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Form of Financial Statement

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Form of Financial Statement

[The form of financial statement presented in the March issue of THE JOURNAL OF ACCOUNTANCY has attracted a good deal of attention among accountants. The subject is of much present importance. We are glad to present herewith expressions of opinion on the form of financial statement from C. E. Freeman of Indianapolis, and Harold Dudley Greeley of New York.—*Editor, THE JOURNAL OF ACCOUNTANCY.*]

BY HAROLD DUDLEY GREELEY, C.P.A.

The analysis of a financial statement printed on page 217 of the March, 1916, issue of THE JOURNAL OF ACCOUNTANCY, while excellent in idea, seems to be misleading in its statement of working capital as \$45,000.00. This working capital is described in the summary as capital with which to operate business. If the operation of the business means the purchase of new material and the payment of new expenses the amount of working capital in this case is \$15,000.00 instead of \$45,000.00, because one of the uses to which the \$45,000.00 must be put is the payment of current liabilities of \$30,000.00. In other words, what is called working capital is merely the current assets of the business. It seems better to designate the \$45,000.00 as working or current assets rather than working capital because the use of the term working capital implies an excess of current assets over current liabilities or an amount of assets which will be available for the purchase of new material and the payment of new expenses.

The idea of capital as the excess of assets over liabilities was emphasized in the report of the committee on terminology printed in the American Association *Year Book* of 1909 on page 163. Capital was there defined as follows:

This term as used in accounting is employed to express—

- (1) The sum of the net assets of the business or undertaking, or that sum which remains after deducting the liabilities from the assets of a business or undertaking.

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- (2) Any principal sum (usually in cash, sometimes in property) contributed to an undertaking by a partner or individual for supplying the means to operate such undertaking.
- (3) The value or amount of interest any individual has invested in an undertaking, and
- (4) Any principal sum which is used or retained to produce income or profit.

The definition under subdivision (4) expresses the idea of capital from the economist's point of view and differs from the preceding definitions of capital which are generally accepted as proper from the accounting point of view. There seems to be no reason why working capital should not be defined in the same way as the excess of current assets over current liabilities.

That the form submitted in the March JOURNAL is misleading can be shown more clearly by an assumed case which would not be extreme.

Assume that \$25,000.00 of additional machinery was secured on short time credit instead of by the sale of capital stock or bonds or investment of surplus. In that case, following the form suggested, the total capital employed would be \$110,000.00; the "fixed investments," \$65,000.00 and the working capital, \$45,000.00; whereas the current assets would be \$45,000.00 and the current liabilities, \$55,000.00. In that case it would be misleading to report that the business had a working capital of \$45,000.00 when it was unable to meet its current liabilities by \$10,000.00.

The idea that working capital, used in the sense of current assets, should be applied to the payment of current liabilities is generally recognized. For example, in a recent decision of the Illinois public utilities commission in *Belleville v. St. Clair County Gas & Electric Company*, P.U.R. 1916B 24, November 24, 1915, working capital is defined as an average sum which is sufficient under normal conditions to meet the obligations incurred in accounts payable and salaries of officers and employees prior to the collection of accounts receivable and which is sufficient under abnormal conditions to provide for unexpected and emergency payments.

After all, isn't the banker for whom this proposed statement is designed interested in knowing how much of the current assets will be available for the purchase of new material and the pay-

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ment of new expenses after provision has been made for liquidating the existing accounts payable? Working capital should be defined as the excess of current assets over current liabilities and in the case presented by the proposed form the working capital under that view would be \$15,000.00 instead of \$45,000.00.

BY C. E. FREEMAN, C.P.A.

In the March issue of *THE JOURNAL OF ACCOUNTANCY* under the above title, it is indicated that suggestions regarding the form of statement there submitted will be acceptable, and in offering what here follows it seems necessary to criticise before being able intelligently to suggest.

In the designing of business forms for use in recording or accumulating details and also for the presentation of results there are at least three important considerations that should govern their construction; viz.: (a) simplicity, (b) lack of duplication, and (c) the use of terms that most clearly and definitely describe the items to which they refer.

Applying the foregoing tests to the statement in question, it is the writer's opinion that it does not comply with any one of them, and that, in part, its form of expression is similar to that of certain writers whose use of negatives obliges the reader to perform one or more mental somersaults before being able fully to grasp the intended meaning.

The form referred to is evidently intended to answer two general questions of fact:

- (A) How much capital are you employing in your business and
- (B) How is your capital being used and what is its existing condition?

In the first section, the statement shows the amount of capital invested as (A1) \$55,000.00 and capital borrowed as (A2) \$30,000.00 or a total of \$85,000.00 employed in the business. This total also represents the total credits (reserve accounts eliminated).

In the second section by deducting fixed investments of \$40,000.00 (B1) from the total credits and adding \$30,000.00 (A2) for the amount borrowed, all subsequent comparisons of

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totals are made at \$45,000.00 in connection with the balancing debits.

It is therefore submitted as a better plan to present the information in the form of direct answers to the two questions referred to—subdivided as the conditions may require—and reply: (1) We have a capital of \$85,000.00 now employed and (2) our capital of \$85,000.00 is now distributed as follows: etc.

In section B2 a superfluity seems to be introduced, as, with the exception of the one item of \$15,000.00 difference between what is there termed working capital and the fixed investments, no additional information is derived and the negative treatment at this point seems to be unnecessarily applied. Furthermore, how could we be justified in jumping at the conclusion that the amount borrowed, \$30,000.00—which elsewhere is shown to include accounts and notes payable to individuals—had all been absorbed into the working capital total of \$45,000.00, when a part of this indebtedness might be actually for some portion of the fixed assets? Even were these facts as alleged in the statement true and correct, what special importance could there be attached to such information?

If we were applying the double account principle of English practice, and the conditions were such as to admit of its application, there might be a reason for showing the amount of unexpended capital receipts; but other features of the case in question apparently interfere with such treatment.

There also seems to be an indiscriminate application of terms, as shown by the following.

The \$55,000.00 in section B2 is designated as working capital etc., while B3 indicates that there is only \$45,000.00 of working capital that is active. In one or the other of these cases the term must be wrongly applied.

The \$55,000.00 total in A1 that is there designated as total invested is in reality the existing proprietary interests, or the proprietary liabilities of the business, while the amount shown to have been invested is \$40,000.00 on paid up stock that appears in the same section, instead of the \$55,000.00 referred to.

And why make use of the summary? The statement may be so condensed as to be seen at a glance. In the opinion of the writer it is more intelligible to say that \$40,000.00 of fixed investments plus \$45,000.00 of working capital equals the total assets

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of \$85,000.00 or capital employed, than it is to say that \$85,000.00 in capital employed minus \$40,000.00 of fixed investments equals \$45,000.00 of working capital; especially as no additional information is given by the latter formula.

In outlining the statement submitted herewith, I have tried to comply with my opening remarks as to the three considerations there mentioned, and without presuming to claim perfection, it is, with the foregoing criticisms, consigned to the tender mercies of your readers for such further consideration as it may seem to deserve.

ANALYSIS OF THE FINANCIAL STATEMENT OF THE BLANK COMPANY,
FEBRUARY 10, 1916

LIABILITIES

A1.—Proprietary:

Invested,			
Capital stock authorized..	50,000.00		
Capital stock unissued....	10,000.00	40,000.00	
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Accrued,			
Surplus earned	10,000.00		
Undivided profits	5,000.00	15,000.00	
		<hr/>	
Total proprietary liabilities.....		55,000.00	

A2.—Contracted:

Notes payable, banks.....	10,000.00		
Notes payable, individuals...	5,000.00		
Accounts payable	15,000.00		
		<hr/>	
Total contracted liabilities.....		30,000.00	
		<hr/>	
Total liabilities			85,000.00
			<hr/> <hr/>

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CONDITION OF ASSETS AND HOW EMPLOYED

B1.—Fixed investments:

Buildings	11,000.00	
Less reserve for depreciation	1,000.00	10,000.00
Machinery and tools.....	17,000.00	
Less reserve for depreciation	2,000.00	15,000.00
Sidings and switches.....	9,000.00	
Less reserve for depreciation	1,000.00	8,000.00
Boilers and engines.....	8,000.00	
Less reserve for depreciation	1,000.00	7,000.00
Total fixed assets.....		40,000.00

B2.—Working capital activities:

Available funds

Union National Bank.....	2,000.00	
Petty cash	100.00	2,100.00

In process of collection

Notes receivable	2,000.00	
Accounts receivable	15,900.00	17,900.00

Available for trading

Inventory, finished goods.....		10,000.00
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Employed in manufacturing

Raw materials	10,000.00	
In process	5,000.00	15,000.00

Total working capital.....		45,000.00
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Total depreciated assets.....		85,000.00
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