TWO

An Accounting Primer: Myths and Realities

. . . in conformity with generally accepted accounting principles applied in on a basis consistent with that of the preceding period.

– Representative Wording, Auditor's Report

Consistency is the last refuge of the unimaginative.

– Oscar Wilde

First We Eat Our Spinach

"Accounting? Ugh!" Please, no groans, Accounting 101 was never so good for you. Skip this chapter only if you've already had seven courses in accounting, made A's in all of them, understood everything that was said, believed less than half, and have begun three or more businesses successfully. (You may also skip this chapter if your name is Peter F. Drucker.) Everyone else — including you CPAs and bankers — should read this chapter twice.

THE BALANCE SHEET

We begin our accounting primer by looking at the balance sheet. The balance sheet turns out to be nothing more than a snapshot of the financial condition of a company *as of a given day.* The balance sheet is not a motion picture, or a history, or a forecast. Therefore, it does *not* show how the company got to that condition on that day, and it does *not* show where the company is heading. It simply puts a frame around one day and shows where the company is — right now.

Parlez-Vous Accounting?

The accounting profession has its own vocabulary and conventions. Not all of what they say is true, and not all of it makes sense. But it always balances, and everybody in the profession uses the same words, and two out of four ain't bad for starters. Now, to make some good practical sense out of what the accountants tell us, we first disarm them by learning a few key words of their language. *Allons!*

Balance Sheet Logic

A balance sheet describes the financial condition of a company in the same way that you would describe your personal financial condition. First, it lists the company's financial resources, such as goods and property and the money other folks owe it, under the heading *assets.* Then, it lists all the debts the company owes to other people and calls them *liabilities.* Then, it subtracts the liabilities from the assets and calls the difference *net worth* or *equity.*

What you own less what you owe is what you're worth. For keeping track of this incredibly complex algebraic relationship, your CPA charges you $100 per hour. So much for balance sheet logic.

An Instructive Example

Let's say that you have $500 in the bank, an old car worth $1,500, and a house and furnishings worth $30,000 on which you owe a $15,000 mortgage. Suppose that you currently owe $50 to the guy who keeps your old car running, $120 on your credit-card bill from last month, and $30 for this month's utility bill. Your personal balance sheet would look like this:

Assets		
Cash	$ 500	
Old car	1,500	
Cheap house	30,000	
Total assets		$32,000
Liabilities		
Mortgage on cheap house (probably at 5%, you lucky devil)	$15,000	
Repair bill owed on old car	50	
Master Charge bill	120	
Light bill (as they say in the country)	30	
Total liabilities		$15,200
Net worth (If you got $16,800 as the answer here, read on; if you didn't, we need to have a talk)		
Net worth		$16,800

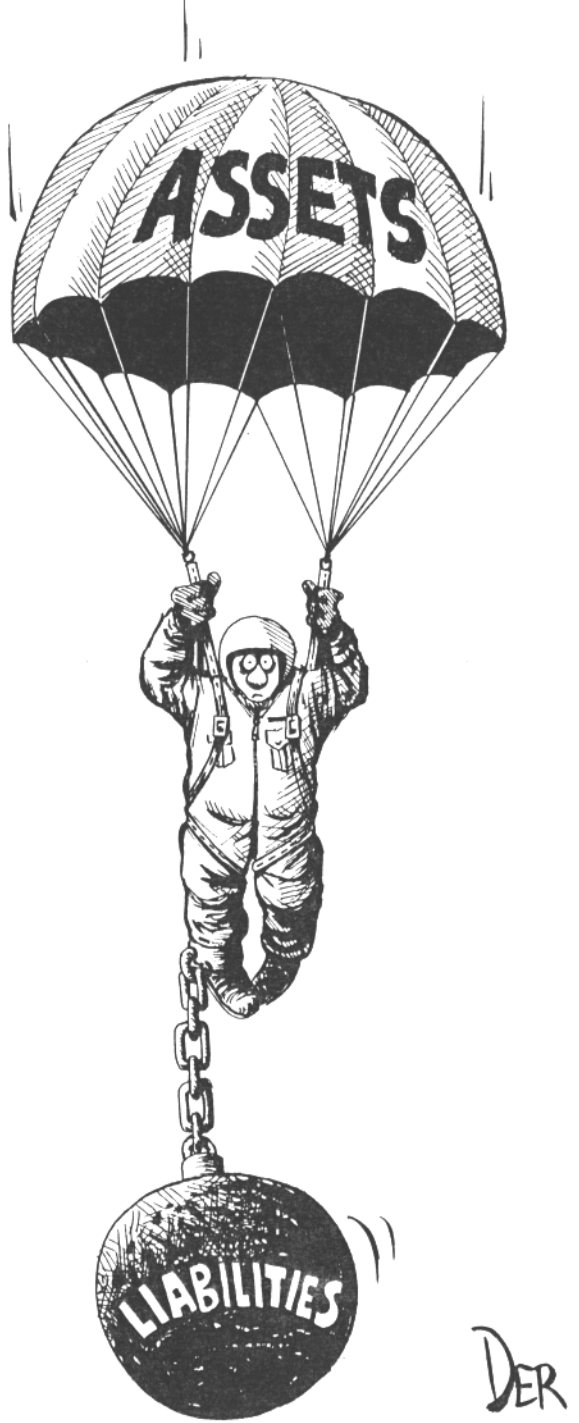
Is It Any Different for a Company?

Nope, just a few more zeros after the numbers; the logic of the balance sheet relationship stays the same for your company as for yourself:

What it Owns Less What it Owes is What it's Worth.

However, for good reasons most companies like to keep track of these three things in a bit more detail. So we see company balance sheets that look more like the following than like the abbreviated statement you just encountered.

Bay Area Corrugated Pipe is a real company I've worked with; the numbers are rounded for convenience.



BALANCE SHEET
Bay Area Corrugated Pipe, Inc.
December 31, 19X2

Assets			
Current assets			
Cash		$ 560,000	
Marketable securities		80,000	
Accounts receivable (net of est. bad debts)		4,600,000	
Inventory		7,200,000	
Prepaid expenses		160,000	
Total current assets			$12,600,000
Fixed assets			
Land		200,000	
Fabrication shop and office	2,500,000		
Furniture	50,000		
Trucks and machinery	1,700,000		
	4,250,000		
Less: Accumulated depreciation	1,050,000		
Net fixed assets		$3,200,000	
Total fixed assets			$ 3,400,000
Total assets			$16,000,000
Liabilities			
Current liabilities			
Accounts payable		$4,420,000	
Notes payable		1,930,000	
Accrued expenses		280,000	
Long-term note (current portion)		700,000	
Total current liabilities		$ 7,330,000	
Long-term liabilities			
Mortgage note payable		2,800,000	
Total liabilities			$10,130,000
Equity			
Capital stock		$ 500,000	
Retained earnings		5,370,000	
Total equity			$ 5,870,000

Quick — Does It Balance?

Bay Area Corrugated owns assets listed on its balance sheet of $16,000,000 and owes liabilities of $10,130,000. Its net worth is the difference between these two figures, $5,870,000. (Net worth is also known as stockholders' equity in a corporation.) The arithmetic checks out, but don't get all fired up over mathematical accuracy — bankruptcy courts are full of mathematically accurate statements from certifiably defunct companies.

My father was in love with statements that balanced. In his later years he had a small wholesale business. He was easy prey to accountants because he looked at "balances to the penny" as the true test of accounting worth. His accountants could spend half a day combing his books to find a 10 cent error, then charge him their full rate for doing it. He delighted in paying them for such stupid effort. It was a kind of sacred trust; they were duty bound to find the 10 cents, and when they had, all was right with God and Pop's books.

A few days after he died, we were in his office trying to make sense out of Pop's books. You couldn't find out a damn thing from them, namely, what he really owned and what he really owed. But, by God, they were in balance — to the penny, of course. Are you listening, Pop?

Naming the Beasts

To portray the financial condition of a company, it isn't enough to deal with total assets or total liabilities. Classifications this broad don't give us sufficient information about what's going on. Therefore, it's common practice to break down these classifications into smaller ones.

Take, for example, the section titled *current assets*. Current assets include cash and other assets that we expect to turn into cash in the near future, and near means within a year from the date of this balance sheet. Total

current assets for Bay Area Corrugated Pipe are shown as $12,600,000. Let's look at them one at a time.

Cash — is exactly that. If you have any money in the bank or lying around your office, you enter it here. Bay Area has $560,000. Wonder what they're going to do with all that.

Marketable securities — is cash that you may have invested in securities like T-bills to earn money during the time you don't need it. Usually, we show these on the balance sheet at what they cost us. Bay Area tells us that it owns securities that cost $80,000. Let's hope the market is up.

Accounts receivable — represents money our customers owe us for work we've done for them. We always enter this figure as a *net* amount; that is, we first subtract money we don't think we are going to be able to collect. Why? Not only is the result more accurate, but subtracting anticipated bad debts also cuts taxes. The IRS lets us deduct money we can't collect — or *say* we can't collect. Netting out bad debts from receivables has nothing to do with balancing, but it is always a good thing to do any time you can. Bay Area says folks owe $4,600,000 that Bay thinks it will collect. We certainly hope so.

Inventory — represents materials Bay Area uses in the manufacture of pipe, both pipe being made in their shop and finished pipe sitting in the yard but not yet shipped. The $7,200,000 Bay lists here represents the lower of (1) its cost or (2) market value. Yes, this is a conservative way to list inventory. But you have probably guessed by now that, if they are anything, CPAs are conservative.

Prepaid expenses — this one is slightly weird. Suppose that on July 1, 19X2, halfway through the financial year (the uptown word for which is fiscal year), BAC paid a year's premium on its casualty insurance for the entire company. If this premium had been $320,000 and six months later if on the day we cipher up our balance sheet, December 31, we still have half a year's insurance paid for, we call that prepaid, and list it as worth $160,000. Thus, prepaids are payments already made, from which the company has not yet received all the benefits it has coming in the current accounting period. Better we should remember this item as "half-used-up insurance policies," OK?

So much for *current* assets. We now know that Bay Area Corrugated claims that it has $12,600,000 in cash and other assets it can turn into cash soon.

Fixed Assets — What's the Matter, Can't They Move?

Trucks are fixed assets, yet they move. Accounts receivable are current assets, yet they stay in a fixed location. So sue me, it gets worse. *Fixed assets* represent assets that you do not *intend* to sell. (Not that you wouldn't sell in a flat minute if somebody offered you enough money.)

The fixed assets section on the balance sheet includes

Land — which is entered here at what you paid for it, even if your granddaddy bought it from the Indians for $24 and called it New Amsterdam. Bay Area bought theirs for $200,000 and it's called Clearwater, but it's home to them.

Buildings and equipment — get different treatment from land. The fabrication shop, furniture, trucks, machinery, portajohns, and mobile barbecue are carried on the balance sheet at *net fixed asset value*, which is what they cost when they were built or bought, less the *depreciation* that has accumulated by the time you cipher up the balance sheet.

Depreciation — is the decline in the useful life of an asset due to wear and tear, time, rust, new inventions, wars, atomic bombs, falling off the back of trucks, and pretty much anything else than can happen to it. When Bay Area, Inc., spent money to build its shop and office, buy furniture, and purchase trucks and machinery, it decided the cost would be spread over the expected useful life of the assets. Thus, *each* year can be charged with a part of the fixed assets.

For instance, if Bay Area bought a light truck for $20,000 and it was expected to last three years, Bay would charge $6,666 depreciation each year for three years. One year after Bay Area bought the truck, its balance sheet would show

Truck	$20,000
Less: Accumulated depreciation	−6,666
Net fixed asset value	$13,334

See how simple it is? Now of course if it really wants to know what the damn truck is worth, all Bay has to do is put an ad in the newspaper and try to sell it; this is cheaper than using a CPA at $100 an hour, but newspapers don't do your taxes for you.

OK, so we total up all the fixed assets and they come to $3,400,000 for Bay Area Corrugated, Inc.; add this to our $12,600,000 of *current assets*, and we can say with mathematical precision that, on December 31, 19X2, Bay, Inc., had total assets of $16,000,000. Are you wondering how much faith we should put in balance sheets done on New Year's Eve? Take heart. Maybe CPAs don't celebrate New Year's Eve like the rest of us.

As They Reap, So Shall They Owe

Liabilities are broken down into categories in all balance sheets, too, just as assets are. *Current liabilities* are debts that will be due within a year from the date of this balance sheet — $7,330,000 in the case of Bay Area, Inc. This is the other side of the coin from current assets. We get the money to pay our current liabilities from our current assets — more about this relationship and what it means for good financial management later.

Accounts payable — Bay Area Corrugated, Inc., lists accounts payable of $4,420,000; this is what it owes to the folks who sell it stuff on credit.

Notes payable — this entry of $1,930,000 means Bay owes this much money either to a bank or some other lender.

Accrued expenses — this is the side of the coin opposite to prepaid expenses. At any point in time, including the day on which the balance sheet balances, Bay Area owes salaries and wages to folks who work for it, interest to folks who lend it money, and fees to CPAs who cipher up all these numbers. Any such debts that have not been paid go here under accrued expenses. Bay Area tells us it owes $280,000 here.

Current portion, long-term debt — it's a fairly common practice to include under current liabilities *this* year's portion of any long-term debt that the company owes. That's so the company can see what is coming due within a year and that's why Bay lists $700,000 under current liabilities as the current portion of its long-term note.

Total up all the above and you get $7,330,000 — that's all the money, as of December 31, that Bay owes and expects to pay within a year. (Of course, if CPAs really do celebrate New Year's Eve, maybe there's something they forgot to list?)

The Longer They Give You to Pay It Back, the Better

Many companies are lucky enough to be able to borrow money for longer than a year, and that's usually a good deal any time they can get it. Bay owes somebody $2,800,000, evidenced by a long-term note. This debt goes in a different place on the balance sheet from current liabilities, probably so that Bay won't worry as much about it as it worries about money it has to scrape up within one year.

Total up current and long-term liabilities and you get $10,130,000, which is all the money Bay Area Corrugated owes — and that's a bunch, isn't it?

What You Own Less What You Owe Is What You're Worth

Fine. If Bay owns assets of $16,000,000 and owes debts of $10,130,000, then it is worth $5,870,000. Earlier we called this net worth or equity. Equity can be broken into two parts. In the vernacular of the street, we call these parts "put-in equity" and "left-in equity."

From the $500,000 entry in the equity section of Bay Area's balance sheet, we know that someone *put in* $500,000 of capital (either to start the business or after it got going); the fancy — or $100-per-hour — term for that is *capital stock*. The *retained earnings* figure of $5,370,000 is nothing more than the sum of all the profits left in the business since it began (after taxes and dividends were paid). Although Bay has retained earnings of $5,370,000, it has only $560,000 of that in cash. Where is the rest? Well, somewhere on the balance sheet — we hope.

The Chi Phi fraternity at our university had a professional audit done, the $100-an-hour variety, that came up with a retained earnings figure of $7,500. This disclosure so excited the brothers that they authorized the purchase of new furniture for the house in the amount of $7,500. Fact was, however, that their cash account was something nearer $100. Now if they had had a few business majors as members rather than all those prelaw, political science majors, the brothers would have known the difference and have avoided embarrassment. (If you believe that one, you don't know nothin' about business schools, and you sure don't know nothin' about fraternities.)

THE BALANCE SHEET — REALITIES

Things are seldom what they seem, and that goes double for balance sheets. The goal of this section is to go back through the balance sheet in the same order as before and look at the realities this time. One word of explanation before we begin this trip. The difference between myths and realities in the balance sheet has multiple causes:

1. *Time.* Even when the rules are applied consistently, time, inflation, and the vagaries of certain marketplaces all make assets and liabilities behave in strange ways; there's little we can do about that.
2. *Diddling.* Some folks "diddle" with their balance sheets. Things that belong there don't get put there, and things that don't belong do get in there. People diddle for lots of different reasons, the two major ones being to impress bankers with how financially strong they are and the IRS with how financially poor they are. Especially in smaller family-controlled companies, balance sheets that have been diddled with tend to merge the family and the corporation to the point that, after years of being diddled, the balance sheet doesn't tell anyone much about either the family *or* the company that makes sense.

   One other thing: diddling comes in two varieties, legal and illegal. I encourage you to diddle legally to the maximum extent possible. That's just good sense. If you want to talk about illegal diddling, you better talk to someone else. I know a few people who have done time in Montgomery, Alabama, for illegal diddling.
3. *Incompetence.* Some folks have — and there is no nice way to say this — damn poor accounting help. When this is your problem, you can be a saint about diddling, you can be wholly free from the ravages of inflation, but your balance sheet over time will still get less and less useful. Read that as farther and farther from the truth, where truth is still defined as "what you own less what you owe is what you're worth." You can do something about this problem: show your accountant the door and get some savvy new help.

Current Assets or Realities I Have Known

Cash is cash. What you see on the balance sheet is what you get. It's hard as hell to make cash where none exists; when you or your auditor verifies your bank balances, that's about it. Although it won't buy as much as it used to, you can pretty much take the cash entry on the balance sheet as gospel.

Marketable securities are another thing entirely. Remember, accounting rules (the $100-an-hour word is *conventions*) require you to carry marketable securities on your balance sheet at what they cost you. Suppose that you bought a thousand shares of Genentech stock for your company when it came public at $6 a share and it is now $240 a share. (If it isn't, don't carp — we can dream.) Your

balance sheet entry under marketable securities ($6,000) is now $236,000 shy of the truth.

What to do — change the entry to $240,000? Heaven forbid, that's against the rules. But now that I have your attention, let's think for a minute about the value of having a *market value balance sheet.* A market value balance sheet is exactly what its name implies, one on which things are listed at what they're really worth, not according to what someone else's rules say they're worth. Does that mean you can get rid of your $100-an-hour "regular balance sheet" (known in the trade as an *historic value balance sheet*)? No, don't tear it up yet. There are still folks like the IRS who require historic value balance sheets, and, besides, if you report to the public you must report that way. There are even some people out there who still actually believe in and support the historic value balance sheet idea. Some of them are CPAs. Will wonders never cease?

What I Owe Ya, Preacher?

I once employed a local Baptist minister, Paul Stevens, as a farm manager. Paul used to delight us with his stories of mountain behavior. One day a young man and his "woman" walked down out of the Tennessee hills to Paul and asked him to marry them, which he did with his customary good humor and grace. When the ceremony was concluded, the young man asked in hill language, "What I owe ya, preacher?" Paul replied, "Whatever you think is right, young man." Whereupon the young man reached in his pocket, picked out a quarter, and gave it to Paul with "I be grateful to ya, preacher."

On the balance sheet, we have to be a bit more careful about what folks owe us. Bay Area Corrugated, Inc., tells us that its accounts receivable (net of estimated bad debts) are $4,600,000 on December 31. In Preacher Paul's parlance, that ain't gospel; it's an estimate at best, because it makes some very explicit assumptions about the collectibility of those debts. Since the IRS lets businesses "charge off" bad debts either when they go bad or as

a percentage of accounts receivable based on some history, it behooves Bay Area (and us) to be pessimistic about collecting. After all, if a doubtful account, previously charged off, does pay us in another year, we can always declare it as income and pay the tax then. In the meantime, we get an inch ahead of the IRS.

Although the IRS allows folks to charge off bad debts (and early too), many companies just don't. Consequently, their accounts receivable entry on the balance sheet cannot be taken at face value. Then, too, many customers have disputes with companies about what they owe. Disagreements are fairly widespread in contracting, for example, but the balance sheet isn't set up with space for disputes.

Conclusion: If you want to know exactly what folks owe you, don't look on the historic value balance sheet. Review each account, make a determination of whether or not it is collectible, match this against your past history of collecting, adjust for "disputes outstanding," and then add it up and see what you've got. Anything else is nothing more than a guess. If what you get is far from what you show on your historic value balance sheet, then all the more reason to consider a market value balance sheet for a better crack at the truth. Oh yes, I forgot for a minute, folks diddle here too. Remember when you sold your brother-in-law a riding mower for $1,600 last spring? Come on now, you know you're never going to dun him for the payments; go ahead and write it off. Take your loss (and your tax deduction) like a man — well, like a brother-in-law.

Beans, Beans . . . Who Can Count All the Beans?

Inventory is another slippery little devil we have to deal with realistically. To find out whether you made any money, you have to calculate something accountants call *cost of goods sold.* In a very simple example, it goes like this:

You tell them you started the year with an inventory of	$ 1,000,000
You tell them you bought widgets, gidgets, and gadgets for	+3,000,000
	$ 4,000,000
And you tell them your year-ending unsold inventory of widgets, gidgets, and gadgets is	−2,500,000
You have thus defined the cost of the widgets, gidgets, and gadgets you did sell as	$ 1,500,000

Very neat, very precise, and very accurate. Hold on, pardner! Look at the role the year-ending inventory plays in this calculation. If it's lower than $2,500,000 (say, $2,000,000), cost of goods sold will be $2,000,000 and profits will be correspondingly lower — and taxes will be lower too, don't forget. And if year-ending inventory is $3,000,000 (instead of $2,500,000), cost of goods will be $1,000,000 and profits will then be correspondingly higher — with higher taxes too!

And just who determines exactly what the value of inventory is? You do, friend! "Oh," you say, "but I have my books audited every year." So did the man in New Jersey (De Angelis was his name) who claimed to have about $100 million in salad oil that simply was not there. And then there's my friend in Kentucky with an inventory of over 12,000 different items (that really are there) whose real value fluctuates so rapidly that probably he is the only person in the world who can state with certainty what they're worth.

Now what's the point of this harangue? Just this. If the inventory entry on your balance sheet has such important consequences for reported profits (and therefore taxes) and if its real value is the subject of a judgment call, then we can easily see how its balance sheet value is sometimes the subject of diddling.

"Well," you say, "I simply wouldn't do anything like that." Fine, I say, but do you remember what we said earlier about inventory being carried on the balance sheet

at the lower of cost or market? Good, then just suppose that last year, right before the price doubled, you bought a million board feet of lumber for $200 per thousand board feet. It's on your balance sheet now at $200,000, but it's really worth $400,000. What to do? Can't change the historic value balance sheet — rules is rules. But what about your brand-new *market value balance sheet?* Remember that in rapidly changing times — inflationary or deflationary — a market value balance sheet is the *only* sensible way for business people to keep up with reality. Look at it this way. If you wanted to borrow money on that lumber inventory of $400,000, would you still claim to your banker that it was worth only $200,000? Gotcha! Would he insist that you claim it was worth $200,000 when you know better? If you say "yes," then what you need is another banker.

Conclusion: Cipher up your historic cost balance sheet for those who love it or need it or believe in it. Then turn around and make yourself a current *market value balance sheet* too. There is no other way to keep score accurately, and someone in your company needs to know what's *really* going on. Why not you?

Fixed Assets Get Accounting Diseases Too

Land, land, they jes ain't makin' any more. I remember when a farmer in South Carolina used that line on me to justify an outrageous price per acre for a farm I wanted. And by gosh, he was right! Land is carried on the balance sheet, using $100-per-hour rules of course, at *cost*. No matter what has happened to it. The owner of Bay Area Corrugated, Inc., shows land on the balance sheet at $200,000. This land happens to be twenty acres near downtown Clearwater, which would bring $1,500,000 at an auction with only one bidder. Clearly, Bay Area's balance sheet net worth is *understated* by $1,300,000.

Solution: You want to change the land entry to $1,500,000 so that it reflects reality? Yes, and you die at dawn if you try it, too! Rules forbid that sort of thing. But

again, take heart — just carry it on your *market value balance sheet* at what it's worth. If anyone gives you a hard time, get an appraisal (you can probably get one for less than $100 an hour at that).

Now suppose Dame Fortune deals you a really rotten hand. Read, you bought twenty acres of swampland near Clearwater that was to be drained and developed, and you got it for a bargain, only $10,000 an acre. Then along came hurricane Izell and your swampland is ocean now. The IRS and CPAs to the rescue. If you can prove it's worth nothing, you can change its value on your balance sheet from $200,000 (what you paid for the swamp) to $0. And there's more — you can take the $200,000 loss off your taxes too. Well, why in hell don't they operate the other way too and let you show the world that your land is worth $1,500,000? You can, you can — just sell it for $1,500,000 cash, pay a lot of taxes, and show the rest on your balance sheet under cash. Now, wouldn't you rather work on a *market value balance sheet*? I'm with you! Nuff said.

The Older It Gets and the Worse It Looks, the More It's Worth and the Longer It Runs (Depreciation in Reverse)

What did we say about depreciation a few pages back? Depreciation is the decline in the value of an asset. My friend at Bay Area Corrugated Pipe, Inc., bought this Transtar, a big gorgeous eighteen-wheeler truck, two years ago for $76,000. He ran it and depreciated it for two years, then found out this spring it was worth $78,000 as a used truck. So much for balance sheet depreciation. So much for controlling inflation too!

Conclusion: The net asset value on the balance sheet is the result of applying a mathematical rule to the purchase price and has nothing to do with the realities of what things are worth. If you want to find out what they're worth, advertise them for sale and see who calls. To main-

tain a balance sheet that reflects the real current value of fixed assets, prepare a market value balance sheet. It may not be as precise as an historic value balance sheet, but it sure as hell is a lot more accurate!

Diddling Revisited

Plants and offices are a favorite diddling place for folks, especially those in the lumber, contracting, and construction supply businesses. Lots of people in these areas have a habit of "expensing themselves" a new fixed asset. Or, put more simply, they use their own labor and materials and build a new warehouse, plant, or office without ever putting it on the balance sheet. That's sort of dangerous diddling, but it's done nonetheless. The market value is there right on the lot, but not on the balance sheet. People in the general aviation business and in trucking often rebuild engines (using their labor and parts), but they don't put the rebuilt engine on the balance sheet as they should. Contractors buy pumps and charge their entire cost to a single job (quite legally, I might add). When the job is finished, they own a perfectly good pump, but, you guessed it, it isn't on the balance sheet.

What to do? Simple. At a minimum keep a separate notebook with what you own and what it's worth this afternoon. If you want to do more, invest some real effort in making a market value balance sheet. It's the best thing to do if you want good practical information, and it's legal too. The best thing about it is that it makes sense even if *you* are the only one who ever looks at it.

But Ain't That Old Historic Value Balance Sheet Good for Something?

We used to be able to say that, if the balance sheet did nothing else right, at least it did show the true balance of what you owed. Sad to say, those days are gone too!

For sure, the balance sheet does a good job of reflecting accurately accounts payable. But then, even if it didn't, your creditors send you accurate reminders each month (at no accounting cost to you, I might add). Notes payable to banks and other lending institutions are the same — just miss a payment and the bank is right on your tail. But what if the note is payable to you or your partner?

It's common knowledge among CPAs that the notes payable section of the balance sheet of closely held corporations tells as much about equity as it does about debt. Now what does that mean? Just this — you can put your money in your corporation two ways, by taking stock or by taking a note. When you take stock for the money, the accounting entry gets made down in the stockholders' equity portion of the balance sheet. When you take a note from the corporation, the accounting entry gets made in the liability section of the balance sheet. Your money doesn't care; it arrives in the cash account either way.

Just try, however, to *take* money out of a corporation. That's another story entirely. If you took stock ten years ago when you put the money in, it will be as hard as hell to get your money back out again without paying through the nose in taxes. If, however, you took a note for the money, it will be a breeze to get your money back tax free.

See? *That's* the reason we can't trust the balance sheet here either. Much of the debt represented under the liability portion may in fact be equity money put in by principals who were savvy enough to know that that's the right way to put it in if they ever intend to get it out and still have some left. More on this in Chapter 4.

One final note about mortgage notes (due and payable). Many corporations rent their buildings and lease their equipment from family-owned partnerships. This practice is exactly what should happen, and we'll have more to say about it in Chapter 4, too. When buildings and machinery get bought and sold between the family and the corporation, legal diddling results *as long as the price*

reflects fair market value. But items bought and sold at prices that in no way reflect the true value of the asset distort the corporate balance sheet. Of course, these transactions may also do very nice things to the family balance sheet.

Conclusion: If your diddling includes the buying and selling of assets between the family and the company on "favorable terms," any similarity between the corporate balance sheet and reality will be purely coincidental. Do your corporate self a favor and keep a separate, real-world balance sheet.

A successful automobile dealer in our area was audited by the IRS a few years ago. On his balance sheet, he showed a substantial entry representing a quarter mile of woven wire fence complete with barbed wire top. A clever field auditor picked this up but could not remember seeing such a fence as he entered the property. A search of the corporate premises that morning failed to turn up any such fence. A quick ride by the owner's palatial country estate, however, disclosed a fence suspiciously like the one on the company balance sheet. Alas, greed got in the way of common sense and led to a substantial settlement with the IRS. Could it have been accounting error and not greed? Probably not. As much grief as I give accountants, they do know the difference.

THE INCOME STATEMENT (A.K.A. PROFIT AND LOSS) — MYTHS

If the balance sheet is a picture of the financial condition of a company as of a given day, the income statement is a record of a company's activity for an entire period. Often, the period is one year, but income statements can be prepared covering any period, including a month, a quarter, or a half-year of time. The income statement matches the money received from selling the stuff you make against all of the costs you incurred to make it. This comparison shows whether or not your company made a profit.

Income Statement
Bay Area Corrugated Pipe, Inc.
Year Ended December 31, 19X2

Gross sales	$24,800,000	
Less: Returns and allowances	800,000	
Net sales		$24,000,000
Expenses		
Cost of goods sold	19,100,000	
Depreciation	680,000	
Sales and administrative expenses	2,690,000	
Total expenses		22,470,000
Operating profit		$ 1,530,000
Less: Interest		910,000
Net profit before taxes		$ 620,000
Provision for income taxes		300,000
Net profit after taxes		$ 320,000

Is There Any Money in the Corrugated Pipe Business?

Our income statement for Bay Area Corrugated Pipe, Inc., covers the period from January 1, 19X2 through December 31, 19X2.

This statement tells us that, in 19X2, Bay Area, Inc., sold $24,800,000 worth of pipe, allowed its customers $800,000 off their bills for returned pipe and such, and wound up the year with $24,000,000 of net sales. The company states here that the cost of goods sold was $19,100,000, that it also incurred depreciation of $680,000, and that it spent $2,690,000 for selling and administration. Subtract the $22,470,000 expenses from the $24,000,000 net sales, and you get what's called operating profit equal to $1,530,000. Farther down the statement it reports paying $910,000 in interest (we remember from the balance sheet that it does owe quite a bit of money), which, subtracted from the operating profit, gives a net profit before taxes of $620,000. The IRS clipped Bay for $300,000 (it's clear that Bay Area needs to read the

later chapters of this book), leaving it with an after-tax profit of $320,000 for the year's work. Whether that's good or bad we'll leave for later. Here we are interested only in how you get the number. All pretty straightforward, so far.

INCOME STATEMENT — REALITIES

Now You See It, Now You Don't

You would think that sales is sales and that's that — just bang the pipe together, load it in a truck, send the bill, get money back, go to the bank with money, come home, and light a fat cigar. Uh oh, not so simple. (It never is.)

The $24,000,000 net sales Bay, Inc., reports represents only the net amount it *billed* customers, not what it *collected*. To use $100-an-hour lingo again, Bay Area recognizes income on the *accrual* basis. Using the accrual basis of accounting means that you put things in the column when they are *billed, not* when they are collected. And most businesses operating today use this method. So, Bay's $24,000,000 of net sales doesn't have a hell of a lot to do with what's in the bank (which you may remember is cash, and that's found on the balance sheet). The entry for $24,000,000 means only that Bay billed people $24,000,000 in a year, not that it collected same. The difference is important. Remember Sim Bell and me in the peach business? All those sales and no cash?

Accrual-basis recognition of income is commonplace; and so is another reality, legal diddling. . . .

Leads and Lags as the Economists Say

Suppose Mr. Bay, Inc., decides late in November 19X2 that his taxable income for 19X2 is already too high (lucky devil), and here he is with more than a month yet to go. He makes a couple of phone calls to customers who are to receive $2,000,000 of pipe in December and a deal is struck. He'll deliver the pipe on schedule — in

December — but delay the billing until January 19X3. Ergo, Bay's income statement no longer reflects what was actually sold this year. Funny thing, neither does Mr. Customer's income statement. "Ought to be a law against this," you say. Nonsense, the IRS lets you average income to reduce taxes. All Bay, Inc., has done is to average its income, and, I might add, without spending a dime on accounting fees.

Now look at another situation. It's late November again, and Mr. Bay is looking back over a dismal 19X2 for profit. There's no real chance to change the profit performance materially in the one month remaining, and he's promised his banker the moon in 19X2. Oh, doctor, can this line of credit be saved? Well, maybe. Mr. Bay makes a couple of phone calls to customers having a particularly good year, and once more a deal is struck. Bay will bill the customers in December for pipe it will ship in January 19X3, and for its trouble will give the cooperative buyers another 4% off the price.

"Hey, just a good business deal," you say. Fine, but the point I'm making is that "deals" like these, though legal and profitable, ruin the ability of the income statement to reflect what really went on in 19X2 (or in any other period for that matter). If you do "deals" like this, and want to make year-to-year comparisons of sales, costs, and profitability, don't plan on getting your information from a single diddled income statement or you'll diddle yourself. You will have to keep another notebook of what you really sold. Or you might invest in another income statement.

You think trying to keep a grip on reality is driving *you* crazy with all these notebooks and income statements? Look at Bay's banker with one diddled income statement. You know the guy is smart if he's got ulcers worrying about reality vis-à-vis Bay and other similar commercial accounts. If he's fat and happy with the statements they feed him, and sleeps like a baby at night, then he's *dumb*.

Building contractors for years were the ultimate users of this now-you-see-it-now-you-don't, leads-and-lags income-reporting strategy. Under the IRS code, con-

tractors used to be allowed to report income on the "completed contract basis," which means you don't report nothin' until the job you're building is completed. Until the IRS got wise, lots and lots of jobs just never got "finished," and millions and millions of tax dollars were never paid. The IRS may be slow, but they sure are relentless, and they finally came out with a rule saying that when 95% of the estimated job cost has been billed the customer, the job is finished — no excuses, no arguments, by God it's finished, now pay us the tax and shut up. That pretty much scotched the contractors' "free lunch," but contractors are tenacious too. If you don't believe it, why are December and January the two months during the year in which more construction jobs get "finished" than any other months? Think it's the fine construction weather we have then? No, silly, it's just contractors exercising their leads-and-lags, now-you-see-it-now-you-don't, poor-man's tax-averaging, bank-confusing, income-reporting strategy — and all legal too. And now the government wants to do away with the completed contract method, pity.

Who Is Us, Who Is Them?

The most common transgression against realistic accounting in closely held corporations is confusing the family finances with the corporation's finances. If IBM, General Motors, and Exxon aren't guilty of this practice, it's probably because they can't figure out how to get away with it, not that they wouldn't like to. Let's get right down to Mama's mink and Dad's Mercedes sports coupe with a short truth test.

Q: Under cost of goods sold, how many relatives work for the company? I mean the ones who are too young, too infirm, too old, or too dumb to do a real job. Gotcha!

Q: Who uses the Beechcraft Baron 58 TC more, the family or the corporation? Gotcha again!

Q: What members of the family drive Porsches, Mercedes, and Cadillacs from the company motor pool but don't turn a hand for the corporation?

Q: Who in the family besides the president of the corporation went along on the last trip to Brussels to the trade exposition and served coffee in the exhibition booth an hour every morning for "appearances" sake?

Q: Why is the rent the corporation pays for the family-owned warehouse 25% higher than the going commercial rate?

Q: Why is the president's father (age seventy-five) living in Sarasota, Florida, and drawing $2,000 a month as a company consultant?

Enough Gotchas

I think we can agree that a family-owned and -run corporation is not a true stand-alone accounting entity, no matter what the president says. And, therefore, its income statement reflects more the "way of life" of the family and corporation combined than it does a true accounting of what the company sold, what it paid out, and what it had left when the period was all over. And, listen, I only laid on you a half-dozen of the more common gotchas; I know a hundred more besides.

So, what's it mean for us? Just this, the fact is that income statements may reflect any number of different things from a small company's performance to leads-and-lags, now-you-see-it-now-you-don't company accounting to combined corporate/family life styles. If income statements measure all these at once, how can anyone really measure how the *company* is doing? No way.

Conclusion (a lecturette): If you engage in any or all of these nefarious practices, don't look to me for approval or criticism — a moralist I'm not. But don't look to me for help either in figuring out who sold what to whom and when. I wasn't there when you did it! Ready for the moral? *Keep some records that make sense,* at least to you.

We had a sawmill operator near one of our farms

years and years ago. His name was Howard and he kept his records on a wooden shingle. Howard knew *exactly* how he was doing; his grip on the reality of his business was flawless.

WRAP-UP AND SCORECARD

Things to remember about accounting myths and realities:

1. What you see is *not* necessarily what you got.
2. Whether the balance sheet actually balances is not the real issue.
3. Inflation undermines democracy and the accuracy of the balance sheet too.
4. Diddling may be legal or illegal, moral or immoral, but diddling without keeping the right records is just plain stupid.
5. Balance sheets based on historic cost cannot help us years later. (If you are into history, buy a damn history book — no, better yet, let the family buy it and you rent it from them.)
6. The only way to tell if the inventory is there is to go count it yourself. If you've done that already, you probably know what inventory means to reported profits.
7. Income is income when it's billed, except when you can't collect it, except when you didn't intend to collect it, . . . except when you've changed your mind about the relative you sold the riding mower to anyhow.
8. Always write off bad debts before you think you should. Shows poor faith on your part about human behavior but helps win the tax battle.
9. The smarter you become in buying low and selling high, the less accurately your balance sheet reflects your acumen.
10. If you diddle yourself up a new plant by using labor and materials, don't put it on the balance sheet, silly.
11. Debt is different from equity except when money that should have been put in the company in exchange for stock is exchanged for notes — except when you never intended to take it out again, in which case you have not read far enough in this book.
12. If you rent to your family, make them sign a long lease and always charge them more than anybody else — they are generally poor tenants.
13. If you want a fence around your beach house, don't buy it with company funds. Let the fence dealer use your prop-

erty free for ten years to test the corrosive-resistant properties of his fencing.

14. Bill them this year and collect next year, or bill them next year and collect this year . . . do anything you want but collect the money, dammit!
15. Cheating the IRS is fun — until they catch you.
16. Cheating the IRS is dumb whether they catch you or not — there are too many ways to do it that are legal.
17. Remember, when all else fails, buy low, sell high, collect early, pay late, and keep your books on a shingle. You know the rest.