value per Share ..	$43.91	$42.11

VIII. Accounting Records Described: Their Use in Claims of Inability to Pay

The accounting (or bookkeeping) records are the source of the figures finally summarized in the financial statements. To fully understand the accounting process, it is necessary to know what these records are and how they may be used. Familiarity with such records is helpful when faced with an employer's claim of inability to pay, or in observation of compliance with wage and fringe benefit provisions of the collective bargaining agreement as set forth in Chapter IX.

1. ACCOUNTING RECORDS DESCRIBED

Financial transactions may be recorded manually in handwritten records, by bookkeeping machine in records designed for such use, or by data processing equipment in a variety of tabulated records. A combination of these methods may be most effective. The size of the business enterprise and the nature of the information to be recorded will determine the most practical method to follow.

In general, accounting records fall into three main categories, namely, underlying source documents, books of original entry, and summary records.

1a. Underlying Source Documents—Business Papers

It is from business papers such as bills, checks, and time cards, that financial transactions are recorded in the books of original entry or journals. To verify a recorded item, it is necessary to examine the original source paper or document. Each cycle of business activity develops its own supporting papers.

Sales activity is carried on by way of customers' orders, shipping instructions, customers' bills, and customers' remittance checks. Purchasing activity leads to purchase orders issued to suppliers, the receiving clerk's report of receipt of goods, bills from suppliers, and disbursement of checks in payment.

Factory operations are guided by production orders. Components of cost of goods manufactured are evidenced by material requisitions and wage payments are supported by employee time cards.

1b. Books of Original Entry—The Journals

Separate journals are used to record like kinds of business activity or financial transactions. Such transactions are entered chronologically each day, and the dollar amounts so recorded are totalled and summarized at the end of each month. The physical appearance of the journals will vary. A record of original entry may be in the form of a bound book, a loose leaf record, or a computer tabulation. A binder containing the duplicate copies of the customers' bills for a period of one month may constitute the sales record.

The books of original entry most commonly in use are the sales record, purchase journal or voucher record, cash receipts record, cash disbursements record, payroll disbursement record, and the general journal. The latter record is used to enter special financial transactions and bookkeeping adjustments, such as for depreciation. Other books of original entry may be used, for example, to record manufacturing data for cost accounting and inventories.

1c. Summary Records—The Ledgers

Ledgers are used to summarize financial data taken from the books of original entry. The most important of these records is the "general ledger." Others are called "subsidiary ledgers." In the latter category are the customers or accounts receivable ledger, accounts payable ledger, employees individual earnings ledger, equipment ledger, investment ledger, and inventory accounts. As with the journals, the physical form of the record may vary. Bound books, loose leaf records, and computer listings may all serve as ledgers.

1d. The General Ledger and Trial Balance

The general ledger is the summary record of all asset, liability, capital, income, and expense accounts. Monthly

totals are transferred or "posted" from the books of original entry. Depreciation and other adjustments are transferred to their respective accounts. At the end of the accounting period a "trial balance" of the dollar balance in each account is listed in order to determine that all of the accounts are in balance and is indicative of the mechanical accuracy of the work.

This trial balance, which with adjustments is called the "working papers," is the immediate source from which the financial statements are prepared. The income and expense accounts are closed out to the profit and loss account at the end of the fiscal year.

Basically the general ledger is part of a "double entry" system of bookkeeping. Each financial transaction results in a "debit" and "credit" entry. For example, a sale of merchandise to a customer results in a debit to the customer's account and a credit to the sale income account. When payment is made, the customer's account is credited and the cash account is debited. Therefore, each entry is self-balancing, and when the trial balance is taken the total of the debit entries is equal to the total of the credit entries.

In actual practice, details of customers' charges and payments are posted to the subsidiary customers or accounts receivable ledger. The general ledger "controlling account" for accounts receivable contains only the totals of sales charged to customers and the totals of payments made by them during the month. The total of the detailed schedule of customers' balances taken from the customers ledger should agree with the accounts receivable account balance in the general ledger.

2. EMPLOYER'S CLAIM OF INABILITY TO PAY INCREASED WAGES

During negotiations there may be a serious contention by the employer that the cost of the union demands, if met, will endanger the very existence of the business enterprise and will result in unemployment for its workers. Accordingly, management in good faith offers to open all pertinent books and records to representatives of the labor union in order to prove its contention. How shall they proceed? What shall they look for?

2a. Examination of Employer's Records

Assume that the negotiating committee has arranged for the union's independent certified public accountant to meet with the corporation's controller for the purpose of examining the records.

The C.P.A. requests the financial reports of the corporation for the past three years which were prepared by the corporation's certified public accountant. He also asks for copies of the corporation's tax returns for the past three years and for the general ledger. A brief comparison of the financial statements with the corporation's tax returns and general ledger satisfies him as to the reliability of the financial statements without a formal examination of the corporation records.

The C.P.A. then proceeds to make his analysis of the financial statements so that he can make an informal report to the negotiating committee. Assume that the financial statements for the first two of the preceding three years showed a substantial profit, but the financial report for the third year showed a loss. Does this mean that the employer cannot afford an increase in wages?

The following are some of the principal items in the financial statements which require careful analysis for their effect on reported earnings.

2b. *Analysis of Merchandise Inventories*

The inventories of a manufacturing corporation consist of raw materials, work in process, and finished goods. For tax purposes these inventories are valued at the lower of cost or market. It is important to know what inventory methods were used and the basis of pricing the inventories entered in the financial statements of each year. A sudden drop in market values in the past year may have caused the corporation to take a huge inventory loss by pricing the inventory at the lower market value, resulting in a net loss for the year. If so, this may not necessarily happen again in the current year and ability to pay a wage increase may not be affected.

The percentage relationships of costs of raw materials and cost of direct labor to the total cost of goods manufactured and to total sales should be compared for each of the three years in order to disclose unusual variations requiring further explanation.

2c. *Analysis of Depreciation Provisions*

Examination should disclose the methods of depreciation that were used and the estimated useful lives of the equipment used as a basis. If the double declining balance method was used for depreciating equipment, the result would be a greater charge against profits in the early years of acquisition. If the estimated useful lives of the equipment were lower than commonly figured in the industry, the depreciation charge for that period would be greater.

If some of these factors are present, for purposes of analysis the depreciation should be recomputed on a straight line basis using the average normal useful lives prevailing in the industry. Again for purposes of analysis only, the reported loss should be adjusted for any excess of depreciation so charged.

2d. Analysis of Officers' Salaries

Examination should reveal the salaries of the principal officers for the past three years and whether or not there has been a substantial increase affecting current profits. The role of salaried relatives may require explanation. Salaries may be compared with those in similar industries.

2e. Analysis of Inter-Company Expenses and Income

Examination of the financial statements of a subsidiary corporation of a large conglomerate parent company should lead to inquiry as to the procedure followed in inter-company transactions. Inquiry must be made as to whether sales from the subsidiary to the parent corporation are made at prevailing market prices. The method of computing service charges to the subsidiary corporation by the parent company must be determined. Any reduction in prevailing market prices in sales from the subsidiary to the parent corporation and excess expense charges by the parent to the subsidiary will result in an understatement of profits by the subsidiary corporation.

A transfer of a sales division from the subsidiary corporation to an affiliated corporation during the current period may have resulted in a loss of income which should be noted.

2f. Analysis of Unusual Nonrecurring Expense Items

If the corporation moved its factory during the year or set up a new manufacturing division, moving expense and start-up expenses of the past year may have caused an operating loss. Such loss will not recur in the following year. If the new move results in greater efficiency, an increase in profits may in fact result.

2g. Analysis of Other Conditions Affecting Profits

A sudden change in marketing conditions for the product during the past year resulting in a loss will not necessarily continue in succeeding years. Recent overexpansion in the industry, another company entering a highly competitive field, temporary overproduction, lack of immediate consumer demand because of temporary economic dislocations will all have a near-term effect on profits.

Inquiry should be made as to whether the operating loss will result in a substantial tax refund, if none is indicated. Operating ratios of the company should be compared with other corporations in the industry before completing the analysis. This may reveal variations requiring explanation.

IX. Compliance With Terms of the Collective Bargaining Agreement as to Wages and Fringe Benefits

1. THE NEED FOR COMPLIANCE

UNDER THE TERMS OF THE collective bargaining agreement, an employer agrees to pay his employees on the basis of a specified wage scale, and if so provided, to make contributions to one or more trust funds set up for purposes of employee health benefits, pension benefits, vacation benefits, or other benefit plans.

Such employee benefit trust funds operate under a Declaration of Trust set up pursuant to the terms of the collective bargaining agreement. The trust agreement is equivalent to a charter or constitution, spelling out in broad general terms how trustees are appointed, their powers, the operation of the trust, and how it may terminate. Under federal labor laws there must be a provision for equal representation by management and labor in the administration of the fund. Administration is vested in the Board of Trustees.

The Board of Trustees may employ a paid administrator to carry out its directives and supervise the collection of employer contributions and disburse funds for benefits and administrative expenses. The Board of Trustees may retain insurance consultants, actuaries, attorneys, accountants, investment counselors, and others to assist it in administration of an employee benefit fund.

The Board of Trustees, meeting periodically, will, among its other activities, provide for the eligibility rules under which employee members become entitled to receive benefits. A fund set up to provide medical, hospital, and surgical benefits may specify a work period expressed in hours of work or months of employment before an employee becomes eligible for benefits. Similarly, a fund set up to provide pensions upon retirement of the employee on attaining a certain age will specify work periods before he attains certain eligibility and vesting rights.

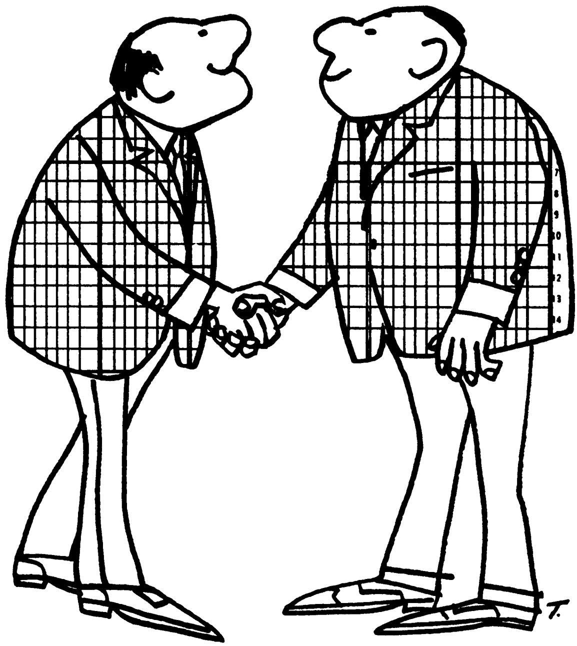
It, therefore, becomes of prime importance that the employer make full and complete contribution reports to the fund administrator in order to maintain the eligibility of the employee to his benefits rights. The usual procedure requires a monthly report by the employer to the administrator, prepared on a prescribed form, listing the name and social security number of each employee and the contributions for each made under the terms of the collective bargaining agreement.

Such contributions may be required on the basis of hours or shifts worked, or for weekly or monthly work periods. The contribution rate specified in the bargaining agreement may take such forms as cents per employee hour worked, dollars per employee per month (with a minimum number of hours constituting a work month), or it may be expressed in terms of a percentage of wages paid.

It is evident that the employee is not only concerned with receiving his earnings under the applicable wage scale, but he is also directly affected by the contributions made to an employee benefit fund covering his hours worked. The labor union anticipates strict adherence to all phases of the contract, including provision for wage and fringe benefits.

It is also to the advantage of the majority of employers that contract provisions be uniformly administered, else an employer underpaying wages or fringe benefit contributions receive an unfair competitive advantage. To the trustees of the fund, effective operation of the employee benefit fund is dependent upon uniformly correct employer contributions. The benefit program undertaken with the aid of insurance and actuarial advisers is based on these anticipated contributions.

In order to assure compliance, collective bargaining agreements may contain a clause providing for audits of employer payroll records by a labor union, by a Board of Trustees of an employee benefit fund, or by their ap-



pointed representatives. Following is an illustration of such a clause from an agreement affecting unions in a building trade:

> The Board of Trustees of each of the trust funds, or their agents, are hereby authorized to examine and audit any signatory employer's books and records of account which are pertinent to the payment of contributions to the respective trust funds, including but not limited to all payroll records, ledgers, time cards, day sheets, payroll checkbooks, and Federal and State employment reports.

Audits shall be conducted at the employer's place of business unless otherwise agreed by the parties. Employers agree that the records will be made available to the Board of Trustees or their agents within three working days from the date such audit is requested. If such audit discloses that there has been under-reporting by the employer, he shall be chargeable with the cost of the audit in addition to any delinquency charges that may be due.

In the absence of adequate hourly time records, the gross monies received by the employee shall be divided by the basic hourly rate to determine the hours worked by the employee and to compute the amount of contributions due the respective Trust Funds by the employer.

2. RESPONSIBILITY FOR EMPLOYEE RECORDS

Collective bargaining agreements may contain a contract provision spelling out a description of the records that the employer is obligated to maintain. Illustrative of such a provision is the following excerpt from a collective bargaining agreement of a labor union in the building trades:

The employer is required to maintain weekly time cards indicating the name of the employee, daily starting and finishing time, daily regular hours worked, daily overtime hours worked, and summarizing the total regular hours and total overtime hours for each pay period.

The employer is required to maintain records indicating each job by name and location, and the names of the employees assigned to each job and the manner of traveling for the purpose of determining travel time, zone transportation, mileage and subsistence.

The employer is required to maintain weekly payroll records indicating the name of the employee, his classification, his rate of pay, total regular hours worked, total overtime hours worked, his regular pay, his overtime pay, his total pay, his vacation contribution, his weekly payments for travel time, zone transportation, mileage and subsistence, his deductions for payroll taxes required under the law, and the amount of his net check.

The employer is required to maintain all of the records enumerated above for a period of three years.

Obviously, federal and state tax laws and wage and hour laws also require the maintenance of records for a period of time so that they may be available for examination by authorities. But such laws do not necessarily elaborate as to the detail of the records in the manner set forth in the preceding illustration.

3. RESPONSIBILITY FOR ASSIGNMENT OF AUDITORS IN CONNECTION WITH FRINGE BENEFITS

In order to assure independence and objectivity, the collective bargaining agreement may provide that an audit of employer payroll records be conducted only by certified public accountants so retained by the Board of Trustees of an employee benefit fund. Other agreements provide for audits by the Board of Trustees without qualification as to who shall represent them in this task.

Arrangements have been known to have been made whereby the employer's auditors were to be instructed to furnish the trust fund with a signed statement indicating compliance with the terms of the collective bargaining agreement as to contributions reported. In another example, the Board of Trustees retained a firm of certified public accountants whenever they required an audit of some employer's records because of indicated non-compliance. Illustrative of procedures followed is that of a trust fund where the Board of Trustees retained a firm of certified public accountants for the purpose of inaugurating a payroll audit program to be carried on by auditors to be regularly employed on the staff of the employee benefit fund.

The nature of the industry, the number of employers, and their general compliance with the agreement will influence the audit policy of the Board of Trustees of an employee benefit fund.

4. RESPONSIBILITY FOR ASSIGNMENT OF AUDITORS IN CONNECTION WITH BOTH WAGES AND FRINGE BENEFITS

The Board of Trustees of an employee benefit fund is primarily responsible for the receipt of all contributions to the trust fund provided for in the collective bargaining agreement. The labor union is concerned with compliance of wage scale provisions as well as the payment of contributions for fringe benefits for its members.

The Board of Trustees of the employee benefit fund and the officers of the labor union may agree to a joint engagement of the auditors in order to ascertain compliance with both wage and fringe benefit provisions. In that event it is likely that there will be an allocation of auditing costs between the trust fund and the labor union.

The labor union itself may have the right under its collective bargaining agreement to verify the accuracy of both wages and fringe benefit contributions. In such cases the union may retain a certified public accountant to make the examination of the employer's payroll records or may instruct its labor representative to do so. In the latter event, the representative should have some familiarity with the records required for examination.

Where the Board of Trustees of a vacation fund initiates an audit relative to employer contributions based on a percentage of earnings, the scope of the examination should be defined by them, for here it may be necessary to determine the accuracy of the wage payments since they form the basis for the vacation benefit contributions.

5. PERFORMING THE AUDIT

In determining whether or not there has been an underpayment of wages and fringe benefits, the auditor should have access to such records as the employees' time cards, payroll disbursements record, the general ledger, and the subsidiary ledger for employees' earnings accounts. He should refer to the collective bargaining agreement for wage, hours, and fringe benefit provisions.

Time cards should be compared to the time recorded and paid for as shown in the weekly payroll disbursements record and employees' individual earnings accounts. Hours worked shown on trust fund contribution reports should agree with the detail shown in the payroll disbursements record. Monthly and quarterly totals of wages shown in the general ledger should agree with totals derived from the weekly payroll records. Such totals should also agree with total wages shown on payroll tax returns and on workmen's compensation insurance reports. When totals are in agreement, there is an indication that no employee records have been overlooked.

A report covering an audit of both wages and fringe benefits should be broken down to disclose underpayments applicable to each individual employee so affected. For substantiation, the auditor's working papers should contain detailed schedules by weeks, showing hours, wage rates, and wages and/or fringe benefits as paid, the correct amount that should have been paid, and the amounts due because of underpayment. The employer should be given an opportunity to review the findings of the auditor.

Where deficiencies are disclosed, the employer is presented with a statement of the claim for additional wages due employees and for any underpayment of contributions due the employee benefit fund. Payment is requested by the union or by the administrator of the fund, as the case may be.

X. Sources of Financial Information

FAMILIARITY WITH regular sources of general economic and financial information and their use is necessary to be fully informed of events affecting both management and labor. A range of publications is available for reference at public libraries, others are worthwhile receiving on a subscription basis, and some may be obtained free on request.

1. GENERAL AND BACKGROUND INFORMATION

There are several publications that cover business in a general way, while at the same time supplying specific financial data that will prove useful. Two of these are newspapers and two are magazines, all worthwhile reading as an original source of timely information.

A daily newspaper, *The Wall Street Journal,* in addition to security listings, reports a wealth of current business, financial, economic, and government news. There are condensed front page capsules of important news items as well as more detailed stories. On alternate days, columns review the business outlook, labor news, tax news, and Washington news. Announcements of quarterly earnings reports of major corporations provide timely financial data.

Barron's, national business and financial weekly, should be read for a review of news concerning events in Wall Street. Articles on activities of corporations or business prospects of a major industry are especially informative. For useful reference, detailed listings, in each weekly edition provide market quotations, current earnings, and dividend declarations of corporations listed on stock exchanges or whose stock is traded "over the counter."

Forbes magazine is published twice monthly and is worthwhile reading for its current feature articles on corporation activities, industry developments, and business leaders. Of particular importance as a reference for good general financial information is the issue containing *Forbes* annual report on American industry, published on January 1st of each year. Past performance and expected future prospects are commented upon for each industry and its principal companies. Ratings are provided for growth, profitability, and earnings trend.

The monthly "business roundup" of *Fortune* magazine is good for its economic forecast. Feature articles are particularly comprehensive in their treatment of businesses and personalities. *Fortune*'s annual directory of the 500 largest industrial corporations is an excellent reference edition published in June or July of each year. Information is provided as to company rank, sales, assets, net profit, invested capital, number of employees, profit as a percentage of invested capital, earnings per share, and rate of growth of major corporations.

Reviews of regional credit and business conditions are covered by monthly newsletters of individual banks and federal reserve banks. Worthwhile for their summaries of business conditions are *The Morgan Guaranty Survey* published by the Morgan Guaranty Trust Company, the *Federal Reserve Bank Monthly Review* published by district federal reserve banks, and the *Federal Reserve Bulletin* of the Federal Reserve Board.

Two U. S. Department of Commerce monthly publications contain a wealth of statistical information showing the trend of business conditions. One is entitled *Business Cycle Developments,* and the other is the *Survey of Current Business.*

The *Monthly Labor Review* of the U. S. Department of Labor, Bureau of Labor Statistics, contains feature articles and statistical information of interest concerning industrial relations, employment, wages and hours, and consumer and wholesaler prices.

The American Federation of Labor and Congress of Industrial Organizations publishes a weekly newspaper and a monthly magazine containing news and articles of general interest to labor. They are entitled the AFL-CIO *News* and *The American Federationist* respectively.

Articles bearing on business conditions affecting management and labor may also be found in trade magazines and in publications of trade associations and universities, generally available at public libraries.

2. FINANCIAL REPORTING SERVICES

Financial reporting services such as *Moody's Investors Service, Inc.*, *Standard & Poor's Corporation*, and the *Value Line Investment Survey* are good financial reference works kept up to date by regular reports received for filing in current volumes. Included are annual financial reports of leading industrial, railroad, insurance, and financial corporations, and items of financial news affecting these corporations. Such services are often available for reference at public libraries, the business libraries of universities, or at leading stockbrokerage offices.

Dun & Bradstreet, Inc. maintains a credit rating agency for the purpose of furnishing to its subscribers credit ratings and financial reports on business firms in the United States. Reports furnished on request to subscribers are especially valuable because of their background information on the officers or owners, business history and activity of the company, as well as for their current financial data. Banks are subscribers to this service, but information is not generally available to the public.

There are many other specialized credit reporting agencies covering manufacturing, wholesale, and retail business activities providing reports to subscribers.

3. CORPORATION FINANCIAL REPORTS

Corporations may be classified as "closed" corporations and "publicly held" corporations. A closed corporation is one whose stock is entirely owned by the officers, or a family, or a small group of individuals, with no stock offered for sale to the general public. The stock of publicly held corporations is traded on organized stock exchanges or over the counter through stockbrokers.

Closed corporations are not required to issue financial reports to outsiders. However, they often do furnish financial information to a credit reporting agency. Corporations that offer their shares to the public are required by security laws and by stock exchange regulations to furnish stockholders with financial reports. These corporations also supply copies of their annual reports to others upon request, or they may be obtained through stockbrokers.

By purchasing one or more shares in a corporation, stockholders receive, in addition to the annual report, quarterly reports of earnings and information submitted with calls for annual meetings. The latter includes information on stockholdings of directors and officers, officers' salaries and pertinent pension information.

Analysts of stockbrokerage firms prepare special analytical reports on businesses from time to time for the purpose of recommending purchase of stock in such corporations. These informative reports about a company are supplied free upon request.

The Securities and Exchange Commission in Washing, D.C., requires detailed financial data in connection with certain proposed stock and bond offerings by corporations. Regulations require that a "prospectus" concerning such securities be made available by the corporation to a prospective purchaser. A current prospectus, which contains a wealth of detailed financial information about a company, may be obtained from a stockbrokerage firm upon request.

XI. Summary and Conclusion

ACCOUNTING IS THE language of business, and its use provides an additional tool in collective bargaining. For this purpose, it is not necessary to acquire the professional knowledge needed in order to prepare financial statements, but only an understanding of their composition and use.

It is important to know that reported earnings are not scientific facts; that the results shown in financial statements are markedly affected by judgments made in treating such items as inventories, depreciation, and research and development costs. Special income tax provisions, such as the investment credit, affect both the amount of taxes to be paid and reported earnings. Carryback and carryover tax provisions reduce the impact of an operating loss.

Relationships observed through analysis of financial statements provide a measure of earnings and productivity and of the financial management of a business. Comparison with other firms will show the relative standing of the company to the industry of which it is a part. Such information is particularly useful in assessing productivity trends and ability to pay.

Many sources of financial information are readily available and should be cultivated in order for one to be informed on economic and business developments, and to obtain specific financial data.

It is to the interest of both management and labor that wage and fringe benefit terms agreed upon be fairly observed. A knowledge of the use of payroll and other records is helpful to those concerned in the fair administration of the terms of the collective bargaining agreement.

Finally, it is hoped that an understanding of the uses of accounting in collective bargaining will contribute to more effective communication between management and labor in a free society.

XII. Suggestions for Further Reading

THERE IS A VAST AMOUNT of literature on the general subjects of accounting and financial statement analysis, security analysis, financial management, and income taxes for those desiring to broaden their knowledge in these areas. Many of these works serve as textbooks for courses of study in their respective fields. A few representative publications are listed here.

1. ACCOUNTING

A comprehensive discussion on the accounting process, financial statements, and financial statement analysis is contained in *Intermediate Accounting* by Harry Simons and Wilbert E. Karrenbrock (4th ed. standard volume, Dallas: Southwestern Publishing Company, 1965). Another complete work in this field is *Essentials of Accounting* by Robert L. Dixon, Samuel R. Hepwirth, and Wm. A. Paton, Jr. (New York: The Macmillan Company, 1966). The authors in their preface point out that accounting must serve the needs of internal management, owners, creditors, government agencies, and employers without being oriented toward any special interest. Their emphasis is on aiding the reader to evaluate the data derived from an accounting system.

A college-level text stressing the analytical, interpretive, and managerial aspects of accounting is *Intermediate Accounting* by Arnold W. Johnson and Oscar M. Kriegman (3d ed.; New York: Holt, Rinehart and Winston, 1964). The chapter on ratio analysis of financial statements should be read. A basic text stressing accounting controls is *Accounting Principles and Control* by Lawrence L. Vance and Russell Taussig (rev. ed.; New York: Holt, Rinehart and Winston, 1966). The last part of the book discusses special controls and analysis for management and investors.

A recent accounting work states in its preface: "More than ever it is imperative that the recipients of accounting data understand the potential uses and limitations of financial reports and the assumptions used in selecting from alternative accounting measurements." It stresses the financial information requirements of decision-makers. The book is entitled *Accounting in Business Decisions, Theory, Method, and Use* by Homer A. Black, John E. Champion, and R. Gene Brown (2d. ed.; Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1967).

Managerial Accounting by Carl L. Moore and Robert K. Jaedicke (2d ed.; Dallas: Southwestern Publishing Co., 1967) emphasizes business problems from the point of view of internal management. There is also discussion on the very same questions that arise when interpreting financial statements for the purposes of collective bargaining is required. Subjects such as variations in accounting methods and difficulties of making financial comparison between companies are covered as well. There are good chapters on the balance sheet, income statement, and on financial statement analysis.

Another book stressing the uses of accounting data for the solution of a wide variety of problems is *Accounting in Action, Its Meaning for Management* by Billy E. Goetz and Frederick R. Klein (Cambridge: The Riverside Press; Boston: Houghton Mifflin Company, 1960). The student is made aware of the needs of managers and others for different types of accounting data and how the data is accumulated. In the second half of the text the significance of the data is explored.

2. SECURITY ANALYSIS

Books on security analysis may be of interest to the reader because the chapters on analysis of financial statements present another approach to understanding the interrelationship of the income statement and balance sheet, and the use of key ratios in that interrelationship. A leading text with good chapters on inventory valuations, depreciation, and cash flow is entitled *Security Analysis—Principles and Technique* by Benjamin Graham, David L. Dodd, and Sidney Cottle (4th ed.; New York: McGraw-Hill Book Company, Inc., 1962).

The reader may find books on investments offering still another approach, as they too contain chapters on making use of financial reports and investment analysis. An easily read introductory book is *Introduction to Investments* by John C. Clendenin (3d ed.; New York: McGraw-Hill Book Company, Inc., 1960). A book designed to stimulate the reasoning power of investors, with good chapters on general analysis and valuation procedures, is *Investments: Analysis and Management* by Douglas A. Hayes (New York: The Macmillan Company, 1961).

3. FINANCIAL MANAGEMENT

The reader may find books concerned with financial administration of interest because they touch on the related subject of financial analysis. Other topics generally covered are financial planning and control, the management of working capital, capital budgeting, capital structure, and the cost of capital. The books enumerated here all contain articles by many contributors on a variety of financial topics.

Representative of this group of books are *Basic Financial Management, Selected Readings* by John F. Weston and Donald H. Woods (Belmont, Calif.: Wadsworth Publishing Co., 1967); *Financial Management in the 1960's—New Challenges and Responsibilities, Readings from Fortune*, John F. Weston, ed. (New York: Holt, Rinehart and Winston, 1966); *Readings in Financial Management*, Edward J. Mock, ed. (Scranton, Pa.: International Textbook Company, 1966); *Readings in Finance*, Harold A. Wolf and Lee Richardson eds. (New

York: Appleton-Century-Crofts, Division of Meredith Publishing Company, 1966); *Elements of Financial Administration,* John L. O'Daniel and Milton S. Goldberg eds. (Columbus, Ohio: Charles E. Merrill Books, Inc., 1962).

For a comprehensive textbook on corporate or business finance refer to *Corporate Financial Management* by Raymond P. Kent (Homewood, Ill.: Richard D. Irwin, Inc., 1964).

4. INCOME TAXES

A textbook designed to help the student learn how the federal income tax works is *Federal Income Taxation—Tax Principles and Tax Planning* by Robert S. Holzman (1st ed.; New York: The Ronald Press, 1960). Another introductory course textbook on the federal income tax is *Federal Income Tax Fundamentals* by William E. Dickerson and Leo D. Stone (San Francisco: Wadsworth Publishing Company, Inc., 1961).

A good one-volume reference work on how the federal income tax laws work is *1968 Federal Tax Course,* described by the publishers as a one volume "original text for handy reference, brush-up, and practical training in the basic principles of federal income tax laws" (Chicago: Commerce Clearing House, Inc., 1968).

An interesting special study in a related field, containing a detailed bibliography, is entitled *Fringe Benefits and Their Federal Tax Treatment* by Hugh H. Macauly, Jr. (New York: Columbia University Press, 1959).

5. GENERAL

The reader will find topics of interest bearing on compliance with the terms of collective bargaining agreements, particularly as they relate to fringe benefits, in the annual published conference proceedings of the National Foundation of Health, Welfare & Pension Plans, Inc. The annual publications also provide a wealth of information on all facets of the benefit structure, operation, and administration of health, welfare, and pension funds. Published proceedings are available for the years 1964, 1965, 1966, and 1967, entitled *Textbook for Welfare, Pension Trustees and Administrators* (Annual Conference Proceedings; Elm Grove, Wisconsin: National Foundation of Health, Welfare & Pension Plans, Inc.).

Another publication of interest by the National Foundation is a *Legal-Legislative Reporter* available to subscribers. A monthly news bulletin is sent to subscribers and members, containing legal and legislative developments involving negotiated employee benefit plans and joint trusts. A bimonthly newsletter sent to members is called the *NF Digest*. There is a good article on payroll audits for fringe benefit funds by the Accountants Committee of the National Foundation of Health, Welfare & Pension Plans, Inc. in volume 5, no. 2, April 1968 of the *NF Digest* (Elm Grove, Wisconsin: National Foundation of Health, Welfare & Pension Plans, Inc.). The Accountants Committee has approved other papers relating to phases of audits of health and welfare funds which will appear in the *NF Digest*. (The author is a member of this Committee.)

As to financial statements and audit of a health and welfare fund, a first publication on this subject is *Case Study of a Self-Administered Union-Industry Welfare Fund* by the Committee on Labor Union and Welfare Funds (New York: American Institute of Certified Public Accountants, 1959). More recently, a new *ad hoc* committee has been formed by the American Institute of Certified Public Accountants (of which the author is a member) to write current audit guides for health and welfare funds and for pension funds. Publication is contemplated in late 1969 or 1970.

A trade publication that will prove of interest to those engaged in collective bargaining is the magazine *Pension & Welfare News*, published monthly by the Dornost Publishing Company, Inc., New York. It contains current articles and departments bearing on collective bargaining for fringe benefits, compliance with provisions of the agreement, and operation and administration of employee benefit funds. The issues of April 1966 and May 1967 contain articles by this author on the financial report sections of the annual disclosure form D-2 required by the Office of Labor-Management and Welfare-Pension Reports of the U. S. Department of Labor.

A chapter on accounting assistance in collective bargaining in connection with claims of inability to pay is contained in *Accounting and Office Manual for Labor Unions* by Harry C. Fischer (Washington, D.C.: BNA, Incorporated, 1961). The book is primarily an elementary bookkeeping manual to assist the union financial secretary.

6. GUIDE TO SOURCES OF FINANCIAL INFORMATION

Sources of financial information discussed in Chapter X refer to newspapers, periodicals, financial reporting services, and corporation reports, which should be reviewed on some continuing basis by those engaged in collective bargaining to keep informed of financial events affecting a particular industry or locality. An alphabetic listing of the most significant of these sources may help the reader in his efforts of continued review.

AFL-CIO News, an official weekly newspaper. *The American Federationist*, an official monthly magazine (American Federation of Labor and Congress of Industrial Organizations, AFL-CIO Building, 815 Sixteenth Street, N.W., Washington, D.C. 20006). *Barron's—National Business and Financial Weekly*, published every Monday (200 Burnett Road, Chicopee, Massachusetts 01021). *Business Cycle Developments*, published monthly by the U. S. Department of Commerce (Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402). *Dun & Bradstreet, Inc.*, credit information and subscription service (P.O. Box 1770, Church Street Station, New York, New York 10006). *Dun's Review*, a monthly magazine (Dun & Bradstreet Publication Corp., P.O. Box 3088, Grand Central

Station, New York, New York 10017). *The Exchange,* a monthly magazine published by the New York Stock Exchange (The New York Stock Exchange, 11 Wall Street, New York, New York 10005). *Financial World,* a weekly magazine (17 Battery Place, New York, New York 10004). *Federal Reserve Bank Monthly Review,* a monthly pamphlet (free); any one of the twelve district offices of the Federal Reserve Bank may be contacted for its regional publication. *Federal Reserve Bulletin,* a monthly bulletin (Board of Governors of the Federal Reserve System, Washington, D.C. 20551). *Forbes,* a magazine published twice monthly (Forbes, Inc., 60 Fifth Avenue, New York, New York 10011). *Fortune,* a monthly magazine (Time, Inc., 540 North Michigan Avenue, Chicago, Illinois 60611). *The Monthly Labor Review,* a magazine published monthly by the U. S. Department of Labor (Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402). *The Morgan Guaranty Survey,* a monthly pamphlet (free); it may be obtained from the Morgan Guaranty Trust Company of New York, 23 Wall Street, New York, New York 10015. *Moody's,* listed and unlisted stock reports and other financial publications, quarterly handbook of common stock (Moody's Investors Service, Inc., 99 Church Street, New York, New York 10007). *Securities and Exchange Commission,* Washington, D.C. *Standard & Poor's,* listed and unlisted stock reports and other financial publications, monthly stock guide, monthly bond guide (Standard & Poor's Corporation, 345 Hudson Street, New York, New York 10014). *Survey of*

Current Business, published monthly by the U. S. Department of Commerce (Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402). *The Value Line Investment Survey,* a financial reporting service (Arnold Bernhard, Inc., 5 East 44th Street, New York, New York 10017). *The Wall Street Journal,* daily newspaper (Monday through Friday) published by Dow Jones & Company, Inc., 30 Broad Street, New York, New York 10004.

PRINTED IN THE UNITED STATES OF AMERICA
BY THE UNIVERSITY OF CALIFORNIA PRINTING DEPARTMENT

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