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Profits of a Corporation: A paper read before the Congress of Accountants, at St. Louis, on September 26, 1904

Arthur Lowes Dickinson

The Profits of a Corporation.

A PAPER READ BEFORE THE CONGRESS OF ACCOUNTANTS,

AT ST. LOUIS, ON SEPTEMBER 27, 1904.

(Second Edition).

By

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PRELIMINARY.

The subject selected for this address must always rank among the most important with which the Accountant is brought in contact, and as such it has been deemed deserving of the consideration of the first general assembly of Public Accountants to be held in this country.

Its adequate discussion involves a brief reference to the nature of Profits and Losses in the abstract, followed by a consideration of the legal and accounting principles relating thereto in the case of corporations; and of the practical application of these principles to ordinary commercial transactions.

DEFINITION OF PROFITS.

In the widest possible view, Profits may be stated as the realized increment in value of the whole amount invested in an undertaking; and, conversely, Loss is the realized decrement in such value. Inasmuch, however, as the ultimate realization of the original investment is from the nature of things deferred for a long period of years, during which partial realizations are continually taking place, it becomes necessary to fall back on estimates of value at certain definite periods, and to consider as Profit or Loss the increase or decrease between any two such periods. Hence, it follows that, as stated in Buckley's treatise on the English Companies' Acts, "the ascertainment of Profit is in every case necessarily a matter of estimate and opinion. * * * The legitimate way is to take the facts as they actually stand and after forming an estimate of the assets as they actually exist" (and presumably, although it is not so stated, of the liabilities) "show a balance so as to ascertain the result in the shape of Profit and Loss."

This definition would permit any business concern to revalue periodically the whole of its assets and liabilities and to record the difference between its surplus so ascertained at the commencement and the end of the year as its Profit or Loss, respectively; and provided that this estimate were fairly and reasonably made, there would be no objection to such a course. In other words, every appreciation of assets is a Profit, and every depreciation a Loss; and in many private concerns this method, technically known as "Single Entry," of ascertaining Profits has been regularly adopted for years without bad results. A corporation, however, being endowed by Statute with special privileges is subject to special restrictions, among others that of a definite fixed Capital Stock upon which dividends are declared out of the Profits of the undertaking. Hence, the consideration of Profits as applied to a corporation involves the consideration also of the limitations placed either by law or by sound principles of accounting upon their distribution as dividends. It is in the legal interpretation of the term Profits of a corporation (which has come to mean Profits available for dividends), and in the distinction between the strictly legal and conservative accounting view of the principles upon which they should be ascertained that the difficulties of the subject chiefly lie.

LEGAL PRINCIPLES.

The law, represented mainly by Case Law, has considerably modified the definition given above; and as up to the present time a larger number of cases have been decided and more definite results arrived at by the English than by the American

Courts, it will be useful here to consider briefly the present condition of the English Law on the subject. The decisions given there have been based on the principles of Common Law rather than on statutes relating to corporations, and these decisions are freely quoted in American text books, which though in slightly different form appear to arrive at substantially the same conclusions. The summaries which follow are given with some hesitation in view of the difficulty of extracting definite principles from a number of more or less conflicting decisions, but they will at any rate serve to illustrate the difficulties which have to be met.

ENGLISH LAW.

The regulations of a corporation in England usually provide that no dividends shall be paid except out of *profits arising from the business of the corporation.* In order to carry on its business a corporation requires certain Capital or Fixed Assets, which must be maintained in a reasonable state of efficiency as long as the business continues; while its Profits or Losses arise from the employment of its Fixed Assets in continuously changing the condition of its Current or Circulating Assets from one form to another, and consist of the difference between the realizable values in the final and in the original condition, subject to deduction of the cost of the change and the expenses of realization.

Changes in the value of Capital Assets are not generally realizable during the continuance of the business, and hence in the determination of Profits available for dividend under the above regulation no increment in the value of its Capital Assets can be considered; but it would seem to be legally permissible to divide among Stockholders as dividend a realized profit on the sale of a Fixed Asset if there were no depreciation on other Fixed Assets to be made good. On the other hand, it is not necessary to charge Trading Profits with any decrement of value not due to causes arising directly out of the business; but any waste of Fixed Assets taking place in the operation of deriving Profits out of the Circulating Assets must generally speaking be made good out of profits. There is, however, an exception to this rule when the constitution of the corporation contemplates the investment of its Capital in certain specified Wasting Assets—such for instance as Mines—and its regulations do not call for any provision out of Profits to replace this waste by means of a Sinking Fund or otherwise; in such cases the English Courts have held that there is no legal obligation to charge the waste against Profits earned from the operations. But this exception does not cover depreciation of Capital Assets due to wear and tear which has not been, but must at some future date, be repaired if efficiency is to be maintained. In the case of Circulating Assets the position is different. The enhancement in the value of these Assets being the source of the Profits of the business, it is necessary and the law requires that they shall be maintained intact, and that only the surplus realizable in excess of the amount invested is Profit; or, conversely, that any deficit is a loss.

The exact distinction between Capital and Current Assets depends necessarily on the nature of the business of the corporation. What are Capital Assets for one business may be Current Assets for another, according as the business of the corporation is to make a Profit by using them continuously in their existing shape or by converting them into some other shape. For instance, if a corporation owns investments for the purpose merely of collecting the dividends thereon, and dividing these among its stockholders, it is not legally bound to make good out of Profits a fall in the value of the investments. But if its business were to traffic in investments, or if it were in fact trafficking in them, any fall in value would be a Loss, and any rise in value a Profit, chargeable or creditable to Profit and Loss.

Apart from the distinction between Capital and Current Assets the following legal principles would seem to be fairly established:

The ascertainment of Profit being necessarily a matter of estimate and opinion, all that is required is that the estimates be fairly and honestly made without any fraudulent intention or purpose of deceiving any one, and that they conform to the constitution of the corporation.

The payment of interest to Stockholders before any Profits have been realized is stated to be *ultra vires;* but interest paid on borrowed Capital employed in the construction of Works, and in the meantime unproductive, may be properly chargeable to Capital Account; and it is perhaps doubtful (although there appears to be no decision on this point) whether under such circumstances interest might not be paid to Stockholders and charged to Capital if the regulations expressly provided therefor.

It also seems probable that a corporation having made a Loss on the operations of previous years, and commencing the year with a deficit in its Circulating Capital, may legally distribute dividends to its Stockholders out of current year's Profits without making good such deficit. In one recent decision on this point a deficit of previous years is treated as a Loss of Capital Assets, and it is stated that the Capital having been lost a distribution of subsequently earned Profits cannot be a payment of dividend out of Capital that had been previously lost.

AMERICAN LAW.

The general law of this country as laid down in the chief text books is based, as before stated, to a considerable extent on the decisions in the English Courts referred to above.

Dividends can be paid only out of Profits—*i. e.*, out of the net increase in the original investment after deducting from the Assets all present debts and making provision for future or contingent claims reduced to their present value. But in arriving at this increase the permanent or Fixed Capital may be valued at the price actually paid for it, although at the time of estimating said increase it could only be sold at a loss. All that is required is that the whole capital originally contributed by the Stockholders shall be put into the business and kept there, and that no part of it shall be taken out again directly or indirectly and given back to them. On the other hand, any depreciation due to wear and tear arising out of the use of the Fixed Assets must be made good out of earnings before the surplus can be applied to the payment of any dividend unless these Fixed Assets are of a wasting nature, such as Mines. There seems also to be a concensus of opinion that dividends can only be paid out of the surplus Profits derived from the use of the Capital of the company for those purposes for which the corporation was constituted.

The Statute Laws vary in every state, but the above principles seem to apply generally, with the exception of certain classes of business governed by special laws ;—such as Banks, which may not pay dividends out of interest accrued, but not received, however well secured, and Insurance Companies, which may not distribute unearned premiums ; and in Connecticut it has been held that if at the time of declaration of a dividend the property is not actually worth the par value of the stock which was issued for it, the dividend is illegal.

ACCOUNTING PRINCIPLES.

From an accounting standpoint, perhaps the only exception that can be taken to the law as at present interpreted is that the latter does not require the maintenance of Wasting Fixed Assets which are used up by slow degrees in the process of earning Profits. On practical if not on theoretical grounds, the principle must be accepted that a decrease in value of Fixed Assets not of a wasting character arising otherwise than in the process of earning Profits need not be provided for. It is true that in the long run all shrinkage of these Assets is a Loss, and that no Profits can be earned over the whole life of a corporation unless its Capital, both Fixed and Circulating, is maintained intact. But the changes in actual values of Capital Assets due to lower range of prices, introduction of improved processes of manufacture, etc., may be so great and at the same time so indefinite, and the actual realization thereof is as a rule deferred to such distant periods, that it becomes quite impracticable to provide for it as a direct charge against Profits; although it is a prudent course to accumulate a sufficiently large Reserve or Surplus Fund, and to make such liberal provision for Depreciation, as will insure the integrity of the Investment and provide ample funds for keeping it continually in the highest state of efficiency.

The sound accounting principles for the determination of Profits may be summed up as follows:

(1) All waste, both of Fixed and Circulating Assets, incident to the process of earning Profits by the conversion of Circulating Assets must be made good out of the Profits earned.

(2) Profits realized on sales of Fixed Assets should be first applied to make good estimated depreciation (if any) in other Fixed Assets not resulting from the ordinary conduct of the business. If there is no such depreciation, such Profits may be distributed as dividends, but should be distinguished from the Operating Profits.

(3) A sufficient surplus should be accumulated (in addition to the provisions required to maintain Wasting Capital Assets under Clause 1) for the purpose of making good Losses due to shrinkage in values of Fixed Assets arising from causes other than the ordinary operations of the Company.

ACCOUNTING PRACTICE.

Turning now to the practical, as opposed to the theoretical view of the question, it will be useful to consider the different elements which enter into the determination of the Profits of a corporation from the point of view of the maintenance of Assets, discussing shortly the principles of valuation which should be adopted for the various Assets and Liabilities in a Balance Sheet, and the effect which each would have on the Profits. If the Balance Sheets at the beginning and end of a period are theoretically and practically accurate, and show the true financial position at those dates, the increase or decrease of the surplus, after allowing for distributions of Profit during the interval, represents the true Profit or Loss for the period. The different captions will be dealt with in the order in which they would usually be stated.

CAPITAL OR FIXED ASSETS.

These would in general consist of one or more of the following classes: Real Estate, Buildings, Plant, Machinery, Tools, Patents, and last but not always least, Goodwill and Franchises.

REAL ESTATE, BUILDINGS, PLANT, MACHINERY AND TOOLS.

Dealing with the first five items it may be stated generally that it is not proper for a corporation to take credit for a Profit, nor on the other hand is it necessary for it to charge itself with a Loss, arising out of a revaluation of such items as long as they are in actual use for the purposes of the business; but here it should be noted that if the business includes among its objects the purchase and sale of Assets of this class they should then be considered not as Fixed but as Current or Circulating Assets, being in fact stock in trade, the turning over of which is expected to result in Profits or Losses to the company. The Fixed Assets now under consideration are those which during the life of the business will remain, whether in their present or some other shape, in a permanent condition, provided that due provision is made for wear and tear or other waste due to operations.

DEPRECIATION.

This raises an issue of great importance, so far as profit is concerned, in dealing with this portion of the company's property. As distinct from fluctuations due to rise or fall in values, there is continually in progress in the case of all property except land a waste due to the use of these properties for the purpose of earning Profits. In accordance with the accounting principles already laid down, this waste must be provided for out of the resulting Profits, or if there have been no Profits, the Losses are really so much more by the amount of waste resulting from the operations.

No provision as a rule requires to be made for depreciation of Real Estate, except in the case of Leaseholds, Minerals, Timber or other similar property. A purchase of Leasehold Property is in effect a payment of rent in advance, and the equivalent rent on an actuarial basis should be charged each year against Profits.

In the case of Minerals, the product taken out of the land becomes the stock in trade of a corporation as soon as it is extracted, and whatever the land was worth before its extraction it is clearly worth an appreciable amount less thereafter. The provision to be made should be on the basis of the number of tons extracted, having regard to the total tonnage available and to the realizable value of the property after the Minerals have all been extracted. The same principle would also apply to timberlands, where no provision is made for re-foresting. The contention is sometimes made that no provision need be made for exhaustion of minerals where the amount of mineral known to be in a definite tract at the end of any period is largely in excess of that which had been discovered at the beginning of the period. This argument cannot, however, for a moment be admitted except as a reason for reducing the tonnage rate to be provided. As a general principle, whatever there was in the land, whether known or unknown, has been reduced during the period under consideration by whatever amount has been extracted ; and while the new discoveries may be accepted as reducing the necessary rate of provision for extinction from (say) one dollar to one cent per ton, the original principle that provision must be made holds good on the smaller figure, whatever it is. It may be, of course, that the provisions made in earlier years have been sufficient to cover a number of future years on the basis, from the commencement, of the rate subsequently found to be sufficient in view of the new discoveries, and in this case there is obviously no necessity to provide further for extinction until the total production at the new rate is equal to the total amount written off.

It would be beyond the scope of this paper to discuss what the different rates of depreciation on different classes of property should be, but it is necessary to emphasize the fact that however long the life of the buildings or plant, and however much may be spent year by year in the actual upkeep thereof, there must be a gradual depreciation in value, due either to direct wear and tear or to the necessity of replacing old and obsolete articles by new and up-to-date ones. It is probable, however, that in any going concern which is maintained in an efficient condition there is a limit to the total amount of this depreciation as between original cost and present value ; in fact, the theory that any piece of machinery or any building continues in use until it reaches an absolute scrap value is not in accord with practical experience, taking any plant as a whole. When the plant is entirely new it may properly be considered as being worth its cost. It will never again attain this standard, because never again will the whole of it be absolutely new ; on the other hand, it can never fall below a certain percentage of this standard without becoming so inefficient that it could not be operated at all. Between these limits, therefore, would seem to lie the total amount of depreciation to be provided out of earnings over a long period of years, assuming that all renewal expenditure tending to increase the life of the plant is charged against the depreciation so provided. It is submitted that perhaps the most satisfactory way of making such provision is in the first instance to estimate the life of the different Assets, assuming that ordinary recurring maintenance and renewal charges are provided out of Profits as they occur, and to set aside each year the corresponding proportion of the original cost, crediting the same to a depreciation fund. From time to time expenditures which may be termed "extraordinary renewals" or "periodical renewals" will require to be made, which from their nature increase the original life of the plant. These should be charged against the fund provided. In this manner an equitable charge would be made against earnings each year to represent the amount of wear and tear that has accrued during the year. In many cases, in place of a basis of life in years, one in tons operated will be found preferable, in which case the charge against Profits would take the form of a rate per ton of production rather than a rate per year of life. There are other methods in force for properly providing for this wear and tear, but there is one method which it may safely be stated is an entirely erroneous one, and that is to set aside such sums as the Directors may decide upon out of the Profits of each year upon no definite basis whatever. A decision as to the period at which the necessary charge should be made against Profits must be admitted to be largely within the discretion of the Managers, for the reason that they have to consider not only sound principles of accounting, but also policy; but it is not inconsistent with this proposition, and is certainly more scientific, to adopt a sound and conservative basis in the first instance and create in the books a subsidiary Suspense Account of the proper amount each year which would be discharged by appropriations made from time to time out of surplus Profits. Such a course is, however, at best, a makeshift and it is the duty of all Accountants, though they cannot compel, at least to urge, corporations to make adequate provision for depreciation each year.

PATENTS, GOODWILL AND FRANCHISES.

The remaing items included in Capital Assets, viz.: Patents, Goodwill and Franchises are very much akin to one another. Theoretically it would seem that if a patent be granted for a term of years the amount paid for it should be written off against the Profits earned during those years. But practically it is found that by the time the original patent has expired the corporation may have built up a practical monopoly, or at any rate such a lucrative business that the original cost of the patent is now replaced by the admitted value of the goodwill. Moreover, it is seldom the case that one patent stands by itself; during its life probably many others have been taken out representing modifications which extend the life of the original in an improved form, and these may have cost small sums as compared with the very much larger cost of the original.

Goodwill represents the value of the trade name, business connection and organization of the corporation's undertaking. As long as the earnings of the business are maintained at not less than the level contemplated at date of purchase, it is impossible to allege any depreciation of value or the necessity of any provision therefor. On the other hand, if any serious depreciation has taken place, the Profits are probably so much reduced that it is not possible to make such provision. Goodwill is in fact a Fixed Asset whose value is to some extent dependent upon the profits earned, its fluctuations being consequent upon and not a cause of the earning of Profits, as are Wasting or partially Wasting Assets, and not therefore to be taken into account in ascertaining them.

Franchises may be either perpetual or for a fixed term. In the former case, the same considerations would apply as in the case of Goodwill. In the latter case, they may be renewed or terminated at the expiry of the fixed term, and prudence would dictate a reasonable provision each year out of Surplus Profits, although no definite amount may be ascertainable.

Provided therefore that the wise policy is followed of writing off at once all expenditure on new patents which do not turn out useful, or which supersede or modify older ones, and provided also that the principle is admitted of building up a substantial reserve fund against whatever portion of the Capital is invested in this class of Assets, it would seem reasonable to merge the three items into one and treat them as part of the permanent invested Capital of the business, which may be left to continue at its original value as long as the business is a going concern.

CAPITAL EXPENDITURE.

In completing the survey of the conditions so far as regards Capital Assets, it is well to consider what expenditures may reasonably be added to the original investment of Capital, instead of being charged against Profits. These expenditures may be divided into the following general classes :

(*a*) Actual additions to the property, such as new buildings, new engines or new tools, which did not exist before, or additions to existing articles of this class. All such expenditure would be at once admitted as a proper charge to Capital Account.

(*b*) Alterations to Capital Assets resulting in increased capacity, some portion but not the whole of which may in most cases be charged to Capital Account.

(*c*) Alterations to Capital Assets resulting not in increased capacity but in a lower cost of output. Such items are frequently treated as additions to Capital Account, even by conservative corporations, but it may be doubted whether they should not rather be considered as operating expenses paid in advance, especially if, as in most manufacturing concerns, the processes to which the improvements are applied have only a limited life, after which they will be superseded by other and more modern ways of doing the same thing. In other words, the most conservative way of treating this class of expenditures would be to consider them as deferred charges to operating to be written off over a definite term of years against Profits. Among this class may be mentioned change of grade or alignment in railroads which is too frequently treated as a Capital charge; the shifting of machinery from one position to another, or a general re-arrangement of a factory; as well as stripping and development work on mineral lands, which is of a Capital nature in so far as it is money sunk in the property prior to taking anything out of it, but in all conservatively managed mines is treated in the way indicated above.

(*d*) Alterations to Capital Assets resulting partly in increased output and partly in decreased operating expenses. In this class much must depend on the nature of the expenditure, but a division between Capital and Operating Accounts on some definite basis arrived at on the principles outlined in (*b*) and (*c*) would as a rule be fair and conservative treatment.

(*e*) Exceptional and extraordinary renewals of existing Assets resulting partly in the increased capacity necessary in order to keep pace with more modern plants, partly in diminished operating expenses and partly in a mere replacement. Such expenditures include the modernizing of a property necessary to prevent or to repair a deterioration in its value, due either to the competition of more modern properties or to the greater demands of the public, and consequently not resulting in increased earnings. Here again many corporations will charge part of such expenditures to Capital Account, and would be legally justified in so doing ; but undoubtedly the safe and conservative course is to charge them wholly against Profits, through the medium of a Depreciation or Improvement Fund.

(*f*) Finally, we have ordinary replacements, repairs and renewals recurrent either at long or short intervals, and resulting neither in increased capacity nor in saving in operating expenses. Such would always be a charge against Profits, either through the Depreciation Fund or direct, according to the nature of the outlay.

It is important to note that the charges made under any of the above headings should be cost only and should not include any addition by way of Profit. The operation is merely a conversion of Current into Fixed Assets, upon which no Profit can be realized as long as the Asset is maintained. Possibly, however, where a corporation employs in the erection of plant for its own purposes facilities which it would otherwise be employing in similar erections for outsiders at a Profit, it would be fair, although not conservative, to consider a reasonable charge for the use of these facilities as part of the cost of erection. Also when special loans are raised for construction purposes, the interest on such loans during the period of construction would fairly be part of the cost.

SALE OF FIXED ASSETS.

If Fixed Assets, becoming unnecessary for the purposes of the business, are sold or are abandoned and dismantled, the question arises whether Profit or Loss arising therefrom should be added to or deducted from the Profit arising from the general operations. Legally, if as a result of a revaluation of Capital Assets a surplus was found to exist, the realized portion thereof may probably be treated as a Profit, but not otherwise ; and on the other hand there would not appear to be any legal necessity to provide for a Loss. As a matter of accounting, the safe policy is to carry forward Profits and provide for Losses, but the circumstances in each case must be considered. Where the Losses are large, as in the case of the dismantling of a whole plant, it would be sufficient to provide for it gradually out of the Profits of a series of years.

CURRENT ASSETS.

Current Assets may be dealt with under the following main headings:

1. Stocks on hand, including Raw Materials, Work in Progress and Partly Finished and Finished Products.
2. Bills and Accounts Receivable.
3. Marketable Investments.
4. Cash.

STOCKS ON HAND.

Perhaps one of the most difficult questions which Accountants have to decide is the correct enumeration and valuation of Stocks on Hand. The theory governing the valuation of this Asset is that, inasmuch as no Profits can be realized until the goods are actually sold, it is not safe to take credit for any Profit thereon until a sale has been effected; that therefore it should be carried forward at the exact cost and no Profit thereon brought into the accounts of the fiscal period. On the other hand, it may be found that the prices both of the Raw Materials and the Finished Product have at the close of the fiscal period fallen below their cost, and while it is impossible to say until the goods have been sold whether any Loss will ultimately be made thereon, at any rate there is a possibility thereof. It is therefore conservative to set aside a sufficient reserve out of Profits which have been realized on goods already sold to provide for the accruing Loss on those which remain in hand. Hence the general rule for valuation of Stocks on hand, namely, "cost or market, whichever is the lower," has been evolved and is adopted by the most conservative commercial institutions. Unfortunately, in practice, many concerns are unable to ascertain the cost of their various products, with the result that their stock valuations are based entirely on estimates of costs made with more or less accuracy. There does not appear to be any legal obligation on a corporation to adopt any particular basis, provided that the price adopted is not in excess of that ultimately realized after deduction of any subsequent cost of completion, storage and sale; but the absence of approximately exact knowledge as to the cost frequently leads to disappointment, both to the directors and stockholders, and even to serious financial loss. It is obvious that a constantly changing basis of cost must lead to serious inequalities in the Profits shown between one period and another, but it is not equally obvious to the commercial community that an erroneous basis of valuation consistently adopted year after year, even if that basis be a conservative one and really below true cost, may result in large and unexpected discrepancies between the Profits shown in different periods. For instance, if Stocks be valued on a basis exceeding cost and the trade, and consequently the materials and products on hand, increase very rapidly for one or more years, the Profits during those years of increase will be abnormally inflated; but when the trade settles down to a comparatively steady turn-over there will be a considerable drop in the Profits as compared with the preceding year on the same amount of business done—a drop which the management as a rule will be unable to account for until an investigation by the Public Accountant discloses the true cause. On the other hand, if the Stocks be conservatively valued considerably below cost, the Profits of a year in which a small quantity of goods is carried over at the close of the year in comparison with the beginning will be inflated as compared with a succeeding year, when an opposite condition prevailed, although the sales and Profit thereon may have been the same in both years; thus entirely upsetting all the calculations and estimates of the managers. The essentials therefore for ascertaining correct Profits so far as Stocks on Hand are concerned are:

(*a*) An accurate enumeration of the quantities on hand.

(*b*) An accurate ascertainment of the actual cost of the different manufactured articles, either completed or in progress.

(*c*) A specific reduction in the prices of raw materials of the amount by which the market valuations at the close of the fiscal period fell short of the cost.

(*d*) A proper provision for all stock which is old or depreciated or for any reason likely to be unsalable.

The more exactly these different elements are ascertained, the more accurate will be the resulting statements of Profits, and if the special reserves be made separately, it will be an easy matter to compare usefully one period with another.

Finally, it should be noted that it is not essential, and in fact it will frequently be incorrect, to value Materials and Products on Hand at the end of the fiscal period upon the same price basis as at the commencement of that period; all that is necessary or proper is that the basis of valuation—that is to say, the principles on which the values are arrived at—should be the same at the beginning and end of the period, the actual prices usually varying from one year to another.

In this connection, it is important to consider to what extent it is permissible to anticipate Profits on work in progress, particularly when the work is being carried out under definite contracts, and when it may perhaps reasonably be contended that at any rate some portion of the Profit is earned at the time when the work is performed. It is quite a frequent practice where contract work extends over long periods of time to estimate and bring into account some portion of the Profit proportionate to the cost for any period, and there does not appear to be any objection in principle to the adoption of this practice. On the other hand, it is undoubtedly more conservative not to take credit for any such Profit until the whole contract is completed. An added reason for this course is that unforeseen contingencies are continually arising during the progress of the work with the result that what was originally expected to realize a Profit may in the end result in a Loss. It is true that the more conservative course may cause large inequalities in the amount of Profit shown for successive periods; but if the accounts are stated on a basis of total work completed less cost thereof, the reasons for the fluctuations, as well as the advantages of more rapid completion are apparent.

If, however, estimates of Profits on pending contracts are to be taken into account, it is of the utmost importance that such should be made on an ultra conservative basis, and further, that estimated Losses should be fully provided for. Neglect of this precaution may easily lead to disaster.

While therefore under certain conditions no objection can be taken to the inclusion in a Profit and Loss Account of Profits on Work in Progress, a sound conservative policy would be against such a practice on the ground:

1. That the best estimates are misleading.
2. That such Profits are not in most cases yet realized and cannot therefore be employed in payment of dividends except by a corresponding increase in Working Capital.
3. That the Asset of Work in Progress is unduly swelled by an addition that may perhaps never be realized.

Accounts and Bills Receivable.

Profits cannot be definitely ascertained until they have been converted into Cash or into some recognized form of negotiable instrument of definite and fixed value, but the usual practice is to consider the Profit realized when a sale takes place and the amount of the sale price is charged to the purchaser. It is essential to an exact determination of Profits to ascertain that as far as possible the purchaser's obligation is good for the face value of the charge made. This is necessarily a matter of estimate and involves two considerations:

(*a*) An estimate of the ability of the purchaser to pay the amount he has contracted to pay within the time contemplated.

(*b*) An estimate of the amount which a debt incurred in a foreign currency may be expected to realize in the standard of the home country at the time when the debt is paid by the purchaser.

On the principle of cost or market valuation, whichever is the lower, the conservative and safe course is to make a reserve sufficient to provide for all discounts that will be allowed and for any debts known to be of a doubtful character; or to build up a general reserve fund against such Losses, on the basis of a percentage on the sales of each year. From the legal point of view, all that would seem necessary would be to make a fair estimate of what each debt might be expected to realize in the currency of the home country, allowing for the time estimated to elapse before collection; but a corporation should aim at a more conservative policy than this, and should not be contented with the minimum amount of reserve which it might be legally called upon to make.

MARKETABLE INVESTMENTS.

The term Marketable Investments is intended to include only such investments as are part of the Circulating as distinct from the Fixed Assets. The latter class of investments may be defined as those which cannot be disposed of without affecting the operations, for the reason that the ownership thereof in a permanent form is necessary, however remotely, to the business which the corporation is carrying on. Their valuation would be governed by the same principles as have been outlined above for other Fixed Assets.

Marketable Investments, on the other hand, may be either:

(*a*) The stock in trade of the corporation, or
(*b*) The investment of surplus cash held in this form until required for ordinary operating purposes, or
(*c*) The investment of a Reserve or other special fund.

In case (*a*) the rule of cost or market value, whichever is the lower, applied to each individual investment and not to the group as a whole, is undoubtedly the most conservative. That is to say, no Profit could be taken up on any investment until it is sold, but on the other hand, where the value has clearly fallen, some provision should be made therefor. Where, however, the investments all have a definitely ascertainable market value at any time, it is perhaps fair and reasonable to allow a fall in value of some individual investments to be set off against a rise in value of others, provided that the aggregate valuation is not above original cost or market value, whichever is the lower.

In case (*b*) the usual custom is to value at the mean market price on the last day of the fiscal period for the reason that the investments represent the equivalent of cash and should therefore be maintained at their cash value in the Balance Sheet.

In case (*c*) any Profit or Loss, either realized or estimated, would be a credit or charge to that fund, and not to the Profit and Loss Account. But in the Balance Sheet such investments should either be clearly stated as maintained at cost or preferably be adjusted each year to the aggregate market value if below cost.

Another method of dealing with the fluctuations of Marketable Investments of classes (*b*) and (*c*) is to create an investment fluctuation reserve, either out of estimated or realized Profits on investments, or by a charge to Profit and Loss of such an amount as may be necessary to prevent this reserve from showing a debit balance, and by charges or credits to this reserve to maintain the Asset at market value.

CASH. This item is the only one which may be said really to represent actual fact as expressed in money value, except when it consists of currency of a foreign country, at a variable rate of exchange. This latter subject is referred to later.

LIABILITIES.

Inasmuch as the liabilities of a corporation are with very few exceptions definitely ascertainable amounts, no question of principle arises thereon in connection with the ascertainment of Profits or Losses except that the omission of any liabilities or an overstatement thereof would necessarily increase or diminish the Profits respectively. There are, however, some important questions in connection therewith, viz.: The proper treatment of Premiums and Discounts on Stocks and Bonds issued, Sinking Funds and Secret Reserves.

PREMIUMS AND DISCOUNTS ON STOCKS AND BONDS. If Stocks or Bonds are issued for the purchase of any definite property, it may be presumed that the property is worth the par value thereof. But when they are issued for cash or a cash equivalent differing from their face value, important questions arise.

So far as Stocks are concerned, it is doubtful how far an issue thereof at a discount is legal at all, and whether if so issued the purchaser or holder is not liable to pay up the whole of the discount, at any rate on liquidation of the corporation. This is the law in England with the exception that it is now legal for a corporation to pay a reasonable commission for services in placing its Stock, and it is also the statute law of some states in this country, notably New York. Discount on Stock would therefore either be an Asset of the corporation recoverable from some person or persons and not chargeable to Profit and Loss, or the liability on the stock would be the amount actually paid for it. Premiums on Stocks Issued are clearly a source of surplus to the corporation eventually, because they are cash received in excess of the authorized Capital which must be maintained intact, but they are not Profit on operations and should not therefore be credited to Profit and Loss, although they may presumably be applied to make good Depreciation in Fixed Assets or exceptional losses, not arising out of the ordinary business of the corporation.

Premium and Discount on Bonds is a deduction from or addition to the rate of interest which the Bond carries; that is to say, there is a rate at which any corporation can place its bonds at par; if it elects to place them at any other rate the Bonds will sell at a premium or discount as the case may be; but the true rate remains the same and this true rate is the proper charge to Profit and Loss Account. Hence the premium or discount should be spread over the term of the Bonds and the annual installment thereof credited or charged to Profit and Loss each year.

SINKING FUNDS FOR REDEMPTION OF DEBT.

Sinking Funds or Debt Extinguishment Funds are not in theory a charge against Profit and Loss, for the reason that they do not represent a loss or expense, but the extinction of an existing liability. Inasmuch, however, as in most cases the only source out of which such redemption fund can be provided is the surplus earnings, it is usual to insert a provision in Trust Deeds that the Sinking Fund is to be provided out of the Profits of the year. The discharge of Liabilities involves either a corresponding reduction in Assets or the accumulation of other Liabilities or surplus. A reduction in Current Assets or the accumulation of other Liabilities as a substitute for Bonded Indebtedness is clearly undesirable, and it is therefore necessary that the amount applied each year to Sinking Fund purposes should be transferred from Profit and Loss either to a Special Reserve Fund or in reduction of some Fixed

Asset account by way of provision for depreciation or otherwise. It must, however, be remembered that such provision for depreciation will be to that extent represented by capital instead of Current Assets, and while there is no theoretical objection to this if the Depreciation Fund is sufficiently large, the latter necessarily ceases to be available in cash for one of its principal purposes, viz., the renewal of various Capital Assets from time to time. If, however, part of the Fixed Assets are of a wasting character, the Sinking Fund may be quite safely applied in reduction thereof, or it may with equal propriety be applied in reduction of Goodwill or Patents. The safest way undoubtedly therefore in every case is to charge the Sinking Fund installment to Profit and Loss each year, and either credit it to a special Sinking Fund Reserve or apply it as Depreciation of some Fixed Asset for the renewal of which no cash expenditure will be required in the future.

SECRET RESERVES.

There is a general consensus of opinion that an overstatement of Profits knowingly made is improper, but the opposite proposition as to an understatement of Profits has so far received little consideration, and yet it is of considerable importance. Corporations are the property of the stockholders, and therefore primarily anything which the stockholders or the directors elected by them may approve may be considered to be within their power to decide as they like, provided that it is within the law; and it is not suggested that there is any general law which would prohibit an understatement of Profits, as it would undoubtedly prohibit an overstatement. But inasmuch as the stocks of the majority of corporations are quoted on the Stock Exchanges throughout the country, the corporation is in some sense the property also of the public. It becomes, therefore, a great question to what extent it is legitimate or proper that it should publish a statement of its earnings or its position which materially underestimates either; and yet it is obviously within the discretion of the managers or directors to make reserves to meet possible contingencies, and the constitution and by-laws of most corporations give them such powers. Secret reserves may take several forms, such as writing down to a comparatively small figure valuable Assets, providing excessive depreciation, providing excessive reserves for bad debts, or contingencies, valuing stocks of materials and products on hand at a large reduction from cost, or including special reserves under the head of Accounts Payable. Inasmuch as the majority of industrial corporations do not publish their gross earnings, such reserves can easily be made and are made continually in a form in which they do not appear in any way in the accounts, and are known therefore only to the directors and managers.

Each case must be judged on its own merits. Where the directors or managers have exercised a wise discretion in providing in advance for contingent Losses which are incident to the nature of the business and cannot, from a reasonable point of view, be considered as in excess of the amounts which a wise foresight would provide, it would seem that no exception should be taken to the undisclosed provision thereof. Where, however, reserves are made largely in excess of any possible contingencies, the amounts provided should be disclosed in the Profit and Loss Account and probably also in the Balance Sheet, so that all those interested may be in a position to form a reasonably correct opinion as to the financial position. For instance, a business such as Banking is from its nature peculiarly liable to large and unexpected Losses, the disclosure of which might prejudicially affect its credit and position in the eyes of the public and of its depositors, and possibly cause a disaster out of all proportion to the cause; and it is therefore obviously sound policy to accumulate such ample reserve as will enable Losses to be met without any apparent disturbance of normal conditions; but so far as the majority of corporations and businesses are concerned, publicity in such matters is undoubtedly most desirable, and all reserves to meet contingencies which may occur in the future, but have not yet occurred, should be fully disclosed.

FLUCTUATIONS IN EXCHANGE.

When a corporation is carrying on a business in a foreign country the rate of exchange exercises a considerable effect on the valuation of its Assets and consequently on its Profits. This question is sufficient in itself to form the subject of an entire paper, and it is only possible here to state quite shortly the general principles which should govern its treatment. Where operations are carried on in a foreign country, the object should be to obtain as nearly as possible an exact equivalent in the home country of all revenue earned or expenditure incurred in the foreign country. So long as a transaction originates and is completed in the foreign country, no question of exchange comes into the calculation. Where, however, in the process of its completion it passes from one country to another, a change in the basis of value occurs, which must be reflected in the accounts. The nearest approach to accuracy will be obtained by taking up the foreign item into the home currency at the rate of exchange of the day on which the transaction represented by that value passed from one country to the other. This would result over a given period in a certain average rate of exchange for all transactions. In the case of capital expenditure, it is probably wise to make that period as short as possible, say monthly. In the case of Profit and Loss items, it is probably sufficient to make it a year or half year. If the conversions at monthly intervals be used in arriving at the average rate of exchange for the year and the Current Assets and Liabilities existing at the end of the year as well as the Profit and Loss items be converted at that average rate, all the operations in the foreign country will be found to have been converted into the home currency at very close to the true rate and there will be no difference, or as it is commonly called, Profit or Loss on Exchange. Inasmuch, however, as this average rate may vary considerably from the actual rate on the last day of the fiscal year, it is further customary in preparing a Balance Sheet to reconvert the Current Assets and Liabilities at the latter rate, and the difference between this conversion and that made at the average rate for the year represents an actual Profit or Loss which would be made if the whole of the Assets or Liabilities were converted into the home currency on that day. This revaluation is necessary in order that the Balance Sheet may show the actual net realizable value of the corporation's Current Assets; and the Profit or Loss thereon is invariably considered a credit or charge to the Profit and Loss Account for the fiscal period. Fixed Capital, on the contrary, if recorded permanently in the currency of the foreign country, should be maintained on the basis of original cost without any change from the original rate; and as this gives rise to difficulties it is preferable that such Assets should always be permanently recorded in the home currency.

FORM OF PROFIT AND LOSS ACCOUNT.

Although the question of Profits has been considered from a Balance Sheet point of view, their presentation will always take the form of an Earnings Statement, each element in which will be accurately determined if due effect be given to the principles of valuations of Assets and Liabilities hitherto discussed. It will be useful now to consider shortly the form which such a statement of Earnings should take.

The following, already in fairly general use, is submitted as perhaps the most complete short form, and by means of exhibits it is capable of amplification to any extent desirable:

Gross Earnings (whether sales of products, transportation earnings, professional earnings, etc.)		$
Deduct—Cost of Manufacture or Operation:		
(*a*) Manufacture (for a manufacturing concern):		
Labor	$	
Material		
General Manufacturing Expenses		
(*b*) Cost of Operation (for concerns not manufacturing):		
(Under suitable headings according to the nature of the business)		
Gross Profits		$
Other Earnings		
		$
Deduct—		
Expenses of sale (manufacturing business only)	$	
Expenses of management (if distinct from operation)		
Net Profits from Operations.		$
Deduct—		
Interest on Bonds	$	
Other Fixed Charges		
Surplus for the year		$
Extraordinary Profits (detailed)		
Surplus brought forward from preceding year		
		$
Deduct—		
Extraordinary charges not applicable to the operations of the year	$	
Interest and Dividends on Stocks		
Surplus carried forward		$

A word of warning may not be out of place against the too common practice of throwing back extraordinary charges on to the previous year's surplus without sufficiently disclosing the same. Cases are frequent in which the earnings for a series of years have been made use of in the public press to show the operating results, and therefore incidentally the earning capacity of a business, while charges made in any year against surplus, on the ground that they appertain to the operations of a preceding year, have been altogether ignored. The form suggested above, if generally adopted, would prevent the possibility of any such misstatements, at any rate without a clear knowledge on the part of those making them that they were altogether misleading.

CONSOLIDATED EARNINGS STATEMENTS.

During the last few years the correct statement of the earnings of a company controlling a number of subsidiary companies has required much consideration. Legally, the earnings of such a corporation consist of the results of its own operations, together with any dividends which may be declared on the stocks which it owns in the subsidiary companies ; and so long as these stocks represent only minority interests in companies which are not in any way controlled or operated by the directors of the holding company, it would seem that a Profit and Loss Account prepared in such a way would be a correct and proper statement from an accounting as well as from a legal point of view. During recent years, however, the practice of consolidating a number of concerns by a control of stock rather than by an absolute purchase of the business has grown into favor and consequently it is usual to find the holding company owning either the whole or a large majority of the stocks of a number of companies doing a similar business, appointing the directors of these sub-companies, dictating their policy and generally acting in every way as if it absolutely owned the whole property. Under such conditions it is submitted that no Statement of Earnings can be considered correct which does not show in one account the Profits or Losses of the whole group of companies, irrespective of whether dividends have or have not been declared thereby. If this principle be not insisted upon it is within the power of the directors of the holding company to regulate its Profits according not to facts, but to their own wishes, by distributing or withholding dividends of the subsidiary companies; or even to largely overstate the Profits of the whole group by declaring large dividends in those sub-companies which have made Profits, while entirely omitting to make provision for Losses which have been made by other companies in the group. It is doubtful whether there is any existing law which could legally require a corporation to make up its Statement of Profits on the basis here suggested, but possibly it may eventually be found that the ordinary rule referred to at the commencement of this paper, of a reasonable valuation of Assets, may be made to cover this point for the following reasons:

It is clear that whatever the value of an investment in a corporation may be at a particular date, its value at any subsequent date (other things being equal) must be greater or less by the amount of the Profits or Losses made during the intervening period. Even if other conditions at the two dates are not the same, and, quite apart from any consideration of the earnings or losses during the intervening period, there is a considerable appreciation or depreciation in the investment, that appreciation or depreciation must undoubtedly be more or less, respectively, by reason of Profits earned or Losses incurred. In this case the change in value of the Asset is at any rate partly due to the result of the operations for the purpose of which the investment is held. On the general principle, therefore, that a Profit and Loss Account should take into account all Profits or Losses resulting from the trading operations, but should not take into account the Profits or Losses arising from a revaluation of Capital Assets, it may eventually be held, on legal as well as on accounting principles, that the statement of earnings presented by a holding company is not correct unless it takes into account by way of either a reserve or a direct addition to or deduction from the capital value of the investment the Profits or Losses made in operating the subsidiary companies.

One other difficult point is the determination of what is or is not a constituent company whose Profits and Losses should be brought into account in this manner. It is suggested that this depends partly on the proportion of stock owned and partly upon the degree of control exercised by the holding company. When the latter owns at least a majority of the stock, operates the company, dictates its policy and practically treats its property as its own, subject only to the right of the minority stockholders to receive a share of the Profits, the conditions would appear to be such as to require the proportion of Profits and Losses corresponding to the stock owned to be taken up; while, on the other hand, a mere majority ownership of stock without any effective control of the management and operation might properly be treated as an investment only, subject to the same rules as other investments of a similar character.

PROFITS EARNED BEFORE DATE OF FORMATION OF CORPORATION OR BEFORE DATE OF CONSOLIDATION.

Another question of considerable importance is that of the proper disposition of the Profits of consolidating companies earned prior to the date of consolidation. There is a clear rule of common sense, and probably also of law, that a corporation cannot earn Profits before it exists, and when therefore a corporation at its organization purchases an undertaking, together with the Profits accrued from a certain prior date, the whole of such Profits earned prior to the date of purchase must be treated as a deduction from the purchase price and not as a credit to Profit and Loss or available for dividends.

This proposition is the more evident if it be remembered that these Profits form part of the Current Assets purchased, and that any realization thereof is merely a return to the purchasing company of a portion of the purchase money, *i. e.*, of the Capital of the corporation. Similar reasoning will show that where a holding corporation purchases the stocks of several others all Profits of the purchased corporations accruing up to the date of the purchase must be treated by the holding corporation as a deduction from the price paid. The subsidiary corporations can legally declare dividends therefrom, but these dividends when received by the holding corporation are merely a transfer to it of some of the Assets included in the value of the stock it purchased and are therefore a return of Capital; and dividends declared and paid by the holding corporation to its stockholders out of such Profits would clearly be paid out of Capital. It is important to note that the date of purchase should be taken as the date of the contract for purchase and not the date of completion. If the purchasing corporation was in existence at the date of entering into the contract, it is to be presumed that the price fixed had relation to the conditions existing at that date, and that the corporation is entitled to treat as Profits all earnings of the subsidiary corporations subsequent to that date. But if the holding corporation had no legal existence until a later date, it is submitted that as it cannot earn Profits when it is not in existence, it is only entitled to distribute as dividends Profits of the subsidiary corporations earned subsequent to the date of its own incorporation, or to the purchase of the property, whichever is the later date.

GENERAL CONCLUSIONS.

In concluding this paper, it is well perhaps to call attention to the difficulty of laying down strictly defined rules of accounting practice. In any question it is sufficiently difficult to distinguish between legal and illegal practice, but it is still more difficult to decide as to the propriety or otherwise from an accounting or commercial point of view of the course adopted. It may safely be said that no Public Accountant, acting in an impartial capacity, can reasonably object to a course adopted by the directors of a corporation which is clearly within their legal powers, provided that the directors fully appreciate all the facts and are exercising a wise and proper discretion in their manner of stating them. If, on the other hand, the Accountant has reasonable doubts on any of these points he is entitled, and it may even be his duty, to state his views in his report or certificate.