
Creating value: economics and accounting – perspectives for managers

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Focuses on understanding accounting and economic concepts, relationships, and factors important as a basis for economic decisions that create value. Provides the background essential for understanding the future papers in the series. Offers a review and develops perspectives useful to those with or without knowledge of accounting. Distinguishes between accounting and economic events, providing examples to support understanding of issues such as types of costs, relevant costs in economic analysis, economic contribution margin and break-even, and basic concepts related to product pricing, and the relationship between risk, expected economic profits and value. Relates costs and risk factors that have an impact on value and addresses issues critical in decision making.

This is the second paper in the "Creating value" series. "Capital economic returns, and the creation of value", *Management Decision*, Vol. 34 No. 6 provides background.

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Introduction

Knowledge of accounting and the economics of the operating cycle levers the talents and abilities of a manager. This paper focuses on issues of importance to the manager in his quest to create value. Perspectives and review relationships are offered that will assist the manager in analysis, decision making, management, and in the persuasion and motivation of others.

Accounting and economics match by accident rather than design. Knowledge of the objectives, merits and limitations of both accounting and economics prepare us to make better decisions and manage for effect. The paper will:

- provide perspectives on financial statements of professional as well as personal interest;
- explain accrual accounting versus cash flow analysis;
- converge on key concepts in managerial accounting;
- distinguish between economic and accounting issues in analysis, decision making, and management;
- review aspects of accounting that support economic analysis, with an emphasis on relevant costs in decision making;
- explain break-even in a manner that requires no memory of equations;
- focus on the crucial importance of economic contribution margin in decision making and management;
- explain the relationship between economic profits, risk and the creation of value.

Books and related statements: perspectives

A firm maintains various "books" and related statements for different purposes. In addition to the familiar "financial statements" which appear in the company's public financial reports, a company also maintains statements or records for purposes of compliance with various tax rules. Companies usually also have various accounting and finance statements to support analysis, management, control and

planning by the managers. In order, the "books" and related statements will be referred to as financial, tax and managerial.

Financial statements

The three most important statements are the balance sheet, the statement of income, and the statement of cash flows. Let us review important issues related to these statements.

Balance sheet

The balance sheet (B/S) has three major sections which jointly preserve the accounting mantra:

Assets = liabilities + equity.

Accountants insist on this equality. With no mistakes, the "double entry" system of accounting ensures this relationship. Rather than focus on accounting, we will touch on those issues important to a manager. The business end of the firm lies on the left-hand side of the balance sheet: the assets. The right-hand side, the liabilities and equity, merely show how the firm finances the assets.

Assets

Assets support our efforts to create value. An asset not creating value or not expected to create value is an idle asset. We make economic decisions to decide what assets to keep, what assets to sell and in what assets to invest.

One refers to short-term assets such as cash and inventories as working assets or working capital since they "turn over" or are replaced. For example, we sell some inventory but make replacement units. Net working capital refers to working capital less current liabilities.

If we buy an asset having expected benefits extending beyond the current accounting period, accountants "capitalize" and put the amount on the balance sheet. Hence the term capital asset. A subsequent paper outlines the analysis of capital investment.

The asset remains on the B/S until sold. Accountants reflect the "using up" of the asset by deducting depreciation and showing the net asset value. The depreciation

deducted for a period is the “depreciation expense” on the statement of income (SOI). This is an accounting entry – not a cash flow expense. The cash event occurred when the company originally paid for the capital asset.

Usually, assets appear in order from most liquid and shortest term to least liquid and longest maturity. Thus, “cash” is first and “land” usually last[1].

Liabilities and equity

These show the claims against the assets as well as the claims against the results of operations. Another perspective: liabilities and equity show how we financed the assets. Maturity determines the order of liabilities. Those obligations due first or having the shortest maturity appear first. The equity accounts are last. Owners are last in line with a residual claim on what is left over after meeting the liabilities.

Historical

In many countries, one develops the B/S on an “historical cost” basis. The numbers show the cost basis and the “book value” of liabilities and equity. Often the market value or economic value of assets, liabilities, and equity are quite different from the numbers shown on the B/S. Good accounting requires “marking down” the stated amount on the B/S if the market value of the asset is less than stated value, particularly for inventory: “cost or market value, whichever is lower”.

“...Often the market value or economic value of assets, liabilities, and equity are quite different from the numbers shown on the B/S...”

Accountants do not “mark up” values on an historical-based B/S. Because of this conservative approach to B/S values, an orderly liquidation of the assets should yield proceeds at least equal to the amount shown on the B/S.

Current value

In some countries, B/S numbers reflect adjustments to “current value”. Rather than debate the merits of historical vs. current value accounting, we simply note that a manager should recognize that the basis of a B/S varies. For example, with an historical-based B/S, the numbers at different spots on the B/S reflect costs at different points in time. Hence, owing to changes in purchasing power of a currency, the numbers in different accounts lack comparability. For example, in 1934 the accountant may have logged ten million in the account, land. The ten million is not properly comparable with ten

million in the asset called accounts receivable, which are created by credit sales during the previous days or weeks.

A B/S is for a point in time

Amounts might differ appreciably the day before or after the time of the B/S. Some companies actually “dress up” their B/S so it looks nice the instant the accountants “take the picture”.

Accounting “value” vs. market value

Current value accounting may result in numbers on a balance sheet approximating market value. The historical B/S will match market value of assets by sheer accident. However, market prices for assets, liabilities and share value are the variables of interest in economic analysis. For example, the decision to reduce liabilities focuses on the actual cash needed to extinguish the liability. Analysis of using owned land for a development should capture the opportunity to sell and realize the value of the land – not the numbers on the B/S.

SOI

The SOI reflects the results of using the assets for a period of time. Net income is the bottom line on the SOI. A simplified SOI is shown below:

Revenues (sales)	\$\$\$\$\$\$\$\$
– Cost of goods made	– \$\$\$\$
– Other costs	– \$
Operating income	\$\$\$
– Interest	– \$
– Taxes	– \$
Net income	\$

Accrual accounting

This guides the construction of the SOI. Accrual accounting recognizes specific events without regard to the flow of cash. Selling a product results in recognition of “revenue” rather than a collection of cash event. A revenue collected during the period flowed into cash. A revenue not yet collected remains as an asset – a receivable – on the B/S. For example, an aircraft manufacturer may recognize revenue when the customer accepts delivery. If the customer has 90 days to pay for the plane, the manufacturer’s SOI may reflect the sale of a jumbo jet even though they have not received a penny in payment.

The matching principle

When a company has costs during a period, the matching principle dictates matching these costs with the revenue recognized because of the cost. Recall, in accrual accounting the incurring of a cost is independent of the cash flow to pay for the cost. A cost not yet paid remains as a liability on the

B/S. When we pay our bills with cash, the cash account decreases and we remove the liability from the B/S.

A matched cost is an expense for the period. A cost that does not match with revenues in one period must be an expense in some other period(s). Recognizing the expense in that other period preserves the matching principle by matching the expense with the revenue of that period.

Relating the SOI to the B/S

In the simplified SOI statement, notice that the portion of the SOI from revenues to operating income – sometimes called NOI for net operating income – captures the results of operating the assets and interaction with markets – the results of using the assets listed on the B/S. Some call NOI “earnings before interest and taxes” or “EBIT”.

Proceeding from NOI to net income, note the subtraction of interest and taxes. This portion of the SOI captures the effects of financing and taxes. The net income reflects the joint effects of operations and financing and taxes.

Remember, the SOI is cast on the accrual basis. For example, a tax expense for the period does not mean the company has or actually will pay that amount in taxes in the period – and possibly not ever[2].

Net income and “retained earnings”
Accountants add the net income number – not cash – to the “retained earnings” account in the equity section of the balance sheet. This is the tie-in between the SOI and the B/S. The B/S still balances since: if revenues turned into cash, the dollars are in cash, passed from cash to new assets, or the company used cash to pay off liabilities or dividends; if revenues did not yet convert to cash, they appear in the form of an asset, accounts receivable, on the B/S. Since “retained earnings” confuses many, the Appendix provides a simple illustration of important issues.

Accrual income and cash flow match only accidentally

One recognizes net income (or loss) independent of cash flow events. A company can have high income for a period but no cash flow – or report massive losses for a period and have considerable cash flow. A company needs cash flow for survival. In addition, a clear understanding of cash flow vs. accrual events is important in economic analysis.

Statement of cash flows

The statement of cash flows (SOCF) – in some countries called “consolidated

statement of changes in financial position” – explains the change in the level of cash between two points in time. In the process of achieving this objective, the SOCF details where money – as opposed to earnings – came from, and what happened to the money. First, an overview and some logic. Then, an appreciation of the construction of the SOCF.

Let us think first about sources and uses of money or funds. We get money by selling product and then collecting cash from the receivable, by selling assets, or from the capital market by borrowing or issuing stock. We use money for paying costs including interest and taxes, to buy assets, to pay liabilities, or to pay dividends or buy back our own stock.

If the cash collected on the product sold exceeds the cash costs of making the product, we have a positive cash margin. We are generating cash in the period.

Without advanced maths, if cash collections on the sale of a product are less than the cash costs of making the product, we are using or eating up cash. Over the long term, a company exists to generate positive cash margins that exceed the cost of capital – and thus create value.

The previous paper discussed investing and disinvesting working capital. For example, if we sold a product and have not collected on the sale, our money remains invested in the asset accounts receivable. Armed with this and other notions from that paper, let us examine a simplified sketch of the SOCF marking our non-standard notes with ***. The overview of the SOCF is as follows:

- Cash flow from operating activities (COA)
 - Selling with positive margin and collecting cash ***.
 - Investing and disinvesting from working assets and changes in spontaneous liabilities[3] ***.

Net cash flow provided by (used in) operations:

- Cash flows from investing activities (CIA).
For example, buying or selling capital or other assets.

Net cash flow used in investing activities:

- Cash flows from financing activities (CFA).
For example, selling new stock, paying off debt, paying dividends.

Net cash flow provided by financing activities:

- Reconcile beginning and end of period cash.

The first section tells us about operations. Note “net cash flow provided by (used in) operations” reflects two very different types of event. Selling and collecting with a positive margin is potentially a repeatable action generating positive cash returns. Disinvesting from (selling) assets or using up spontaneous debt capacity is a one-time event. By selling down assets, a company could report positive net cash flow provided by (used in) operations even though it was selling/collecting a product with a negative margin.

Managing net working capital in terms of investment and disinvestment is very important. Selling product and collecting with positive cash margin is critical to survival and to the creation of value.

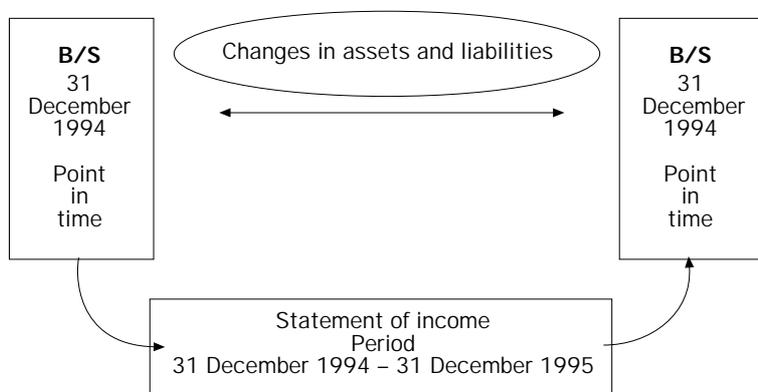
The second and third sections tell us about investing and financing activities, reflecting changes in assets and liabilities and equity. Paying out a dividend on equity stock is a financing activity – essentially the reverse of obtaining new money from equity by issuing new shares of common stock.

The overview for the SOCF

The SOCF tells us where we got money and what we did with it. To construct the SOCF we need two B/Ss and the statement of income for the period between the dates of the B/S. Figure 1 depicts the scheme. Let us sketch the major steps.

The SOI is on an accrual basis. The adjustments to cash flow involve two major steps.

Figure 1
Statement of cash flows



Note: Balance sheets (B/S) show assets and claims against assets – liabilities and equity – at points in time. The statement of income (SOI) reports the results of activity (profit or loss) on an accrual basis for the period between those points in time. The statement of cash flows (SOCF) reconciles beginning of period cash with end of period cash. The reconciliation method reveals: cash from operating activities – selling product and collecting cash from the receivable as well as changes in net working capital; cash flows involving investment and financing activities

- 1 Net income + add-back non-cash flow expenses such as depreciation deducted in arriving at net income.
- 2 Capture the effects of accrual items on the SOI that have not yet become cash flows. For example, we sold some product and recognized the sale as a revenue but it has not yet turned into a cash collection. This sale remains as an accounts receivable (A/R) and causes the A/R amount to increase representing a use of operating funds – namely, the investment into the working asset, A/R.

Consequently, comparing the levels of assets and liabilities between two points in time from two B/Ss and use of the SOI – with adjustments for non-cash expenses – for the period of time allows us to determine the cash flow effects for the period. A subsequent paper will illustrate the value of information provided by the SOCF.

“Tax books”

Rather than complicate the issues, let us just make some points about accounting for tax purposes. Tax regulations and financial reporting have different objectives. Hence the treatment of some events for tax purposes is different from its treatment for financial reporting. At this stage, we just want to remember that such differences exist. Here are two examples.

The life over which we depreciate an asset for tax purposes as well as the depreciation expense in a period usually is different on the tax books. Hence, income on the tax books is different from income reported on the public financial statements.

Often the tax expense for the period on the tax books as well as the actual taxes paid (cash flow) differ from the tax expense shown on public financial statements. Differences in depreciation expense mentioned above is just one reason that may cause this. A difference in the tax expense on the public reports from the tax expense on the tax statements for the same period of time will alter the number in the “deferred tax” account on the B/S. For now, we will just remember that the “deferred tax” is a liability reflecting the difference in timing of the recognition of tax expense for financial reporting versus tax reporting.

Managerial reports

Companies also have internal reports that differ in format and content from public

financial reports and the tax books. As we continue in the series, you will recognize the information that your internal reports should include.

We recognize the general criteria for managerial reports: *Managerial accounting should provide in lucid form the information needed to support analysis, decision making, management and control to create value.*

Accrual versus cash flow

Managers must carefully distinguish between accrual accounting events and cash flow or economic events. Accounting has certain objectives. Economic analysis has other objectives. Do not confuse their objectives or use. Let us illustrate the difference between cash flow and accrual by examining the operating cycle discussed in the first paper of the series. Figure 2 provides details for our discussion.

We sell product, recognize revenue and influence reported income when we reach the point of value. The sale is on credit and thus creates an accounts receivable (A/R). However, on a cash basis some days may pass until the customer pays us and the A/R converts to cash.

Break-even illustration

Break-even (BE) – discussed in more detail below – provides one example illustrating the impact of the difference between cash flow and accrual. When “revenues” = “all

costs”, we are at accrual break-even. When cash flow in a period = cash flow requirements for costs, we are at cash flow break-even. Since the timing of the recognition of accrual income often differs from the collection of cash, accrual and cash flow break-even often occur at two different points in time in the operating period. Importantly, recall that accrual recognition of revenues and costs are accrual entries. Paying bills – as opposed to incurring costs – requires (and is itself) a cash event.

Separate from the timing of achieving break-even, the sales needed for accrual vs. cash flow break-even normally differ. Accrual expenses often include non cash flow items such as depreciation. Thus accrual break-even usually is greater than the cash flow break-even.

Managerial accounting

A few key accounting concepts support decision making and management. Using simple illustrations, we focus on depreciation, types of cost, relevant costs and contribution margin.

Depreciation

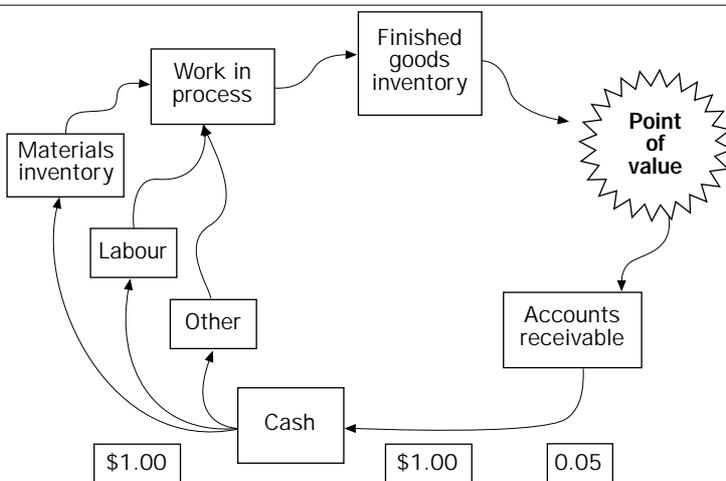
An example illustrates this notion. We buy equipment for \$200, paying cash now. The benefits of ownership will extend beyond the current period and expensing the full \$200 now would violate the matching principle. Instead, we capitalize the asset and place it on the B/S. The asset cash decreases by \$200 and the asset equipment increases by \$200 and we preserve the (assets = liabilities + equity) relationship.

During its life, we will use up the economic worth of the machine. Assume a ten-year life. With “straight-line depreciation”, we would recognize \$20 per year as depreciation expense on the SOI. This matches the “using up” of the equipment against the revenues realized partly because of this equipment. This depreciation is not a cash flow. The cash event occurred when we purchased the equipment.

In theory, depreciation for a period is the recognition of, then the “using up” of the economic worth of an asset. In actuality, we may use up the value of the asset faster or slower than the depreciation amount. In a subsequent paper, we will focus on important details of depreciation. For now, realize:

- Depreciation amounts may not equal the actual economic decline in asset value.

Figure 2
Operating cycle



Note: The \$1.00 is the variable costs invested in a unit of product. The unit is sold for \$1.05 creating an accounts receivable of \$1.05 per unit. The customer pays. Of the \$1.05, \$1.00 is a return of capital. The \$0.05 is a gross return on capital. The \$0.05 is the contribution margin that contributes towards covering the total dollars of fixed costs

- Depreciation amounts in a period for the same asset often differ on the financial reports compared with tax reports.
- Depreciation is deductible on the financial statement of income and normally on the tax statement of income. Although not a cash flow, depreciation for tax purposes saves on taxes. Reducing tax payments is a cash flow event.

Types of costs

Fixed costs

Fixed costs (FC) are those costs we have in a period even if we do not make or sell any product. Real estate taxes, insurance, a portion of utilities, some salaries and depreciation are samples of fixed costs. To achieve break-even, the company must “cover fixed costs” as well as costs that occur only because it makes product. Remember, since some fixed costs are non-cash flow – like depreciation – having enough cash to cover cash fixed costs is not the same as having enough accrual revenue to cover accrual costs which include non-cash costs.

Allocated fixed costs

For various non-economic reasons, accountants take the total dollars of FC for a period, somehow divide them into little pieces, and then allocate the fixed costs to different levels of the organization and to individual projects. The allocation of FC is a non-economic event that successfully confuses many. Burn this into the economic side of your mind: *total dollars of FC the company will pay are very relevant. Allocated FC are irrelevant in economic analysis and decision making.*

Variable costs

Variable costs (VC) occur only if we make a unit of product. At some point in time we must make a cash payment for all variable costs. VC end up being cash we must pay only because we made a unit. Examples of these are: materials, energy and labour costs incurred only because we make units. Allocated overhead or “burden” is not a VC even though the amount accountants allocate may vary with volume, sales or some other factor. The total dollars of FC are very important – and we will capture FC costs in our analysis.

Sunk costs

These are costs already incurred even if we have not yet made cash payment. Hence they are not relevant in decisions related to incremental or forward looking decisions. Considering sunk costs can lead to poor economic decisions. For example, a manager considers

investing more money into a machine that is unlikely to meet demands because “we have invested so much in it already – it seems a shame to not get it running”. In economic terms, the shame would be if more good money were thrown after the bad.

Opportunity costs

These are costs associated with an alternative. For example, we may have currently unused land written on the B/S in the amount of \$30. If currently we could sell the land and net \$70 after tax, the opportunity cost of keeping the land is \$70.

The capital cost

This is the cost of having capital available for use. Normally one characterizes capital cost in terms of an annual percentage. A paper in this series will focus on the “cost of capital”.

The concept of contribution margin

The concept of contribution margin (CM) is critical in the creation of value. Understanding and grasping its significance supports the understanding of BE calculations, important elements of risk, pricing strategy and a host of issues we will address in detail in future papers.

CM = revenues – variable costs.

FC are not in this expression. We state CM on a per unit or as a percentage of revenues. As an example, suppose making a unit has VC of \$1.00 and we sell it for \$1.05.

CM = \$1.05 – \$ 1.00 = \$.05/unit
or \$.05/\$1.05 = 4.76%.

Figure 3 illustrates the relationship between CM, total FC of \$1.80, BE and pre-tax profits. CM contributes towards eating up FC. If CM = FC, we are at BE. Loss = the amount by which CM failed to eat up the FC. CM from units above BE contributes to profits.

Armed with the notion of CM, BE analysis is straightforward. Calculate the CM per unit. Determine the units needed to generate the CM that will just cover the FC – always ignoring allocated FC in the calculation.

CM: critical issues

CM plays an important role in many economic decisions. To illustrate an example of the use of CM and the break-even relationship, consider this scenario: lower VC per unit and CM per unit increases. Now we need fewer units to reach BE. In addition, once we are past BE, profits grow at a faster rate.

Once “plant and equipment” and attendant FC are in place for a period, the strategy is to

maximize total CM given risk is held constant. Detailed explorations of risk, return and valuation are deferred, to a future paper.

Normally, CM is a crucial factor in economic analysis and strategy for several reasons. It is important in:

- providing the basis for pricing products and services including the relative pricing of substitute products;
- pricing and marketing strategy in markets having elasticity of price-demand;
- assisting in evaluating the risks associated with the acquisition of capital assets;
- process design and construction of new facilities that must produce products for markets offering uncertain demand;
- assessing the risk-return trade-off between variable costs of producing product and the fixed costs associated with the productive process;
- the evaluation of incremental sales;
- evaluating alternative strategies with respect to the effect on break-even, risk and value;
- providing a critical role in pricing when the opportunity to sell an incremental unit expires, e.g., a seat on an aeroplane that will depart soon;
- market strategies;
- bidding for incremental business;
- risk management with respect to the behaviour of competitors.

Economic versus accounting issues

Economic analysis focuses on cash flow events that result from pursuing a particular course of action. If the time and risk-adjusted cash returns on invested capital exceed the opportunity cost of capital or appropriate cost of capital, we create value. The popular terms for the value expressed in today's dollars of created value is "economic value added" or shareholder value added. By the time we finish this paper series, you will be familiar with the concepts. Recognizing the importance of the difference between economic (cash flow events) and accounting (accrual events) is just one of the puzzle pieces. For now, accept this essential element of economic analysis: economic analysis captures cash flow events that will occur only as a result of pursuing a particular course of action.

Economic profits, risk and value

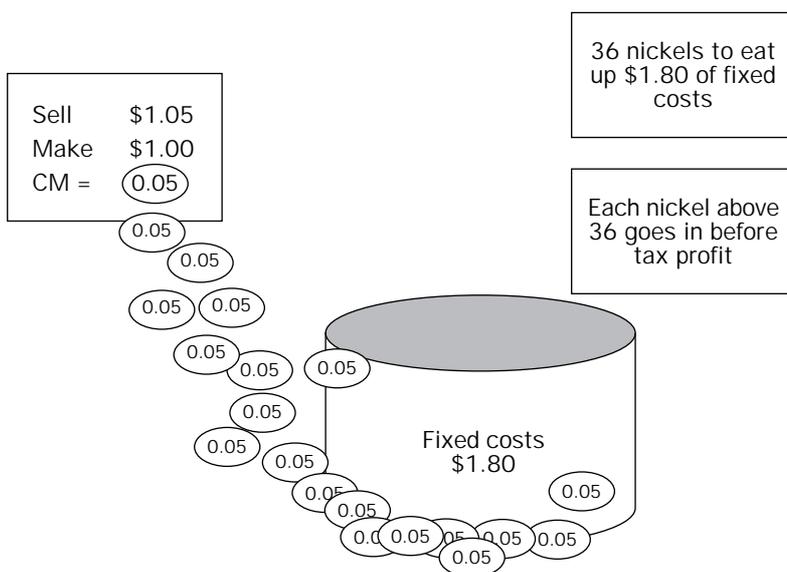
The following discussion makes certain assumptions: People value assets based on perceptions. It is perceptions rather than the objective facts that dictate human behaviour. Human behaviour affects the valuation of assets. People value what they expect to get. They would rather have more of something good than less. The uncertainty of receiving a future benefit influences the value people assign to an asset. These concepts support the relationships between risk, profits and value.

Figure 4 summarizes relationships between risk, expected economic profits and value, holding constant other factors such as the price of bearing risk. We add the following points.

- The greater (less) the perceived risk of the expected benefit – expected cash profit – the less (more) its perceived value.
- An equal increase or decrease in perceived risk does not have the same dollar change on value. The relationship between risk and value is non-linear. Details on this will be deferred to a future paper.
- If we can have the same expected profits with less risk, we term the risk eliminated as unnecessary risk.

In a future paper, the concept of cost of capital will be illustrated. At this stage we can relate efforts to the creation of value. We create or add value if the economic profits net of all economic costs – including taxes – provides a time value cash return that

Figure 3
Break-even



Note: Total fixed costs are \$1.80. Variable costs to produce a unit are \$1.00 and the sales price (revenue) per unit is \$1.05 Contribution margin per unit, CM = \$1.05 – \$1.00 = \$0.05

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exceeds the cost of capital associated with the financing of our activities.

Summary

This paper provided a review of accounting and the economics of the business cycle important to the professional regardless of functional area of expertise. It focused on critical issues of import to the manager in his/her quest to create value. It offered perspectives and reviewed relationships that will assist the manager in analysis, decision making, management, and in the persuasion and motivation of others. It emphasized critical differences between accounting and economics in just those areas that will be important as we continue the series of papers.

“... We create or add value if the economic profits net of all economic costs – including taxes – provides a time value cash return that exceeds the cost of capital associated with the financing of our activities...”

Knowledge of limitations of both accounting and economics prepare us to make better decisions and to manage to create value.

The paper offered perspectives on financial statements of professional as well as personal interest. It explained some crucial differences between accrual accounting versus cash flow. It focused on key concepts in managerial accounting related to types of cost, the concept of depreciation, contribution margin, and break-even. The paper

emphasized the role of economic contribution margin and explained break-even in a manner requiring no memory of equations. Last, it characterized the basic relationships between economic profits, risk and the creation of value.

Notes

- 1 For interest, the ordering on the balance sheet in some countries, in companies such as utilities, is “backwards”. For example, “plant and equipment” appear first under assets.
- 2 For a variety of reasons related to the difference between the calculation of taxes for the tax books versus the tax expense for public or financial reporting, a company may defer a portion of taxes for a long time or forever.
- 3 Spontaneous liabilities are those liabilities that “automatically” increase or decrease with company activity. For example, if the company begins to produce more and hence buy more raw materials, then the accounts payable (A/P) increase. As you recall, A/P represents short-term credit provided to us by others without an explicit interest charge.

Appendix. Retained earnings, dividends, cash flow

Equity accounts

The equity accounts on the balance sheet normally include:

Common stock account (at par)	\$2
Capital paid in excess of par	\$8
Retained earnings (RE)	\$20

The company originally sold two shares of stock @\$5 per share, each share of par value \$1.00. The excess over par ($\$5 - \$1 = \$4$) is logged in “capital paid in excess of par”. No money went or ever goes into any of the above accounts – nor can you take money out of these accounts. The cash from selling two shares at $\$5 = \10 went into the asset account, cash. The \$20 number – not cash – in RE represents the recognition of net income cumulated from all past periods net of a reduction in the number for dividends declared. Let us trace the accounting and cash flow events.

Declaring and payment of dividends

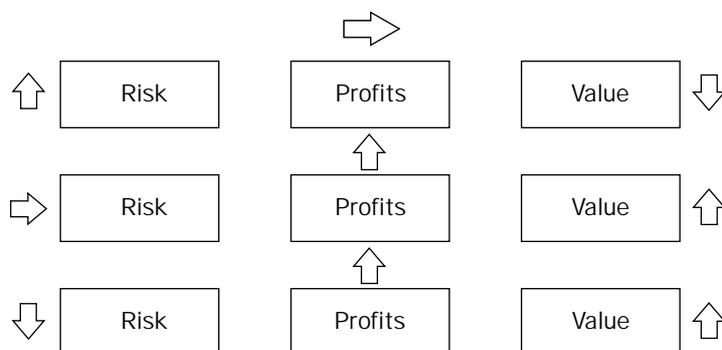
Assume:

Beginning of period RE	= \$20
Earnings for the period	= \$7
Dividends declared during the period	= -\$3
End of period retained earnings on B/S	= \$24

- 1 Before the directors declare a dividend.
Assets = liabilities + equity (includes RE)
 $\$42 = \$15 + \$27$
- 2 Board declares a dividend of \$3, not yet paid. New liability: declared, unpaid

Figure 4

Risk, economic profits and value



Note: Economic profits are cash profits. As perceived risk increases, market assigns lower value. If perceived risk remains constant and expected profits increase, market assigns higher value. A decline in perceived risk with an increase in expected profits results in dual additions to value

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dividend = \$3 and RE amount reduced by
 \$3. These are accounting, not cash flow
 events.

Assets = liabilities + equity (includes RE)
 \$42 = \$15 + \$27
 +\$3 + -\$3 (reduce number
 (declared, in RE)
 unpaid
 dividend)

3 Date of payment of dividend. Cash flow
 event.

Assets = liabilities + equity (includes RE)
 \$42 = \$15 + \$27
 +\$3 + -\$3 (reduce number
 (declared, in RE)
 unpaid
 dividend)
 -\$3 = - \$3 (the \$3 taken out
 of the asset cash is the cash flow
 event)

Assets = liabilities + equity (includes RE)
 \$39 = \$15 + \$24

Application questions

1 Should basic accounting knowledge be
 part of every manager's toolkit? Can value
 management and creation be understood
 without it?

2 If your organization's management infor-
 mation was reduced to five ratios, what
 would they be? How often would the infor-
 mation be updated?