
CHAPTER 1

THE RESPONSIBILITIES OF THE CONTROLLER

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Although the responsibilities of the controller and the treasurer may overlap between different companies, the controllership functions, themselves, remain basically similar between industries and companies. The controller may provide financial information to diverse users, including internal management, stockholders, creditors (including banks and suppliers), stock exchanges, employees, customers, the public at large, U.S. government agencies (e.g., the Securities and Exchange Commission, Internal Revenue Service, Department of Commerce, Department of Labor, and the Federal Trade Commission), and state and local tax and other agencies.

RESPONSIBILITIES

The role of the controller is changing. Businesses growing in size and complexity, intervention by the government, and more diverse means of raising capital have added to the functions and responsibilities of the controller, and these functions

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continue to change rapidly. Traditionally, the controller has been thought of as the chief accounting officer and financial planner of a corporation. Indeed, *Webster's Dictionary* defines the word *controller* in just those terms. The typical controller was the executive in charge of the record keeping for a company, the preparer of financial statements, and the person responsible for internal controls. Though still responsible for these functions, controllers today have expanded responsibilities and are becoming more involved with strategic planning.

Strategic planning entails becoming involved with the decision-making processes of the organization. The controller is in the unique position to do this, as he or she has knowledge of the company plus the financial know-how that few others in the corporation possess. As more chief executive officers begin to rely on the controller's office for information and for input into planning decisions, the controller will likely become an even more valuable member of the management team. No longer is it sufficient for a controller to just add up the numbers; most executives expect more.

Controllers can do more than gather the data of past performance and pump out reports. They can use the information collected to become involved in the dynamics of running the business. Controllers have already gathered much of the information required to improve profits and operations, reduce costs, and develop strategies for the company. Moreover, they have a "hands-on" feel of the operating environment, such as the interrelationships among management, production, and sales. The accounting function, by its very nature, provides a large percentage of the information needed by executives. The trick is to put this information to use for the future and not just report on the past. Where is the company headed? Although controllers must not turn their backs on the traditionally assigned accounting tasks, they must apply a vast body of knowledge to the future prospects of the organization. It is in this regard that controllers will prove useful and valuable to any company.

The controller is usually the head officer of an accounting department whose size varies by company. He or she is responsible for the products of the accounting department as well as for running an efficient and effective department. Maintaining the company records for accounts payable, accounts receivable, inventory, and other pertinent areas has traditionally been considered the primary function of the controller. All transactions must be recorded properly and in a timely manner, either manually or using computer software. Along with record keeping, the controller is responsible for the preparation of financial statements and, if required, interpreting these statements for management. In doing so, the controller may work closely with the independent auditors to ascertain that the statements are presented fairly in accordance with generally accepted accounting principles (GAAP). The controller will also work hand-in-hand with the auditors as they perform the year-end independent audit and may require his or her staff to assist the auditors in certain tasks. Furthermore, the controller may play an important role in terms of involvement with the audit committee. In addition to assisting with the external audit, the controller is involved with internal auditing on a year-round basis: evaluating the company's internal control structure in order to determine that

it is operating effectively and efficiently; making improvements in the structure if it is determined that there are deficiencies; and reporting to the audit committee or board of directors—perhaps on a regular basis—the status of the internal control structure. Addressing the needs of management is another important aspect of the controller's role. It must not be overlooked that the goal of business is to realize a profit. Without information about the costs of production and distribution, management cannot determine how to proceed in regard to marketing decisions.

The controller must construct reports relating to production costs and distribution costs. To help management determine the most profitable course to follow, the controller should be acquainted with break-even analyses, cost-volume-profit relationships, and standard cost methods. Adequate reporting to management to enable intelligent decision making requires knowledge not only of cost accounting but of responsibility accounting and exception reporting. The controller must be able to report historical data as well as develop trends and relationships from existing data. In addition, the controller should know how to make use of financial relationships, determine the trend of ratios, present the ratios in suitable form, and interpret the data in a comprehensive report.

Tax returns and other tax matters that pertain to the corporation are also handled by the controller. Although some companies refer tax matters to the public accountants, it is still the responsibility of the controller to avoid excess taxes. The controller must be fully informed about tax matters, particularly federal income taxes. Identifying and analyzing tax implications of a given transaction are important functions of the controller because the controller's role is not limited to verifying the validity of tax computations. Most important, to minimize the tax obligation, tax planning is crucial. The controller must recognize tax problems in the making—that is, before the transactions are complete.

Any statistical reports that are needed by management are usually prepared in the controller's department. Therefore, the controller must be familiar with the operational flow of the company as well as the needs of its executives so that useful information can be developed and presented. The controller must prepare a variety of reports for distribution to different levels of management, depending on their needs. These reports enable various managerial objectives to be attained and can include weekly sales reports segregated by territories, salespeople, or products, and labor reports based on actual and standard costs that can be presented by product, division, material usage, or other important variables. The annual budget, an important planning tool, is generally prepared by the controller's office. The construction of the budget and its basic guidelines are determined by the controller. The controller is expected to analyze the plan to ascertain that it is reasonable and reliable. In addition, proposing suggestions for improvements is vital to a company's growth. The budget may be flexible, fixed, or zero based and the controller must be knowledgeable in these areas. Once prepared, the budget becomes a control device, and the controller analyzes variances and advises management to take corrective action, if necessary.

The controller may also be expected to determine whether the company is carrying adequate insurance on properties and other assets. It is important to

maintain adequate records of all contracts and leases and it is the controller's function to determine that they are recorded properly. The controller is also responsible for determining that the entity is satisfying all regulations prescribed by governmental agencies. If the board of directors sets any goals regarding financial transactions, these are listed in the minutes of the board, and it is the obligation of the controller's office to ensure that they are acted upon.

The passing of the Foreign Corrupt Practices Act in 1977 required corporations to maintain financial records and to establish and maintain an effective internal control structure. The controller must be aware of this Act and its requirements and realize that maintaining reasonable records and adequate controls is now a matter of law. The controller must be familiar with the mechanics of establishing a sound internal control structure as well as understand the cost/benefit relationships in establishing and monitoring the structure. Failure to do so will lead to problems such as that experienced by Enron and others.

The reporting function of the controller's job is not limited to just internal uses. The controller will be called upon to assist in the formulation of the annual report to stockholders and to prepare other reports for government agencies such as the Securities and Exchange Commission (SEC). The information in the annual report must be easily understood and well written and should frequently use graphical and other illustrative material. The financial information contained therein is typically prepared by the controller who will be responsible for its content. There should always be adequate disclosure and the information must conform to GAAP and to SEC requirements.

SKILLS

To cope with all these various tasks, the controller must possess certain skills, the most important being a knowledge of current accounting principles and practices and an ability to communicate effectively to management the impact of recent promulgations. The controller also must keep abreast of any significant changes to GAAP. This can usually be accomplished by receiving advice from the independent auditor or by referring to published sources. The controller must know how to communicate ideas both orally and through written representations. A forward-looking controller understands that information should be presented in a useful and understandable format. He or she always considers future consequences and directions.

The ability to motivate and organize subordinate staff members is essential. As the head of the accounting department, the controller must be able to direct the members of the department so that they are responsible for their own work. It is important to be fair and reasonable when dealing with subordinates.

In addition, the controller must be able to interact with people at all levels of the organization. Because the controller's position requires the providing of information to many levels of management, it is crucial that the controller possess a basic understanding of the problems faced by the business as a whole and the problems faced by individual departments within the company. Although the controller is not expected to become an expert in engineering or production, it is

important to be familiar with these areas in order to anticipate the needs of all departments. To be effective, the controller has to get involved to some extent with the day-to-day operations of the company. After formulating suggestions, the controller must be able to market them. Gaining respect from other executives will enable this. If others see that the controller wants to help, they will actually seek his or her advice.

A wise controller knows the limits of his or her prescribed functions and knowledge base. The preparation of voluminous reports that are never read may make it appear that the controller is working to his or her utmost capacity, but in reality very little is being accomplished. Certain areas of reporting would more properly be done by managers with expertise in other areas, such as engineering or sales. Without the proper support staff, the controller cannot function at the level he or she would like to.

CONTROLLER VERSUS TREASURER

Unlike the controller, the treasurer's responsibility is mostly custodial in nature and involves obtaining and managing the company's capital; he or she primarily deals with "money management" activities. The treasurer's activities are *external*, primarily involving financing matters and mix; he or she is involved with creditors (e.g., bank loan officers), stockholders, investors, underwriters for equity (stock) and bond issuances, and governmental regulatory bodies (such as the SEC). The treasurer is responsible for managing corporate assets (e.g., accounts receivable and inventory), debt, credit appraisal and collection, planning the finances, planning capital expenditures, obtaining funds, dividend disbursement, managing the investment portfolio, and pension management.

In some organizations the duties of the controller and treasurer overlap, with the treasurer being, in effect, the controller's superior.

CONTROLLER'S REPORTS

A successful controller will possess the ability to communicate ideas to various interested parties through the preparation of various types of reports. Prospective financial information is often needed to enable departments and segments to plan the future effectively. In this regard, planning reports are often issued by the controller. Information reports, analytical and control reports, as well as exception reports prepared by the controller enable analysis of a diverse amount of information and situations. Reports prepared for the board of directors must address specific policy matters and general trends in revenue and profits. These reports must enable the Board to establish and attain specified goals. Reports prepared for other company employees must be useful and timely. Reports to stockholders and relevant stock exchanges must be informative and complete. The controller's role in reporting information, therefore, cannot be overstated.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Inasmuch as the controller is primarily responsible for the entity's accounting functions, he or she should be fully cognizant of recent promulgations in financial accounting. It is critical that the controller be able to prepare detailed and meaning-

ful financial statements. There are a host of reporting mandates applicable to the income statement, balance sheet, and statement of cash flows. To inform readers properly, disclosures should be made of all important items not presented in the body of the financial statements.

Note: On July 1, 2009, the *FASB Accounting Standards Codification*[™] (ASC) became the one source of authoritative U.S. GAAP. Effective after September 15, 2009, the Codification supercedes all present accounting standards as the single official source of authoritative U.S. GAAP.

The Codification changes the manner in which U.S. GAAP is documented, updated, referenced, and accessed. All authoritative literature applicable to a particular topic is in one place.

The Codification includes standards issued by the following standard setters:

- Financial Accounting Standards Board (FASB)
- American Institute of Certified Public Accountants (AICPA)
- Securities and Exchange Commission (SEC)
- Emerging Issues Task Force (EITF)
- Derivative Implementation Group (DIG) Issues
- Accounting Principles Board (APB) Opinions
- Accounting Research Bulletins (ARB)
- Accounting Interpretations (AIN)

The Codification does not change generally accepted accounting principles (GAAP). Rather, it takes the individual pronouncements that presently comprise GAAP and reorganizes them into approximately 90 accounting Topics and displays them using a consistent structure.

To locate information about a specific issue in the Codification:

1. Go to the Topic itself (e.g., Accounts Receivable) and expand the Topic outline to find the appropriate material.
2. Use a word search.
3. Go directly to the paragraph if the reference is known.

MANAGEMENT ACCOUNTING

The controller truly serves as a financial advisor to management. He or she must be familiar with a wide variety of managerial accounting concepts and tools.

There are many basic cost concepts, classifications, and product costing systems. Knowledge of job order costing, process costing, direct costing, standard costing, and just-in-time manufacturing may be needed. Focus is also placed on cost analysis for planning, control, and decision making.

Regression analysis and mixed cost analysis may be required. The controller should be equipped with tools for sales mix analysis and what-if analysis.

In budgeting and financial modeling, the controller should use innovative and sophisticated techniques to maximize corporate objectives.

Knowledge of responsibility accounting and cost allocation is also needed. How has the performance of the responsibility centers been? Why? It is suggested that the controller be familiar with gross profit analysis, segment reporting, and contribution analysis. How may problems be identified and corrective action taken? Transfer pricing is also needed to determine divisional profit. Once such profit has been computed, the controller can calculate and analyze return on investment and residual income. In what ways may profit be improved? There must be efficient and effective analysis of company projects, proposals, and special situations. Consideration must therefore be given to time value concepts, capital rationing, capital budgeting, and mutually exclusive investments.

Quantitative applications in managerial accounting cannot be overlooked by the controller. The controller must understand decision theory and be able to make decisions under conditions involving uncertainty. Linear programming, shadow prices, and the learning curve should not be ignored in fulfilling the role of controllership. A controller familiar with Program Evaluation and Review Techniques (PERT) and inventory planning models is in a position to further assist senior level management. Multiple regression and correlation analysis depict previous relationships that will aid in making future predictions.

INTERNAL AUDITING AND CONTROL

The controller is often called upon to establish, monitor, and analyze the internal control structure of the company. In this regard, an internal control questionnaire may be useful. It is important to keep in mind that every company is different and, therefore, the internal control questionnaire should be tailored to the particular needs and peculiarities of each company. Internal controls should be put in place in conjunction with the outside auditors to facilitate their function and lessen audit costs.

In connection with the internal audit function, controllers must identify financial statement assertions, select appropriate audit procedures, and develop audit programs. Audit programs may be used for all accounts, including cash, receivables, inventory, fixed assets, payables, equity accounts, income, and expenses.

FINANCIAL ANALYSIS

A truly effective controller is equipped with tools for financial analysis. Risk and reward have to be considered. Techniques for analyzing and managing risk must be employed. Insurance policies must be scrutinized because proper financial management includes securing adequate insurance coverage in terms of insurance type and dollar amounts. Adequate insurance records must be kept for major assets.

Once financial statements are prepared, they must be analyzed for proper internal use. Attention should be given to horizontal and vertical analysis, evaluation of liquidity, examining corporate solvency, balance sheet analysis, and appraisal of income statement items.

Legal exposure of the firm must be monitored, and means to minimize litigation undertaken. An example is product liability insurance.

The effect of the economy on business operations always has to be considered and protective measures taken. What exposure does the company have in a depression, a recession, or an inflationary environment?

MANAGEMENT OF ASSETS

An organization's assets must be managed and used effectively to achieve the best possible return while controlling risk. Crucial assets to be managed include cash, marketable securities, accounts receivable, and inventory.

INVESTMENTS

The wealth of a service or sales organization can be strengthened by making sound investment and financing decisions. Investments in quality equity securities provide an excellent vehicle for achieving financial wealth. Controllers must measure return and risk, value securities, and make the best investment selections.

FINANCING

The optimal financing strategy has to be decided upon. Based on the particular facts, is it better to finance for the short term, intermediate term, or long term? If long-term financing is chosen, should equity or debt be issued? Of course, there are a host of factors to be considered in selecting a financing vehicle, including risk, maturity, liquidity, cost, and tax rate. The overall cost of capital must be minimized. Multinational companies have added international finance problems.

TAX PREPARATION AND PLANNING

Every business must consider the impact of payroll and income taxes. Proper corporate management involves selecting the proper form of business and minimizing the tax liability by judiciously applying relevant tax laws. Important business decisions are often based on tax factors, in addition to general business considerations. All businesses with employees must face the deposit and reporting requirements of various governmental agencies. Corporate financial managers should carefully review tax rules and use tax-planning strategies to the fullest extent. Tax planning should be done in conjunction with the outside auditors.

MERGERS AND ACQUISITIONS

Proper planning is essential in executing business combinations. Objectives of a merger should be clearly defined, acquisition criteria definitively stipulated, and pitfalls avoided. Leveraged buyouts are popular today but should be entered into with caution. Divestitures also occur in today's business world. Reasons for, and objectives of, divestitures must be established. Employee considerations should not be overlooked.

CONCLUSION

Corporate financial management clearly is predicated on a strong controllership function. The role of the controller is diverse and includes not only reporting and accounting functions but decision making. The controller must consider the financial strengths and weaknesses of the business. Current and prospective problems

also must be considered, along with ways to solve them. The objectives and policies of the business and its segments must be carried out.

The controller may deal with finance, accounting, production, marketing, personnel, and operations. Cost control is directed at manufacturing, administration, and distribution. Costs must be compiled, tracked, and analyzed.

CHAPTER 2

SEC REPORTING

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Note: The Obama Administration recently proposed regulatory reforms that aim to modernize the financial regulatory structure and improve the SEC's ability to protect investors, concentrating on fairness, transparency, and accountability. More specifically, the proposed reforms are to improve transparency and disclosure, improve investor protection, regulate systematic risk, align executive compensation with shareholder interests, and prevent regulatory arbitrage. The Administration also proposed major corporate governance reforms, such as enhanced compensation committees and shareholder advisory votes on compensation.

The plan gives new authority to the SEC to protect investors, raise standards, improve disclosure, and increase enforcement. Any institution representing a risk to the financial system must be carefully supervised.

The Administration also proposed to create a regulator over all systemically important companies and markets. The regulator would take steps to prevent or

minimize systematic risk; and legislation would regulate the entire financial system, not solely its individual components. To identify systemically important companies, the Administration would look at the following:

- Company size, leverage, off-balance sheet exposure, and extent of reliance on short-term funding.
- Financial system's interdependence with the firm.
- Importance of the company as a credit source for households, businesses, and governments as a liquidity source.

Executive compensation incentives, especially bonuses, would be aligned with shareholder interests and long-term company profitability. Bonuses would reflect actual performance and thus not be guaranteed in advance.

Compensation practices would be aligned with sound risk management. Golden parachutes and retirement packages would be reevaluated to assure they serve the interests of executives and shareholders.

The Securities and Exchange Commission (SEC) was established to protect investors by requiring full and fair disclosure in connection with the offering and sale of securities to the public. A major responsibility of the SEC is to ensure enforcement of the Securities Act of 1933 and the Securities Act of 1934.

The SEC's disclosure rules were strengthened by the Sarbanes-Oxley Act of 2002. The accounting rules of the SEC are enumerated primarily in Articles 3A through 12 of Regulation S-X, Financial Reporting Releases (FRRs), Accounting and Audit Enforcement Releases (AAERs), and Industry Guides.

SECURITIES ACT OF 1933

The Securities Act of 1933 (as amended) pertains to the initial offering and sale of securities through the mail; it does not apply to the subsequent trading of security investments. The Act requires that entities involved in a public offering file a registration statement with the SEC. Some of the more common exemptions under the registration provisions of the Act are (1) private offerings, (2) intrastate offerings, (3) governmental securities, (4) offerings of charitable institutions, and (5) bank offerings. The objective of this filing is to prevent misrepresentation, deceit, and other fraudulent activity in the sale of securities. Most of the information included in the registration statement must be provided to potential investors in a prospectus. Investor protection is provided by: (1) the imposition of stiff penalties in the event of the filing of false and misleading information, and (2) the ability of the investor to recover losses through litigation. The 1933 Act is primarily a disclosure statute. Disclosure is required of the securities to be issued, by whom, and how the securities are to be sold. The Act is concerned with securities distribution.

SECURITIES ACT OF 1934

The Securities Act of 1934 does not pertain to the initial offering and sale of securities to the public. Rather, the 1934 Act is designed to regulate the subsequent trading (secondary markets) of securities on the various national stock exchanges.

Under the 1934 Act, a scaled-down version of the 1933 Act registration statement must be filed by an entity if its securities are to be traded on a national exchange.

The 1934 Act requires the periodic filing of information reports with the SEC in order to maintain the full and fair disclosure objective of the 1933 Act. The annual Form 10-K and the quarterly Form 10-Q are the most common types of reports required by the 1934 Act. Most of the information included in these reports is available to the public. The Act is designed to prevent fraud and market manipulation. It also deals with margin trading, insider trading, and proxy solicitation.

Note: According to Accounting Standards Update (ASU) No. 2010-04 (January 2010), *Accounting for Various Topics*, when financial statements are presented to the Securities and Exchange Commission they cannot be misleading. Subsequent events must be disclosed. An earnings release does not represent financial statements being issued.

When there is a business combination accounted for as a purchase, push-down accounting should be used.

INTEGRATED DISCLOSURE SYSTEM

The complexity of the reporting requirements under the 1933 and 1934 Acts was somewhat mitigated in 1980 when the SEC adopted the Integrated Disclosure System, which requires the Basic Information Package (BIP).

The BIP consists of the following:

- Audited balance sheets for the last two years and audited statements of income, retained earnings, and cash flows for the most recent three years.
- A five-year summary containing certain selected financial data.
- Management's discussion and analysis (MD&A) of the entity's financial condition and results of operations.

S FORMS

Form S-1

Form S-1 is normally used by any entity that desires to issue a public offering and that has been subject to the SEC reporting requirements for less than three years. Some of the more common items required to be disclosed in Form S-1 are:

- A synopsis of the business, including relevant industry and segment information, cash flows, liquidity, and capital resources.
- A listing of properties and risk factors.
- Background and financial information pertaining to the entity's directors and officers, including pending litigation involving management, and compensation arrangements.
- A description of the securities being registered.
- Identification of major underwriters.

Form S-1 also requires the disclosure of a five-year summary of selected financial data, which need not be audited by the independent certified public accountant. The data to be presented include the following items:

- Net sales or revenues.
- Total income or loss from continuing operations.
- Per-share income or loss from continuing operations.
- Total assets of the entity.
- Long-term debt, including capital leases and redeemable preferred stock.
- Declared cash dividends on a per-common-share basis.
- Disagreements with the independent certified public accounting firm.

S-1 is presented in textual form in two parts: the first is the prospectus, and the second contains supplementary and procedural information.

Form S-3

Form S-3 may generally be used by a company that passes the "float test." In other words, at least \$150 million of voting stock is owned by nonaffiliates. Form S-3 may also be used if the entity has a float of \$100 million accompanied by an annual trading volume of 3 million shares. Annual trading volume is the number of shares traded during a recurring 12-month period culminating within 60 days before the filing.

Form S-3 is an abbreviated form, because the public already has much of the information that would normally be required to be included. Accordingly, Form S-3 provides for incorporation by reference.

Form S-4

Form S-4 is applicable in registrations of securities in connection with such business combinations as mergers, consolidations, and asset acquisitions. Form S-4 also provides for incorporation by reference to the 1934 Act reports.

Form S-8

When registering securities to be offered to employees pursuant to an employee benefit plan, Form S-8 should be filed. Information presented in Form S-8 is normally limited to a description of the securities and the employee benefit plan. Disclosure is also made about the registrant, although this information is made available through other reports required by the 1934 Act.

Form S-18

A company whose objective is to raise capital of \$7.5 million or less may file a registration statement using Form S-18. Disclosures presented in Form S-18 are quite similar to those required in Form S-1. One difference between the two forms is that management's discussion and analysis is not required. Additionally, only one year's audited balance sheet and two years' audited statements of income and cash flows are required.

MANAGEMENT'S DISCUSSION AND ANALYSIS

MD&A is an integral part of the registration filing and pertains to (1) the three years covered in the audited financial statements that are submitted as part of the registration process and (2) any interim financial statements that are also submitted. The MD&A should therefore specify the significant changes in financial condition and results of operations. To accomplish this, the following items must be disclosed:

- Liquidity.
- Capital resources.
- Results of operations.
- Positive and negative trends.
- Significant uncertainties.
- Events of an unusual or infrequent nature.
- Underlying causes of material changes in financial statement items.
- A narrative discussion of the material effects of inflation.

Though not required, forecasted information may be presented.

REGULATION S-X

Regulation S-X stipulates the accounting and reporting requirements of the SEC. It encompasses the rules pertaining to the auditor's independence, the auditor's reports, and the financial statements that must be submitted to the SEC. Regulation S-X is continually amended by the issuance of Financial Reporting Releases (FRRs). FRRs enable the SEC to present:

- New disclosure requirements.
- The required treatment for certain transaction types.
- The SEC's opinions on essential accounting issues.
- Interpretations of current rules and regulations.
- Amendments to financial statement reporting requirements.

In general, the accounting rules under Regulation S-X parallel generally accepted accounting principles (GAAP). Occasionally, however, the disclosure rules under Regulation S-X are more expansive. For instance, financial statements filed with the SEC require the following disclosures, which are not normally included in financial statements prepared in conformity with GAAP:

- Lines of credit.
- Compensating balance arrangements.
- Current liabilities if they represent in excess of 5% of the entity's total liabilities.

Regulation S-X is divided into 12 articles as follows:

- Article 1—Application of Regulation S-X.
- Article 2—Qualifications and Reports of Accountants.

- Article 3—General Instructions as to Financial Statements.
- Article 3A—Consolidated and Combined Financial Statements.
- Article 4—Rules of General Application.
- Article 5—Commercial and Industrial Companies.
- Article 6—Regulated Investment Companies.
- Article 7—Insurance Companies.
- Article 9—Bank Holding Companies.
- Article 10—Interim Financial Statements.
- Article 11—Pro Forma Information.
- Article 12—Form and Content of Schedules.

Also to be disclosed are third-party restrictions on fund transfers, inventory categorization, and redeemable preferred stock.

FORM 10-K

To comply with the Securities Act of 1934, most registrants will be required to file a Form 10-K on an annual basis. Form 10-K is due within 60 days subsequent to the closing of the registrant's fiscal year. The rules apply to companies with a market value capitalization of \$75 million.

The contents of Form 10-K include general instructions; a cover page; signatures; supplemental information; and disclosures, which are divided into four parts, as follows:

Part I

- Item 1—Business.
- Item 2—Properties.
- Item 3—Legal Proceedings.
- Item 4—Submission of Matters to a Vote of Security Holders.

Part II

- Item 5—Market for the Registrant's Common Equity and Related Stockholder Matters.
- Item 6—Selected Financial Data.
- Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations.
- Item 8—Financial Statements and Supplementary Data.
- Item 9—Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

Part III

- Item 10—Directors and Executive Officers of the Registrant.
- Item 11—Executive Compensation.

- Item 12—Security Ownership of Certain Beneficial Owners and Management.
- Item 13—Certain Relationships and Related Transactions.

Part IV

- Item 14—Exhibits, Financial Statement Schedules, and Reports of Form 8-K.

In 2006, the SEC required most companies to include a footnote in the financial statements referred to as Unresolved Staff Comments. In this footnote, the company must disclose any material comments from an SEC review of its filings, issued more than 180 days before year-end, or continue unresolved by the date of Form 10-K. Examples of issues might be financial statement item restatements, procedural or disclosure questions, and accounting violations. Regulators also are increasingly disclosing the contents of correspondence with companies, which can be found under the company's name on the EDGAR search portion of the SEC Web site. Code words include *upload*, which is the SEC's staff comments, and *cover* or *corresp*, which is the company's response.

FORM 8-K

Form 8-K essentially must be filed immediately after the occurrence of a significant event (generally within 15 days) that materially affects the company's financial position or operating results. It is a current report. Form 8-K lists the following as significant events:

- Item 1—A change in control of registrant.
- Item 2—The acquisition or disposition of assets.
- Item 3—Bankruptcy or receivership.
- Item 4—Changes in registrant's certifying accountant.
- Item 5—Other events (e.g., litigation, acts of nature, new product introduction).
- Item 6—Resignation of a registrant's directors.
- Item 7—Financial statements and exhibits.

For items 4 and 7, Form 8-K must be filed within five days.

FORM 10-Q

Changes in operations and financial position since the filing of the most recent Form 10-K are disclosed in the quarterly Forms 10-Q. The quarterly Form 10-Q is due within 35 days after the end of each of the first three fiscal quarters.

Form 10-Q specifically lists the items that must be disclosed as follows:

Part I—Financial Information

- Item 1—Financial Statements.
- Item 2—Management's Discussion and Analysis of Financial Condition and Results of Operations.

Part II—Other Information

- Item 1—Legal Proceedings.
- Item 2—Changes in Securities.
- Item 3—Defaults upon Senior Securities.
- Item 4—Submission of Matters to a Vote of Security Holders.
- Item 5—Other Information.
- Item 6—Exhibits and Reports of Form 8-K.

STAFF ACCOUNTING BULLETIN

FASB Accounting Standards Codification (ASC) 250, *Accounting Changes and Error Corrections* (ASC 250-10-S99) provides guidance on quantifying material financial statement misstatements, including coverage of the impact of carryover and reversal of previous-year misstatements. Misstatements should be appraised from the prospective of their effect on the current year's income statement and balance sheet. The SEC will not object to a registrant making a one-time cumulative effect adjustment to correct errors from previous years that are qualitatively and quantitatively immaterial, based on appropriate use of the registrant's previously employed approach.

ELECTRONIC FILING

The SEC's electronic data gathering, analysis, and retrieval (EDGAR) system for public companies has registration, documents, and other information available via online databases. Thus, the controller can use EDGAR to gather for research purposes the way in which other companies have presented information to the SEC.

EDGAR will be replaced by the interactive data electronic application (IDEA) system. IDEA is a different approach than EDGAR, as it provides investors with easier and quicker access to financial information about public companies. Initially, IDEA will supplement EDGAR and then ultimately replace it.

IDEA uses data-tagging software similar to bar codes for financial data. The technology is based on the extensible business reporting language (XBRL). It allows for fast comparisons of different business entities or different time periods. The information will be available at no cost on the Internet.

TAKEOVER REGULATION

If an investor acquires in excess of 5% of a company's stock, it must file with the SEC, target business, and its stockholders the investor's identity, the financing source, and the reason for the acquisition.

CONCLUSION

It should be clear that regulation by the Securities and Exchange Commission imposes reporting and filing burdens. The controller has a vital role in ensuring that accurate data, for reporting purposes, are accumulated in a timely manner. The controller is also responsible for the timely filing of reports mandated by the SEC.

Note that financial regulation still has much uncertainty given that there are so many regulations and rules yet to be legislated.

According to the 1933 Act, securities offered to the public must be registered before they can be issued. There are two parts to the registration statement. In part 1 (the prospectus), data are contained regarding the investment decision. In part 2, there is procedural and supplemental information. The *earliest* a securities issuance can occur after the registration statement becomes *effective* is *20 days*. It is *illegal* for an underwriter to deliver securities to an investor until he or she has received a final prospectus. Those involved with a defective registration statement, including the issuing company, outside CPAs, and underwriters, are legally liable. Legal liability may also fall under the RICO Act of 1970.

As amended in 1964, the 1934 Act requires registration of all unlisted companies with at least \$5 million in assets and at least 500 stockholders.

A *comfort letter* may be obtained from the independent CPA furnishing specified assurances regarding financial statement information contained in the registration statement.

CHAPTER 3

CONTROLLER'S REPORTS

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In addition to SEC reporting (discussed in Chapter 2), the controller is responsible for communicating useful and accurate information to senior-level management, the board of directors, divisional managers, employees, and interested third parties. It is crucial that reports are issued in a timely manner and are understood by a diverse audience.

The needs of management vary from one organization to another. Management reports should be sufficiently simplistic to enable the reader to center his or her attention on problems or predicaments that may or could arise. Consistency and uniformity in report format and issuance can only enhance the organization's operational effectiveness and efficiency. The data presented in reports issued to management, employees, and third parties should be based on facts that may be corroborated by underlying financial and accounting data.

PROSPECTIVE FINANCIAL STATEMENTS

Prospective financial statements encompass financial forecasts and financial projections. Pro forma financial statements and partial presentations are specifically excluded from this category.

Financial forecasts are prospective financial statements that present the entity's expected financial position and results of operations and cash flows, based on assumptions about conditions actually expected to exist and the course of action actually expected to be taken.

A financial forecast may be given in a single monetary amount based on the best estimate, or as a reasonable range.

Caution: This range must not be chosen in a misleading manner.

Financial projections, on the other hand, are prospective statements that present the entity's financial position, results of operations, and cash flows, based on assumptions about conditions expected to exist and the course of action expected to be taken, given one or more hypothetical (i.e., what-if) assumptions.

Financial projections may be most beneficial for a limited number of users, because they may seek answers to questions involving hypothetical assumptions. These users may wish to alter their scenarios based on expected changing situations. A financial projection, like a financial forecast, may contain a range.

A financial projection may be presented to general users only when it supplements a financial forecast. Financial projections are not permitted in tax shelter offerings and other general-use documents.

Financial forecasts and financial projections may be in the form of either complete basic financial statements or financial statements containing at least the following items:

- Sales or gross revenues.
- Gross profit or cost of sales.
- Unusual or infrequently occurring items.
- Provision for income taxes.
- Discontinued operations or extraordinary items.
- Income from continuing operations.
- Net income.
- Primary and fully diluted earnings per share.
- Significant changes in financial position.
- Management's intent as to what the prospective statements present, a statement indicating that management's assumptions are predicated upon facts and circumstances in existence when the statements were prepared, and a warning that the prospective results may not materialize.
- Summary of significant assumptions.
- Summary of significant accounting policies.

PLANNING REPORTS

The controller may prepare short-term company-wide or short-term division-wide planning reports. This includes forecasted balance sheets, forecasted income statements, forecasted statements of cash flows, and projections of capital expenditures.

Special short-term planning studies of specific business segments may also be prepared. These reports may relate to the following:

- Product line expansion.
- Plant location feasibility.
- Product distribution by territory.
- Warehouse handling.
- Salesperson compensation.

Long-range planning reports include five- to ten-year projections for the company and segments therein.

INFORMATIONAL REPORTS

Informational reports may be prepared by a controller for submission to management personnel. These reports are frequently used to depict trends over long periods of time. Accordingly, informational reports may be used to report trends in sales and purchase requirements over the last five years. The format of information reports is generally left to the preparer's judgment, although graphic depiction (including charts) is popular.

ANALYTICAL AND CONTROL REPORTS

Analytical and control reports contain data derived from analytical procedures. Analytical procedures involve comparisons of financial and nonfinancial information. As a result, analytical and control reports are often utilized to disclose current-period versus prior-period changes in financial statement accounts. For example, analytical and control reports might disclose the increases and decreases in selected expense accounts over the past two years. Analytical reports are also used to summarize and describe variances from forecasts and budgets. Analyses of variances may be by revenue, expense, profit, assets, territory, product, and division.

EXCEPTION REPORTS

Exception reports are used to present detailed listings of problems that have arisen during a specified period of time. Exception reports might encompass internal control deficiencies or questionable areas pertaining to the application of generally accepted accounting principles (GAAP). This type of report may be used by or prepared by the controller. In an organization that utilizes electronic data processing, exception reports should be computer generated and should normally detail problems that may have arisen during the input, processing, and output stages of data processing.

FINANCIAL REPORTS

The controller is relied on to prepare complete and accurate financial statements that fairly present the financial position, results of operations, and cash flows of the company. The financial statements must include adequate and informative disclosures. The controller must keep in mind that the year-end financial statements must be audited by an independent certified public accountant. Accordingly, the year-end financial statements may have to include information that might not have been

required had the controller prepared financial statements which were to be used solely by management.

Financial reports may also be prepared to describe operating results of individual divisions of the entity. These reports may not take the form of complete financial statements. As a result, the statements might include information that is not normally needed or used by individuals outside of the company.

REPORTS FOR THE BOARD OF DIRECTORS

The board of directors is typically interested in broad policy matters, general trends in revenue and profits, and competition. The board of directors is also concerned with short-term and long-term matters. Useful information in reports addressed to the board of directors includes company and divisional operating results, historical financial statements, prospective financial statements, status reports pertaining to capital expenditures, and special studies.

SPECIAL REPORTS TO SENIOR MANAGEMENT

Special situations and circumstances may occur that mandate separate analysis and study. For example, it may be necessary to identify the reason for a continual drop in the profitability of a particular product or territory. Another example is a feasibility study on the opening of a new plant facility. Narrative explanation of the analysis and the decision, along with proper statistical support, is crucial. Graphic presentations may also be enlightening.

REPORTS FOR DIVISIONAL MANAGERS

Reports prepared to aid divisional managers in gauging performance and improving operating results include:

- Sales and net income.
- Return on investment.
- Profitability by product line, project, or program.
- Sales by geographic area.
- Divisional contribution margin, segment margin, and short-term performance margin.
- Divisional performance relative to other divisions in the same company and to competing divisions in other companies.
- Expenses and labor performance by cost center.
- Cash flow.
- Production orders received and unfilled orders.
- Idle time.
- Comparison of operations with general indices of business conditions.

REPORTS TO EMPLOYEES

Reports may be directed toward the interests and concerns of employees. These reports may contain the following information:

- Explanation of financial condition.
- Profit per employee.
- Profit per sales dollar, units sold, and amounts invested.
- Taxes per employee relative to wages, per share of stock, dividends, and net income.
- Salaries including comparison to other industries and cost of living.
- Analytical profit and cost information.
- Investment per employee.
- Future outlook.
- Industry trends.
- Achievement in production, sales, or safety.
- Nature and importance of break-even point.
- Explanation of changes in pension, welfare, and other benefit plans.
- Need for stockholders.
- Nature of properties.
- Source of capital.
- Dividends relative to wages, per employee, and percent of investment.

An illustrative report to employees is shown in Exhibit 3-1.

Exhibit 3-1: An Illustrative Report to Employees

X COMPANY STATEMENT OF REVENUE AND EXPENSE FOR EMPLOYEES FOR THE YEAR ENDED DECEMBER 31, 20X6

	Total Amount	Amount per Employee	Cents per Dollar of Receipts
The company received:			
From customers for goods and services rendered			
Dividends			
Interest			
Total amount received			
Corporate expenses were:			
For materials, supplies, and other expenses			
Depreciation			
Taxes			
Total expenses			
Balance remaining for salaries, dividends, and reinvestment in the business			

	Total Amount	Amount per Employee	Cents per Dollar of Receipts
This was divided as follows:			
Paid to employees (excluding officers) as wages			
Paid for employee fringe benefits			
Total			
Compensation of officers			
Paid for officer fringe benefits			
Paid to shareholders as dividends			
Reinvested in the business for growth			
Total division			

REPORTS TO STOCKHOLDERS

An important role of the controller is to present useful information to stockholders. Reports to stockholders should be designed to communicate financial position, results of operations, and cash flows for a specified period of time. The annual report to stockholders is required by companies regulated by the Securities and Exchange Commission (SEC). The SEC generally permits flexibility in the format and content of the annual report to stockholders, encouraging the use of graphs and charts. Although not required by any regulatory agency, a message from the company's president is usually included in the annual report to stockholders. The president's message is usually presented before the financial statements and the report of the independent certified public accountant. It should be remembered that the president's letter is the first item normally read by the user of the annual report. As such, it primes the reader and should clearly present highlights of the company's operations and future expectations. Annual reports to shareholders also quite commonly include nonfinancial information in narrative and photographic form.

REPORTING TO THE NEW YORK STOCK EXCHANGE

The listing application to the New York Stock Exchange contains an agreement to furnish annual reports and periodic interim financial statements. Timely disclosure must be made of information that may impact security values or influence investment decisions.

CONCLUSION

The controller's role in reporting information cannot be understated. In addition to the ability to formulate useful financial and nonfinancial information, the controller must be able to communicate effectively and efficiently to management, employees, and outsiders. Reports containing data for decision-making purposes should be prepared in a timely manner.

APPENDIX I

THE SARBANES-OXLEY ACT AND CORPORATE GOVERNANCE

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On the heels of corporate scandals, a series of sweeping changes are being sought, such as forcing boards to have a majority of independent directors, granting audit committees power to hire and fire accountants, banning sweetheart loans to officers and directors, and requiring shareholder's approval for stock option plans. New

CHAPTER 10

**FINANCIAL STATEMENT REPORTING: THE
STATEMENT OF CASH FLOWS**

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As per ASC 230, *Statement of Cash Flows*, a statement of cash flows is required in the annual report. The objective of the statement is to furnish useful data regarding a company's cash receipts and cash payments for a period. There should exist a reconciliation between net income and net cash flow from operations. In addition, separate reporting is mandated for certain information applicable to noncash investments and financing transactions. This chapter discusses how the statement may be prepared as well as the analytical implications for the financial manager.

PREPARATION OF THE STATEMENT

The statement of cash flows explains the change in cash for the period. The statement of cash flows classifies cash receipts and cash payments as arising from investing, financing, and operating activities.

Investing Activities

Investing activities involve cash flows generally applicable to changes in long-term asset items. Investing activities include purchasing debt and equity securities in other entities, buying and selling fixed assets, and making and collecting loans. Cash inflows from investing comprise (1) receipts from sales of equity or debt securities of other companies, (2) amounts received from disposing of fixed assets, and (3) collections or sales of loans made by the company principal portion. Cash outflows for investing activities include (1) disbursements to buy equity or debt securities of other companies, (2) payments to buy fixed assets, and (3) disbursements for loans made by the company.

Note: Activities related to acquisition or sale of a business or part thereof are investing items.

Caution: Gains or losses on sales of noncurrent assets are included as investing activities along with the assets to which they relate. These gains or losses are not included in net cash flow from operating items. Thus, they are an adjustment to net income in obtaining cash flow from operations.

Financing Activities

Financing activities include cash flows generally resulting from changes in long-term liabilities and stockholders' equity items. Included in financing activities are receiving equity funds, furnishing owners with a return on their investment, debt financing, and repayment or settlement of debt. Another element is obtaining and paying for other resources derived from creditors on noncurrent credit. Cash inflows from financing activities are composed of (1) funds received from the sale of stock and (2) funds obtained from the incurrence of debt. Cash outflows for financing activities include (1) paying off debt, (2) repurchase of stock, (3) dividend payments, and (4) other principal payments to long-term creditors.

Note: Stock dividends, stock splits, and appropriations of retained earnings are not included as financing activities because they do not use cash. They are intra-stockholder equity transactions.

Caution: Gains or losses from the early extinguishment of debt are part of the cash flow related to the repayment of the amount borrowed as a financing activity. Such gains or losses are not an element of net cash flow from operating activities.

Operating Activities

Operating activities relate to manufacturing and selling goods or the rendering of services. They do not apply to investing or financing functions.

Cash flow derived from operating activities typically applies to the cash effects of transactions entering into profit computations. Cash inflows from operating activities include (1) cash sales or collections on receivables arising from the initial sale of merchandise or rendering of service; (2) cash receipts from returns on loans, debt securities (e.g., interest income), or equity securities (e.g., dividend income) of other entities; (3) cash received from licensees and lessees; (4) receipt of a litigation settlement; and (5) reimbursement under an insurance policy. Cash outflows for operating activities include (1) cash paid for raw material or merchan-

dise for resale; (2) principal payments on accounts payable arising from the initial purchase of goods; (3) payments to suppliers of operating expense items (e.g., office supplies, advertising, insurance); (4) wages; (5) payments to governmental agencies (e.g., taxes, penalties); (6) interest expense; (7) lawsuit payment; (8) charitable contributions; and (9) cash refunds to customers for defective merchandise.

Additional breakdowns of operating cash receipts and disbursements may be made to enhance financial reporting. For example, a manufacturing company may divide cash paid to suppliers into payments applicable to inventory acquisition and payments for selling expenses.

ASC 410, *Asset Retirement and Environmental Obligations* (ASC 410-20), provides that a cash payment to pay off an asset retirement obligation should be presented under operating activities.

Other Considerations

There should be a separate presentation within the statement of cash flows of cash inflows and cash outflows from investing and financing activities. For example, the purchase of fixed assets is an application of cash, whereas the sale of a fixed asset is a source of cash. Both are shown separately to aid analysis by readers of the financial statements. Debt incurrence would be a source of cash, but debt payment would be an application of cash. Thus, cash received of \$800,000 from debt incurrence would be shown as a source, and the payment of debt of \$250,000 would be presented as an application. The net effect is \$550,000.

Separate disclosure shall be made of investing and financing activities impacting upon assets or liabilities that do not affect cash flow. Examples of noncash activities of an investing and financing nature are bond conversion, purchase of a fixed asset by the incurrence of a mortgage payable, capital lease, and nonmonetary exchange of assets. This disclosure may be footnoted or shown in a schedule. An illustrative presentation is as follows:

Net increase in cash	<u>\$980,000</u>
Noncash investing and financing activities:	
Purchase of land by the issuance of common stock	<u>\$400,000</u>
Conversion of bonds payable to common stock	<u>200,000</u>
	<u>\$600,000</u>

If a cash receipt or cash payment applies to more than one classification (investing, financing, operating), classification is made as to the activity that is the main source of that cash flow. For instance, the purchase and sale of equipment to be used by the company is typically construed as an investing activity.

In the case of foreign currency cash flows, the exchange rate at the time of the cash flow should be used in reporting the currency equivalent of foreign currency cash flows. The effect of changes in the exchange rate on cash balances held in

foreign currencies should be reported as a separate element of the reconciliation of the change in cash and cash equivalents for the period.

Cash flow per share shall not be shown in the financial statements because it will detract from the importance of the earnings-per-share statistic.

Direct Method versus Indirect Method

The direct method is preferred in that companies should report cash flows from operating activities by major classes of gross cash receipts and gross cash payments and the resulting net amount in the operating section. A reconciliation of net income to cash flow from operating activities should be shown in a separate schedule after the body of the statement.

Note: This schedule has the same net result as gross cash receipts and cash payments from operating activities.

Although the direct method is preferred, a company has the option of using the indirect (reconciliation) method. In practice, most companies are using the indirect method because of its easier preparation. Under the indirect method, the company reports net cash flow from operating activities indirectly by adjusting profit to reconcile it to net cash flow from operating activities. This is shown in the operating section within the body of the statement of cash flows or in a separate schedule. If presented in a separate schedule, the net cash flow from operating activities is presented as a single line item. The adjustment to reported earnings for noncash revenues and expenses involves:

- Effects of deferrals of past operating cash receipts and cash payments (e.g., changes in inventory and deferred revenue) and accumulations of expected future operating cash receipts and cash payments (e.g., changes in receivables and payables).
- Effects of items whose cash impact applies to investing or financing cash flows (e.g., depreciation, amortization expense, gain or loss on the retirement of debt, and gain or loss on the sale of fixed assets).

The basic difference in statement presentation between the direct and indirect method relates solely to the operating section. Under the direct method, the operating section presents gross cash receipts and gross cash payments from operating activities with a reconciliation of net income to cash flow from operations in a separate schedule. Under the indirect method, gross cash receipts and gross cash payments from operating activities are not shown. Instead, only the reconciliation of net income to cash flow from operations is shown in the operating section or in a separate schedule with the final figure of cash flow from operations presented as a single line item in the operating section.

The indirect method is the one commonly used in practice. Exhibit 10-1 presents the reconciliation process of net income to cash flow from operating activities.

Exhibit 10-2 shows a skeleton outline of the indirect method.

Exhibit 10-1: Indirect Method of Computing Cash Provided by Operations

	<i>Add (+) or deduct (-) to adjust net income</i>
Net income	\$XXX
Adjustments required to convert net income to cash basis:	
Depreciation, depletion, amortization expense, and loss on sale of noncurrent assets	+
Amortization of deferred revenue, amortization of bond premium, and gain on sale of noncurrent assets	-
Add (deduct) changes in current asset accounts affecting revenue or expenses (a)	
Increase in the account	-
Decrease in the account	+
Add (deduct) changes in current liability accounts affecting revenue or expense (b)	
Increase in the account	+
Decrease in the account	-
Add (deduct) changes in the deferred income	
Taxes account	
Increase in the account	+
Decrease in the account	-
	<u> </u>
Cash provided by operations	\$XXX
(a) Examples include accounts receivable, accrued receivables, inventory, and prepaid expenses.	
(b) Examples include accounts payable, accrued liabilities, and deferred revenue.	

Exhibit 10-2: Format of the Statement of Cash Flows (Indirect Method)

Net cash flow from operating activities:		
Net income	x	
Adjustments for noncash expenses, revenues, losses, and gains included in income:	x	
	<u>(x)</u>	
Net cash flow from operating activities		x
Cash flows from investing activities:	x	
	<u>(x)</u>	
Net cash flows provided (used) by investing activities		x

Cash flows from financing activities:	x
	(x)
Net cash provided (used) by financing activities	<u>x</u>
Net increase (decrease) in cash	—
Schedule of noncash investing and financing activities:	<u>xx</u>
	x
	x

FINANCIAL ANALYSIS OF THE STATEMENT

An analysis of the statement of cash flows will provide financial managers with essential information about the company's cash receipts and cash payments for a period as they apply to operating, investing, and financing activities. The statement assists in the appraisal of the effect on the firm's financial position of cash and noncash investing and financing transactions.

Comparative statements of cash flows must be analyzed in detail because they hold clues to a company's earnings quality, risk, and liquidity. Comparative statements show the degree of repeatability of the company's sources of funds, their costs, and whether such sources may be relied upon in future years. Uses of funds for growth as well as for maintaining competitive share are revealed. An analysis of comparative statements of cash flows holds the key to a full and reliable analysis of corporate financial health in the present and future. It aids in planning future ventures and financing needs. Comparative data help managerial accountants identify abnormal or cyclical factors as well as changes in the relationships among each flow component.

The statement serves as a basis to forecast earnings based on plant, property, and equipment posture. It assists in evaluating growth potential and incorporates cash flow requirements, highlighting specific fund sources and future means of payment. Will the company be able to meet its obligations and pay cash dividends?

The statement reveals the type and degree of financing required to expand long-term assets and to bolster operations.

The financial executive should calculate for analytical purposes cash flow per share equal to net cash flow divided by the number of shares. A high ratio is desirable because it indicates the company is in a very liquid position.

A discussion of the analysis of the operating, investing, and financing sections of the statement of cash flows follows.

Operating Section

An analysis of the operating section of the statement of cash flows enables the financial manager to determine the adequacy of cash flow from operating activities to satisfy company requirements. Can the firm obtain positive future net cash flows? The reconciliation tracing net income to net cash flow from operating activities

should be examined to see the effect of noncash revenue and noncash expense items.

An award under a lawsuit is a cash inflow from operating activities that results in a nonrecurring source of revenue.

An operating cash outlay for refunds given to customers for deficient goods indicates a quality problem with the firm's merchandise.

Payments of penalties, fines, and lawsuit damages are operating cash outflows that show poor management in that a problem arose that required a nonbeneficial expenditure to the organization.

Investing Section

An analysis of the investing section of the statement of cash flows enables identifying an investment in another company that may point to an attempt for eventual control for diversification purposes. It may also indicate a change in future direction or change in business philosophy.

An increase in fixed assets indicates capital expansion and growth. The financial executive should determine which assets have been bought. Are they assets for risky (specialized) ventures or are they stable (multipurpose) ones? This provides a clue as to risk potential and expected return. The nature of the assets signals future direction and earning potential of product lines, business segments, and dimensions of the business. Are these directions sound and viable?

The financial manager should ascertain whether there is a contraction in the business arising from the sale of fixed assets without adequate replacement. Is the problem corporate (e.g., product line is weakening) or industrywide (e.g., industry is on the downturn)? If corporate, management is not optimistic regarding the future. Nonrecurring gains may occur because of the sale of low-cost-basis fixed assets (e.g., land). Such gains cause temporary increases in profits above normal levels and represent low quality of earnings sources. They should be discounted by the analyst.

Financing Section

An appraisal of the financing section will help the financial manager form an opinion of the company's ability to obtain financing in the money and capital markets as well as its ability to satisfy its obligations. The financial mixture of equity, bonds, and long-term bank loans impact the cost of financing. A major advantage of debt is the tax deductibility of interest. However, dividends on stock are not tax deductible. In inflation, paying debt back in cheaper dollars will result in purchasing power gains. The risk of debt financing is the required repayment of principal and interest. Will the company have the needed funds at maturity? The financial manager must evaluate the stability of the fund source to ascertain whether it may be relied upon in the future, even in a tight money market. Otherwise, there may be problems in maintaining corporate operations in a recession. The question is: Where can the company go for funds during times of cash squeeze?

By appraising the financing sources, the financing preferences of management are revealed. Is there an inclination toward risk or safety? Creditors favor equity issuances because they protect their loans. Excessive debt may be a problem during economic downturn.

The ability of a company to finance with the issuance of common stock on attractive terms (high stock price) indicates that investors are positive about the financial health of the entity.

The issuance of preferred stock may be a negative indicator because it may mean the company has a problem issuing common stock.

An appraisal should be made of the company's ability to meet debt. Excessive debt means greater corporate risk. The problem is acute if earnings are unstable or dropping. On the contrary, the reduction in long-term debt is favorable because it lessens corporate risk.

A financing cash outflow for the early extinguishment of debt will result in a gain or loss resulting in a one-time earnings impact.

The financial manager should appraise the firm's dividend-paying ability. Stockholders favor a company with a high dividend payout.

Is there a purchase of treasury stock resulting in an artificial increase in earnings per share?

Schedule of Noncash Financing and Investing Activities

A bond conversion is a positive signal about the entity's financial health since it indicates that bondholders are optimistic about the firm's financial well-being and/or the market price of stock has increased. A conversion of preferred stock to common stock is also favorable because it shows preferred stockholders are impressed with the company's future and are willing to have a lower priority in liquidation.

Bond and preferred stock conversions affect the existing position of long-term creditors and stockholders. For example, a reduction in debt by conversion to stock protects to a greater degree the loans of the remaining bond holders and banks.

COMPREHENSIVE EXAMPLES

Current profitability is only one important factor for corporate success. Also essential are the current and future cash flows. In fact, a profitable company may have a cash crisis.

Management is responsible for planning how and when cash will be used and obtained. When planned expenditures necessitate more cash than planned activities are likely to produce, managers must decide what to do. They may decide to obtain debt or equity financing or to dispose of some fixed assets or a whole business segment. Alternatively, they may decide to cut back on planned activities by modifying operational plans, such as ending a special advertising campaign or delaying new acquisitions. Or, they may decide to revise planned payments to financing sources, such as delaying bond repayment or reducing dividends.

Whatever is decided, the managers' goal is to balance, over the short and the long term, the cash available, and the needs for cash.

Managerial planning is aided by evaluating the statement of cash flows in terms of coordinating dividend policy with other corporate activities, financial planning for new products and types of assets needed, strengthening a weak cash posture and credit availability, and ascertaining the feasibility and implementation of existing top management plans.

The analysis and evaluation of the statement of cash flows is essential if the analyst is to properly appraise an entity's cash flows from operating, investing, and financing activities. The company's liquidity and solvency positions as well as future directions are revealed. Inadequacy in cash flow has possible serious implications, as it may lead to declining profitability, greater financial risk, and even bankruptcy.

EXAMPLE 1: X Company provides the following financial statements:

X Company
Comparative Balance Sheets
December 31
(In Millions)

	20X6	20X5
Assets:		
Cash	\$ 40	\$ 47
Accounts receivable	30	35
Prepaid expenses	4	2
Land	50	35
Building	100	80
Accumulated depreciation	(9)	(6)
Equipment	50	42
Accumulated depreciation	<u>(11)</u>	<u>(7)</u>
Total assets	<u>\$254</u>	<u>\$228</u>
Liabilities and stockholders' equity:		
Accounts payable	\$ 20	\$ 16
Long-term notes payable	30	20
Common stock	100	100
Retained earnings	<u>104</u>	<u>92</u>
Total liabilities and stockholders' equity	<u>\$254</u>	<u>\$228</u>

CHAPTER 23

EVALUATION OF SEGMENTAL PERFORMANCE AND TRANSFER PRICING

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A segment is a part or activity of an organization from which a manager derives cost or revenue data. Examples of segments are divisions, sales territories, individual stores, service centers, manufacturing plants, sales departments, product lines, geographic areas, types of customers, types of employees, and states.

Analysis of segmental performance assists in determining the success or failure of the divisional manager as well as the division. Performance reports should include industry and competitor comparisons. Also, the performance reports should match cycles of major business lines, activities, and geographic areas.

Performance measures look to the contribution of the division to profit and quantity as well as whether the division meets the overall goals of the company. It is difficult to compare profit of different segments of a company, especially when segments are of different sizes or provide different kinds of products or services. Measures of divisional performance for a particular segment should be compared to previous periods, other segments, and predetermined standards.

Profit planning by segments applies to selecting among alternative uses of company resources to accomplish a target profit figure. Segmental profit planning necessitates that the profitability of each segment be measured to determine the overall profitability of all feasible combinations or alternatives.

APPRAISING MANAGER PERFORMANCE

In appraising manager performance, a determination must be made as to which factors were under the manager's control (e.g., advertising budget) and which factors were not (e.g., economic conditions). Comparison should be made of one division in the company to other divisions as well as of a division in the company to a similar division in a competing company. Appraisal should also be made of the risk and earning potential of a division. Graphic presentation shows comparisons, whether of an historical, current, or prognostic nature.

It is important to measure the performance of the divisional manager, because doing so:

- Assists in formulating management incentives and controlling operations to meet corporate goals.
- Directs upper management's attention to where it would be most productive.
- Determines whom to reward for good performance.
- Determines who is not doing well so corrective action may be taken.
- Provides job satisfaction, since the manager receives feedback.

In decentralization, profit responsibility is assigned among subunits of the company. The lower the level where decisions are made, the greater the decentralization. Decentralization is most effective in organizations where cost and profit measurements are necessary and is most successful in organizations where subunits are totally independent and autonomous. Decentralization is in different forms, including functional, geographical, and profit.

The advantages of decentralization are:

- Top management has more time for strategic planning.
- Decisions are made by managers with the most knowledge of local conditions.
- There is greater managerial input in decision making.
- Managers have more control over results, resulting in motivation.

The disadvantages of decentralization are:

- Managers become "narrow-sighted" and look solely at the division rather than at the company as a whole.
- Duplication of services can result.
- There is an increased cost in obtaining additional information.

For comparison purposes, replacement cost instead of historical cost should be employed. It furnishes a relative basis of comparison since it represents the comparable necessary investment at the end of a reporting period. Evaluating

replacement cost assists in comparing asset valuation to current productivity. If replacement cost cannot be determined, valuation can be based on the present value of future net cash flows.

The major means of analyzing divisional performance is by responsibility center—revenue center, cost center, profit center, and investment center.

RESPONSIBILITY CENTERS

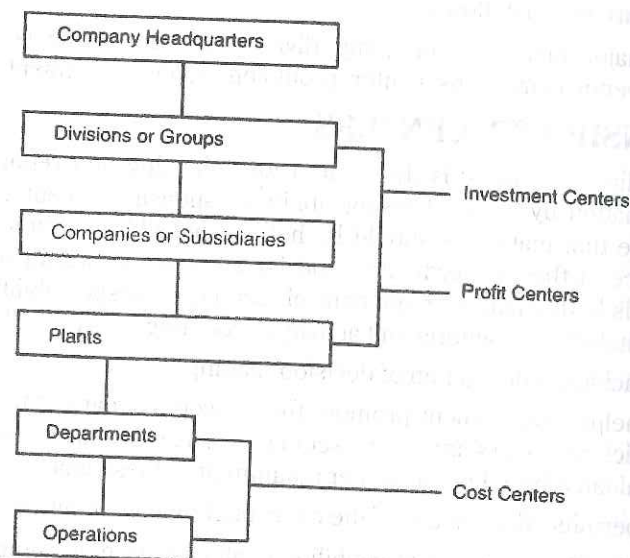
Responsibility accounting is the system for collecting and reporting revenue and cost information by areas of responsibility (responsibility centers). It operates on the premise that managers should be held responsible for their performance, the performance of their subordinates, and for all activities within their responsibility centers. It is both a planning and control technique. Responsibility accounting, also called profitability accounting and activity accounting, has the following advantages:

- It facilitates delegation of decision making.
- It helps management promote the concept of management by objective, in which managers agree on a set of goals. The manager's performance is then evaluated based on his or her attainment of these goals.
- It permits effective use of the concept of management by exception.

Exhibit 23-1 shows responsibility centers within a company; Exhibit 23-2 presents an organization chart of a company.

A well designed responsibility accounting system establishes responsibility centers within the organization. A responsibility center is defined as a unit in the organization that has control over costs, revenues, and investment funds. A responsibility center may be responsible for all three functions or for only one function. Responsibility centers can be found in both centralized and decentralized organizations. A profit center is often associated with a decentralized organization while a cost center is usually associated with a centralized one. However, this is not always the case.

There are lines of responsibility within the company. Shell, for example, is organized primarily by business functions: exploitation, refining, and marketing. General Mills, on the other hand, is organized by product lines.

Exhibit 23-1: Responsibility Centers within a Company**Revenue Center**

A revenue center is responsible for obtaining a target level of sales revenue. An example is a district sales office. The performance report for a revenue center should contain the budgeted and actual sales for the center by product, including evaluation. Usually, the manager of the revenue center is responsible for marketing a product line. A revenue center typically has a few costs (e.g., salaries, rent). Hence, a revenue center is responsible mostly for revenues and only incidentally for some costs, typically not product costs.

Sales analysis may involve one or more of the following: prior sales performance, looking at sales trends over the years, and comparing actual sales to budgeted sales.

In a service business, some performance measures include billable time, average billing rate, and cost per hour of employee time.

Accountability for departmental sales revenue assumes the manager has authority to determine product sales prices.

Cost Center

A cost center is typically the smallest segment of activity or responsibility area for which costs are accumulated. This approach is usually employed by departments rather than divisions. A cost center has no control over sales or marketing activities. Departmental profit is difficult to derive because of problems in allocating revenue and costs.

A cost center is a department head having responsibility and accountability for costs incurred and for the quantity and quality of products or services. For example, the personnel manager is accountable for costs incurred and the quality of services rendered.

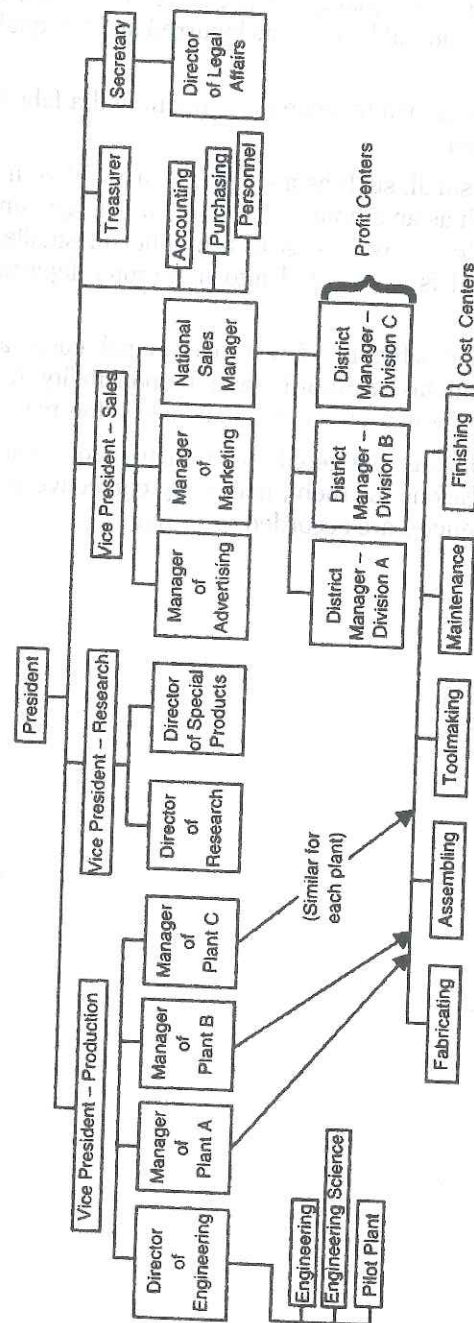
Examples of cost centers include a maintenance department and a fabricating department in a manufacturing company.

A cost center may be relatively small, such as a single department with a few people. It can also be very large, such as an administrative area of a large company or an entire factory. Some cost centers may consist of a number of smaller cost centers. An example is a factory that is segmented into numerous departments, each of which is a cost center.

A cost center is basically responsible for direct operational costs and in meeting production budgets and quotas. Authority and responsibility for cost centers must be under the control of the department head, usually a foreman.

In the cost center approach, compare budgeted cost to actual cost. Variances are investigated to determine the reasons for them, necessary corrective action is taken to correct problems, and efficiencies are accorded recognition.

Exhibit 23-2: Organization Chart of a Company



This topic is covered in detail in Chapter 17, "Cost-Volume-Profit Analysis and Leverage." The cost center approach is useful when a manager possesses control over his or her costs at a specified operating level.

Recommendation: Use this approach when problems arise in relating financial measures to output.

Suggestion: Cost center evaluation is most suitable for the following functions: accounting and financial reporting, legal, computer services, marketing, personnel, and public relations. In evaluating these functions, there is a problem in quantifying the output in financial terms.

Provision should exist for chargebacks, where appropriate. For example, if a quality control department made an error in its evaluation of product quality leading to acceptance by the purchasing department, the quality control department should be charged with the increased costs to improve the purchased goods to meet acceptable standards incurred by the purchasing department.

Note. The cost center approach may be appropriate for nonprofit and governmental units where budgetary appropriations are assigned. Actual expenditures are compared to budgetary amounts. A manager's performance depends on his or her ability to achieve output levels given budgetary constraints.

When looking at a manager's performance, say at bonus time, the relevant costs are those incremental costs over which he or she has control. Incremental costs are those expenditures that would not exist if the center were abandoned. Hence, allocated common costs (e.g., general administration) should not be included in appraising manager performance. Such costs should, however, be allocated in determining the profit figure for the entire division. Cost allocation must conform to goal congruence and autonomy and should be applied consistently among divisions.

Cost center evaluation will not be worthwhile unless reliable budget figures exist. If a division's situation significantly changes, an adjustment to the initial budget is necessary. In such a case, actual cost should be compared with the initial budget figure (original goal) and the revised budget. Flexible budgets should be prepared to enable the examination of costs incurred at different levels of capacity. For example, there can be figures budgeted for expected capacity, optimistic capacity, and pessimistic capacity. Better comparisons of budget to actual can thus be made given changing circumstances.

When a transfer occurs between cost centers, the transfer price should be based upon either actual cost, standard cost, or controllable cost. Transfer price is the price charged between divisions for a product or service.

Warning: Using actual cost has the problem of passing cost inefficiencies onto the next division. There is no incentive for the transferer to control costs.

Solution: Using standard cost corrects for the problem of transferring cost inefficiencies to the next division. However, standard cost includes allocated fixed cost, which might be subjective.

A good transfer price is a controllable cost.

What to Do: Charge the cost center with actual controllable cost and credit it with standard controllable cost for the assembled product or service to other divisions.

Rectifying the Problem: By solely including the controllable cost, the subjectivity of the allocation of fixed noncontrollable cost does not exist.

In evaluating administrative functions, prepare performance reports examining such dollar indicators as executive salaries and service department costs as well as nondollar measures such as number of files handled, phone calls taken, and invoices processed.

In appraising a cost center, look at the ratio of indirect to direct personnel. The ratio equals the number of indirect labor employees to the number of direct labor employees.

Note: Indirect manpower is not directly involved in production or performing customer services. The ratio of indirect to direct personnel reveals the division manpower planning and control. Manpower needs are based on the individual unit's variable activities and needs. In order to accomplish divisional goals, there should be a proper relationship between indirect labor and direct labor so that services are performed to generate maximum profitability. Indirect personnel should be closely monitored because of its effect on overhead costs.

Warning: A high ratio of indirect labor may mean the division is top heavy in administrative and clerical staff because of improper controls on the nature of the division's activities. Perhaps the support activities should be curtailed.

EXAMPLE 1: The indirect personnel to direct personnel ratio averaged about 45% each month over a six-month period. This is favorable because management has maintained a fairly consistent relationship between direct and indirect personnel.

In order to appraise the effectiveness of employee staff in generating divisional revenue, the following ratios may be computed:

- Sales to direct labor.
- Sales to total number of employees.
- Sales to total dollar salaries of employees.

Higher ratios are desirable because they indicate favorable employee performance in generating sales for the company. For example, an increasing trend in revenue per employee indicates greater productivity.

Caution: A decline in the ratios may be due to lower sales because of external factors beyond the control of the division manager,

Cost reduction measures may be implemented without having a negative long-term effect on the company. Such measures may improve short-term profitability. Short-term cost cutting measures may include:

- Marketing

1. Paying salespeople on a commission basis instead of a fixed salary.
2. Using distributors rather than direct selling.

- Manufacturing

1. Hiring per diem laborers rather than subcontracting the work.
2. Buying raw materials outside rather than producing them. When the quantity of the product required is relatively low, it is typically better to buy from the outside. Once production exceeds a specified level, the company can increase profitability by doing its own manufacturing.
3. Using parts rather than subassemblies as the raw materials.

Profit Center

A profit center is a responsibility unit that measures the performance of a division, product line, geographic area, or other measurable unit. A profit center has revenue and expenses associated with it. Net income and contribution margin can be computed for a profit center. Profit centers typically do not have significant amounts of invested capital.

Benefits: The profit center approach enhances decentralization and provides units for decision making purposes.

When to Use: Use it when there is a self-contained division (with its own manufacturing and distribution facilities) and when there are a limited number of interdivision transfers. The reason for this is that the profit reported by the division is basically independent of other divisions' operating activities.

Each division's profit should be independent of performance efficiency and managerial decisions elsewhere in the company. Further, divisional earnings should not be increased by any action reducing overall corporate profitability. Also use a profit center when divisional managers have decision-making authority in terms of the quantity and mix of goods or services manufactured. Because with a profit center you determine net income as if the division were a separate economic entity, the manager is more cognizant of outside market considerations. There are different ways of expressing profit, such as net income, contribution margin, gross profit, controllable profit, and incremental profit. Examples of profit centers are an auto repair center in a department store and an appliance department in a retail store.

A profit center has the following characteristics: (1) defined profit objective, (2) managerial authority to make decisions impacting earnings, and (3) use of profit-oriented decision rules. A typical profit center is a division selling a limited number of products or serving a particular geographic area. It includes the means of providing goods and services and the means of marketing them.

In some instances, profit centers are formed when the company's product or service is used solely within the company. For example, the computer department

of a company may bill each of the firm's administrative and operating units for computing services. It is not essential that fixed costs be allocated. Hence, contribution margin may be a good indicator of divisional performance. If each division meets its target contribution margin, excess contribution margin will be adequate to cover general corporate expenses. A contribution margin income statement can be prepared to evaluate divisional and managerial performance. It also aids in computing selling price, the price to accept an order given an idle capacity situation, output levels, maximization of resource uses, and break-even analysis. The contribution margin income statement is illustrated in Exhibit 23-3.

Note: Controllable costs are under the division manager's control. They are the incremental costs of operating a division. In effect, they are costs that could have been avoided by the company if the division were shut down. Non-controllable costs are common to a group of divisions that are rationally allocated to them.

A difficulty with the profit center idea is that profit is calculated after subtracting noncontrollable costs or costs that have been arbitrarily allocated and are not directly related to divisional activity. The ensuing profit figure may hence be erroneous. However, cost allocation is required since divisions must incorporate nondivisional costs that have to be met before the company will show a profit.

Special Note: Policies optimizing divisional earnings will likewise optimize corporate earnings even before the allocation of nondivisional expenses.

Exhibit 23-3: Contribution Margin Income Statement for Divisional Performance Evaluation

Sales
Less variable production cost of sales
Manufacturing contribution margin
Less variable selling and administrative expenses
Contribution margin
Less controllable fixed costs (i.e., salesperson salaries)
Controllable contribution margin by manager (measures performance of the segment manager)
Less uncontrollable fixed costs (i.e., depreciation, property taxes, insurance)
Segment contribution margin (measures performance of the division)
Less unallocated costs to divisions (excessively difficult to allocate objectively or illogical to allocate, such as the president's salary; corporate research)
Income before taxes (measures performance of the company in its entirety)

While an uncontrollable income statement item is included in appraising the performance of a profit center, it should not be used in evaluating the performance of the manager. An example is the effect of a casualty loss.

A profit center manager should be responsible not only for profit and loss items attributable directly in the division, but also for costs incurred outside the center (e.g., headquarters, other divisions) for which the center will be billed directly. The manager should also be responsible for an expense equal to the

company's interest rate multiplied by controllable working capital. This charge will take into account tradeoffs between working capital levels and profits. For example, increased inventory balances will mean less loss from stock-outs. The profit center manager is the only person that comprehends these tradeoffs.

Advantages of the profit center approach are that it creates competition in a decentralized company, provides goal congruence between a division and the company, and aids performance evaluation. A drawback is that profits can be "massaged" since expenses may be shifted among periods. Examples of discretionary costs where management has wide latitude are research and repairs. Also, the total assets employed in the division to obtain the profit are not considered.

EXAMPLE 2: You can sell a product at its intermediate point in Division A for \$170 or its final point in Division B at \$260. The outlay cost in Division A is \$120, while the outlay cost in Division B is \$110. Unlimited product demand exists for both the intermediate product and the final product. Capacity is interchangeable. Division performance is:

	Division A	Division B
Selling price	\$170	\$260
Outlay cost—A	(120)	(120)
Outlay cost—B		(110)
Profit	<u>\$ 50</u>	<u>\$ 30</u>

Sell at the intermediate point because of the higher profit.

Other measures in appraising divisional performance that are not of a profit nature that must be considered are:

- Ratios between cost elements and assets to appraise effectiveness and efficiency.
- Productivity measures, including input-output relationships. An example is labor hours in a production run. Consider the input in terms of time and money, and the resulting output in terms of quantity and quality. Does the maintenance of equipment ensure future growth? Another example is the utilization rate of facilities.
- Personnel development (e.g., number of promotions, turnover).
- Market measures (e.g., market share, product leadership, growth rate, customer service).
- Product leadership indicators (e.g., patented products, innovative technology, product quality, safety record).
- Human resource relationships (e.g., employee turnover rate, customer relations, including on-time deliveries).
- Social responsibility measures (e.g., consumer medals).

A transfer price has to be formulated so that a realistic and meaningful profit figure can be determined for each division. It should be established only after proper planning. The transfer price is the one credited to the selling division and charged