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Accounting for Investors

By J. M. B. Hoxsey

The title of this address may be a trifle ambiguous. It is not meant to imply by "Accounting for investors" that investors need to be explained in any way nor that the question under discussion is "Why are investors," neither is it meant to imply that any of them have become lost, strayed or stolen and need to be accounted for in that sense. If, from time to time, letters or personal visits are received from investors indicating that they feel themselves lost, it is not in the corporeal sense, but in their endeavor to get a clear understanding, from published financial statements, of the progress of the corporations whose securities they own that they find themselves in this condition.

It is to this phase of the subject that this paper is addressed. I make no pretense of an accurate technical knowledge of the art of accounting; but in the course of my work with the New York stock exchange, I have occasion to examine closely from the investors' standpoint a great many sets of financial statements, and I feel certain that there are improvements upon certain commonly accepted practices which can be definitely and strongly recommended and others which may be suggested as worthy of careful thought at least.

I do not wish to give the impression that the stock exchange has adopted an official position upon all of these matters which will be discussed. Upon some of them it has; upon others it has not. Its official position can only be told from the public pronouncements it has made.

It has been said a hundred times that "accounting is a matter of conventions," and it is questionable whether these conventions have kept pace with the changes in modern business conditions. As the art stands today, it appears to the business man to have evolved with primary emphasis upon two objects:

(a) To give to management that accurate information and aid which is essential to the successful conduct of a business, and

(b) To give to actual and prospective creditors that accurate information essential to the determination of the volume of credit which may safely be extended and the conditions under which it may be allowed.

*An address delivered at the annual meeting of the American Institute of Accountants, Colorado Springs, Colorado, September 17, 1930.

Under conditions of ownership where the number of partners or stockholders was small, where enterprises were largely managed by their owners, or by the personally chosen representatives of a few owners in close contact with the business, and where it was the custom to finance permanently but little beyond minimum needs and to borrow largely to meet peak needs, accounting adequately performing these two functions probably sufficiently served the needs of the then situation. In the meantime the widespread diffusion of corporate ownership, with which we are all familiar, has occurred. There are few large enterprises which have not taken on the corporate form, and a large proportion of the total ownership is in the hands of millions of relatively small investors who have no direct contact with management and whose only knowledge of the company is derived from its financial reports. In recent years there has been a marked tendency to finance more or less permanently for peak requirements, becoming lenders of money at the time of minimum requirements, and so tending to lessen the aggregate volume of bank credit needed.

Because of these changes, coupled with a growing tendency toward extreme broadness and flexibility in the corporation laws of many states, the time appears to have arrived for some changes of emphasis as to the objects to be achieved by sound accounting practice. While there have been able efforts devoted toward this end, the result so far generally attained does not seem to me sufficient to meet the needs. The need of accurate information for the aid of management is still paramount; but, under conditions of today, the next object in order of importance has become

> to give to stockholders, in understandable form, such information in regard to the business as will avoid misleading them in any respect and as will put them in possession of all information needed, and which can be supplied in financial statements, to determine the true value of their investments.

This is, of course, the object in which the stock exchange is particularly interested. The primary object of the exchange is to afford facilities for trading in securities under the safest and fairest conditions attainable. In order that parties may trade on even terms they should have, as far as is practicable, the same opportunities for knowledge in regard to the subject matter of the trade.

The exchange is interested in the accounts of companies as a source of reliable information for those who deal in stocks. It is not sufficient for the stock exchange that the accounts should be in conformity with law or even that they should be conservative; the stock exchange desires that they should be fully and fairly informative. The exchange hopes for coöperation to this end from the accounting profession.

It is a commonplace that the moral duty of the accountant making an audit (I would not undertake to discuss the legal obligation) is not merely to the client who retains him, but to all those who may be invited to act on the faith of his certificate. While the exchange does not itself value securities in listing them, perhaps if the matter could be reduced to percentages 90% of the information required to be set forth in a listing application is for the purpose of enabling investors to form for themselves an adequate idea of the value of the securities, and the remaining 10% for the purpose of enabling the exchange authorities to determine as to whether the corporation is of a type and size and so officered and directed as to warrant listing. For this reason agreements are required from companies for frequent publication of financial reports, from which a fair evaluation of the investment should be available to the investor. The companies enter into agreements with the exchange, among the most important of which are those which relate to accounts. If when the accounts are published they do not set forth the true condition of the company, or if they are in any way misleading to stockholders, the efforts of the exchange in this direction are rendered worse than useless. I do not think it is any extension of the principles already recognized as affecting the duty of accountants to ask them to make sure that the books of listed corporations are so kept, and the accounting statements rendered are so set forth, as to live up in spirit, as well as in letter, to the agreements into which the corporations have entered both explicitly and impliedly at the time of listing and to draw attention, wherever necessary, to any serious departure from the principles underlying this relationship.

The work which the exchange is now doing to secure fair and adequate disclosure of financial facts is, I believe, of importance and value to the whole community. Support and coöperation from the accounting profession will make that work more effective and valuable.

I appreciate fully the fact that the auditor holding his appointment by virtue of action of the directors of the corporation may be placed in a difficult position if his judgment is wholly out of accord with theirs. But every accountant who aspires to a high position in his profession must be prepared, on occasion, to sacrifice appointments, perhaps important appointments, rather than his principles. If his principles are sound and he uses good judgment in deciding when he must take a firm stand, his moral authority will soon become established, so as to make such occasions infrequent. And, may I add, I believe those who do so will find the attitude of the exchange to be appreciative and helpful.

Fortunately the attainment of this object is in no wise incompatible with that of affording to either management or creditors the information which they respectively need. If the object be worthy of attainment—and of that there would seem to be no doubt—it is in order to examine existing practices, and see whether a consensus of opinion can be reached as to what changes, if any, are advisable to achieve it—either in the form of reports submitted or in accepted conventions, even though these latter are of long standing. For this purpose I have selected, from among the many which have been discussed with accountants by the exchange forces, certain matters which appear to me to be worthy of critical examination.

To avoid the necessity of too frequent reference to my personal opinion, I am going to ask you here and now to take my sense of courtesy toward you individually and collectively for granted and to regard any statements which may otherwise appear dogmatic as being made with due deference to any contrary opinion.

Depreciation

There are so many different theories of depreciation that an exact understanding of the actual policy pursued is essential to any just appraisal of values or comparison of earnings of different companies. It is seldom that this can be obtained from published reports. Whatever type of depreciation theory may be correct, some practices are clearly ultra-conservative and others are unconservative. Grant that a given correct broad theory is pursued, the final result will depend upon the classes of property, the retirement or replacement of which are passed through the depreciation account and the classes as to which these entries are made direct to current maintenance.

Assume two companies each of which endeavors to write off the wearing value of the properties, as to which it sets up a depreciation reserve, in equal monthly instalments throughout their serviceable life. One of these charges to reserve the replacement or abandonment of all property whose normal life is more than one year. The other makes similar charges only as to discontinuous structures or as to items whose cost is more than some stated and relatively large sum. There can be no comparison of results without full knowledge of the actual practice pursued. Assuming identical properties, identical operating efficiency and correctly estimated rates of depreciation in each instance, the combined maintenance and depreciation expense of the first company will be larger than that of the second and it will have in its reserve for depreciation at all times a sum representing the accrued unrealized depreciation upon all of its property; whereas the second company will have in reserve only the accrued unrealized depreciation upon a portion of its property.

Reports become still more difficult to judge when the same company varies from year to year the character of plant, the retirement or replacement of which goes through the reserve as against direct charges to maintenance.

Whatever else depreciation may be or may not be, it is certainly a function of plant and not of earnings. The determination of the actual rate of depreciation is an engineering rather than accounting question and it is the duty of accountants to qualify their certificates in regard to this rate only when it departs from the percentages commonly accepted in the business, in which case a qualification should undoubtedly be made.

It is difficult to determine the exact responsibilities of the auditor as regards this important matter, owing to the necessary limitations upon the length of a certificate of audit. It is suggested that one year is the commonly accepted accounting cycle, and that where it is the practice of the company to charge directly to current maintenance the retirement or replacement of any property whose normal life is more than one year, the certificate of audit should enumerate the classes of property so treated, thus bringing into relief the fact that the corporation is accumulating nothing in reserve for the accrued unrealized depreciation upon such classes of property. It seems certain that the certificate should disclose the fact if either the percentage rates of depreciation or the nature of the charges as between depreciation and

current maintenance have been materially altered since the preceding year.

The effect of variation in the ratio of depreciation to plant, even by an apparently small percentage is shown as an appendix (appendix A) illustrating simply a hypothetical company with a pyramided capital structure. The figures both as to capital structure and rates of depreciation, while purposely somewhat extreme to illustrate the point, are well within the bounds of actual experience. This illustration shows a company, the correct rate of depreciation upon whose plant is assumed to be 2½%. If the correct rate of depreciation is charged there are no earnings available for dividends upon common stock of the parent company. If, however, a depreciation rate of 1.8% is substituted for the correct rate of 2½%, the common stock earns apparently 10% instead of nothing. If a depreciation of 1.1% is substituted, the apparent earnings of the common stock become 20%. It is quite within the lines of probability that a rapidly growing corporation, the correct rate of depreciation upon whose plant is 2½%, could appropriate only 1.1% for the purpose and show a substantial addition to reserve each year for a number of years.

It goes without saying, from the foregoing, that disclosure is never adequate unless the income account shows the amount of the current appropriation for depreciation, nor unless the balance-sheet shows separately the accrued reserve for that purpose. This brings up a matter that, while relatively minor, is still of real importance. This is the place where these accounts should be shown in the statements. While the amount of the depreciation charges is a matter of judgment, it is not, or at least should not be, a matter of discretion, once that judgment has been formed with adequate skill upon adequate data. Though a deferred expense, it is none the less real and inevitable and it is as much a part of the operating expense as the wages of an employee. It should always be so shown and never far down in the income account as though, like interest, it were a thing apart from the cost of operations. To do so distorts the real picture. It is, however, proper to include in surplus account a belated entry to depreciation to make good inadequate charges in prior years.

Of less importance is the placement of the accrued reserve in the balance-sheet. Theoretically, at least, it should appear upon the liability side instead of as a deduction from assets, for the

reason that if depreciation be computed in instalments to retire the property at the end of its serviceable life, whether the straight-line plan or the sinking-fund plan be used, it will be purely accidental if the line of actual depreciation coincides with that of the accrued reserve, excepting at the beginning and at the end. The actual depreciation, conceived in terms of lessening in value, will be either much more or much less than the accrued reserve, dependent upon the nature of the property. To bring down a figure representing net plant value after the deduction of the reserve gives an appearance of accuracy which is misleading and not borne out by the facts.

A recent decision of the supreme court of the United States in reference to depreciation may give much concern to accountants.

In the case of *The United Railways and Electric Company of Baltimore* v. *West et al.*, I quote from the majority opinion delivered by Mr. Justice Sutherland and in doing so I have italicized certain words that they may be considered in relation to each other.

"The allowance for depreciation made by the commission was based upon cost. The court of appeals held that this was erroneous and that it should have been based upon present value. The court's view of the matter was plainly right. One of the items of expense to be ascertained and deducted is the amount necessary to restore property worn out or impaired, so as continuously to maintain it as nearly as practicable at the same level of efficiency for the public's service. The amount set aside periodically for this purpose is the so-called depreciation allowance. Manifestly, this allowance can not be limited by the original cost, because, if values have advanced, the allowance is not sufficient to maintain the level of efficiency. The utility 'is entitled to see that from earnings the *value* of the property invested is kept unimpaired, so that at the end of any given term of years the original *investment* remains as it was at the beginning.' *Knoxville* v. *Water Co.*, 212 U. S. 1, 13–14. This naturally calls for expenditure equal to the cost of worn out equipment at the time of replacement; and this, for all practical purposes, means *present value.* It is the settled rule of this court that the rate base is present value, and it would be wholly illogical to adopt a different rule for depreciation."

This majority opinion was vigorously combatted in a dissenting

opinion by Mr. Justice Brandeis, concurred in by two other members of the court, which unfortunately is too long for quotation here.

It is not the function of an address like this to presume to express an opinion upon a matter of law, particularly where the supreme court of the United States has spoken; but, particularly where there has been such vigorous dissenting opinion within the court itself, it is I trust within the bounds of all proper respect to say that if accountants in discharge of duties relating to this question are intellectually convinced that to base an accounting system upon the principles laid down in the decision rendered would violate sound principles of accounting or economics, even though conforming to law, it is their duty to themselves to follow sound principles of accountancy and economics and to let the law take care of itself, which it can very well do at any time that a specific case is under consideration, by substituting legal for economic principles if the two be in conflict.

It is suggested, therefore, that if and when accountants are called upon to choose between basing the depreciation allowance upon the cost of property or upon its present value, they read carefully the dissenting opinion in this case and that they reflect that after all depreciation is an expense, that over a period of time expense is necessarily limited by actual expenditure, that the actual expenditure as to the property consumed in giving service can be no more and no less than its original cost, plus cost of dismantling less salvage, plus the upkeep and repairs thereof during its serviceable period, as reflected in the current maintenance accounts, and that if upon replacement the new property costs either more or less than the property replaced, such new property, to be used by a future generation, can be and should be capitalized at its exact cost and its future depreciation based thereon.

In closing the treatment of depreciation, it may be noted that no attempt has been made to differentiate or choose between the various methods in use as to the determination of and application of the charges themselves as distinguished from the base against which they are computed. This is not from lack of strong personal conviction on the subject, but because the methods are so many in number and so controversial in nature that their adequate consideration would require a volume much larger than the entire limits of this address.

Consolidated Statements

The most pronounced step forward in the direction of adapting accounting to the needs of investors is the introduction of consolidated financial statements. The question is as to whether they are as inclusive as they should be. There appears to be no consensus of opinion as to the degree of ownership which warrants consolidation. Accountants vary all the way from a bare majority of the voting stock to more than 90% of it as such a basis. Consolidated statements would appear to be of use to management only as to the broadest aspects of the business. They must be practically useless to the short-time creditor, unless accompanied by parent company statements. Why not let them attain their maximum usefulness to the stockholder by preparing consolidated accounts including all corporations in which directly or indirectly there is a holding of a majority of the voting stock?

As a case in point a certain very large corporation formerly published consolidated statements, including only its wholly owned subsidiaries. These statements apparently justified the dividends which were regularly paid. It also held from 75% to 85% of the stock of certain large unconsolidated subsidiaries. When asked to publish either fully consolidated statements or separate statements of the subsidiaries, it developed that the company's proportion of the current losses of the unconsolidated subsidiaries had for years been larger than the total profits of the rest of the system as shown by the consolidated statements. Certainly in this case, however unintentionally, the stockholders had been misled.

Complete consolidation will help many and can deceive no one if it is accompanied, as it always should be, by parent company statements and by adequate information as to arrears, if any, in interest, cumulative dividends, sinking fund and redemption fund requirements. If, however, there should be those who think it unwise to break away from the conventions which they have established in this respect, it is submitted that no accountant should certify partly consolidated statements without including in them a clear statement of the company's equity in the current undistributed earnings or losses of its unconsolidated subsidiaries and a statement of its equity in their earned surplus, since acquisition, as at the date of the report. Without at least this, there is no adequate disclosure of affairs and the stockholder is helpless in trying to form an opinion of the true status of his company.

There are many circumstances which may occur to prevent the most complete consolidated statements from being fully informative. After all, it is the parent company whose securities are in the hands of the public and regarding which, as a separate corporate entity, information is necessary; and, while parent company statements alone fall far short of satisfactory disclosure, they should always accompany the consolidated statements, so that a complete picture may be presented.

Showing Volume of Sales or Gross Revenue

There is one point in the process of giving information to stockholders which is progressing like the cat in the well—two steps forward and three back. This is in the matter of showing the amount of net sales. More and more corporations are abandoning the practice on two grounds: first, that in certain instances it creates sales resistance where the margin of profit is at all wide and second that in other cases it gives advantage to competitors. The first, as to certain types of business may be frequently true; the second rarely is. It may even be questionable whether a business so precarious in its nature that any leak in information as to its volume of sales would be of serious disadvantage competitively is a type of business suitable for public ownership. Next only to net profits the amount of sales (or gross revenue) is probably the most significant figure of the financial statements. It is the key upon which almost every item of analysis of the competence of the management depends. So much is this the case that one of the great statistical companies has adopted the policy of refusing to recommend to its clients the securities of companies which do not give this information, on the ground that not enough information is disclosed to permit an adequate analysis. You accountants meet this situation at its source. You can help in individual instances to combat the crystallization of opinion along unnecessary and harmful lines and I submit that wherever you are not intellectually convinced that the objection is based upon sound grounds, you could help the public interest by using your influence to secure the dissemination of this needed information.

Other Income

As a corollary of the condensed reports which follow from the omission of this information, there is frequently no distinction

made between operating income and other income. The importance of first confining operating income to the major activity of the business and of showing other income separately, with itemization of any large entries, is obvious as is the duty of the accountant to insist upon such separation or specifically to qualify his certificate in its absence.

Surplus and Surplus Entries

As investors tend more and more to value stocks upon a basis of earnings and less and less upon an assets basis, the relative importance of the income statement tends to increase and the relative importance of the balance-sheet to diminish. The introduction of no-par stock has been accompanied under the laws of many states with permission to credit substantially any part of the consideration received for the issuance of stock to capital account and the remainder to surplus account and the surplus so created appears to be as available for dividends, legally, as though it had been earned. Actually few corporations pay either cash dividends upon common stock or current periodical stock dividends out of capital surplus, and the earned surplus of the corporation is, I believe, by common consent regarded as the maximum measure to which current dividends can be paid over any extended period of time.

The item earned surplus, therefore, becomes one of the most significant remaining features of the balance-sheet and it should always be carefully segregated from all other items of surplus and from capital account. If all of the surplus has been earned it should be called "earned surplus." Stockholders are entitled to know, as of each published report, the amount of the undistributed earnings, either from organization or from some stated date of reorganization or recapitalization.

To avoid an undue number of separate surplus accounts it would seem well to regard capital surplus as a generic term embracing all forms of unearned surplus, such as:

Paid-in surplus

Surplus arising from appreciation of property

Surplus arising from creation of a goodwill item, and, upon the consolidated balance-sheet,

Surplus of subsidiaries at date of acquisition, if any, and

Surplus arising from acquisition of property at less than its book value.

Using this generic definition of capital surplus I have been unable to see the difficulty, which is frequently spoken of, in keeping clear the distinction between capital surplus and earned surplus, except, possibly, in cases of long corporate history, where the earlier records are obscure or have been lost. The only concrete statement of this difficulty which has come to my personal attention has been, as regards the consolidated statements, in reference to the separation of earned surplus and capital surplus on the books of acquired companies where the distinction has not been made.

This, however, would appear to present no difficulty excepting, possibly, in cases of true merger (as distinguished from purchase or acquisitions either of stock or of property) where the identity of the merged corporations continues, though in different form, and where the earned surplus of the merged corporations may be properly continued as such by the merging company.

In cases of acquisition of stock of another corporation, the acquiring company is merely substituted for the former stockholders and manifestly derives no element of earnings at the time of acquisition. The price paid for the acquired stock is for such stock "as is" with all that it represents. While the earned surplus of the acquired company persists upon its own books, it is represented by a decrease in other assets, such as cash, or by an increase in capitalization on the books of the acquiring company. The surplus of the acquired company, whether capital surplus or earned surplus, is properly one of the eliminated items upon the consolidated statements.

In cases where the property of the acquired corporation is sold to the acquiring corporation, to be followed at a greater or less interval by the dissolution of the acquired corporation, the consideration paid by the acquiring corporation for the assets to be transferred, subject to the liabilities, if any, to be assumed, is for the purchase of the entire property, irrespective of the source of the funds from which such property was originally constructed or acquired by the selling corporation and the acquiring company clearly derives no element of earning from the fact of the acquisition as such.

It appears self-evident that, excepting in cases of true merger, it is utterly misleading to continue earned surplus of the acquired corporation as earned surplus, either of the acquiring corporation itself or upon the consolidated balance-sheet of the acquiring corporation. So much is this the case that I would apologize for

any discussion of the matter, except for the numerous cases in which non-professional accountants have sought to justify the continuation of the earned surplus as such and except for the fact that the laws of at least one state appear specifically to authorize that this be done.

As to the mechanics of setting up surplus of acquired companies upon the consolidated accounts of the acquiring company there are two methods in vogue. One is, roughly, to give a stated value (or stated value and capital surplus) to the securities issued in exchange equal to the full book value of the acquisition and to add, raw-so, to the consolidated assets the surplus of the acquired company. The other is to state the consolidated assets correctly, but to diminish the stated value of the securities issued to an amount necessary to offset the surplus to be shown. The first of these methods appears indefensible even with full disclosure. The second may be correct from an accounting standpoint provided the surplus so set up is denominated "capital surplus" or "surplus of acquired companies at date of acquisition" or in some other manner clearly indicated as not being earned surplus of the reporting company out of which dividends may be currently and conservatively paid.

Why, however, show such surplus at all? There are certain circumstances in which it may be proper and advisable to set up an item of capital surplus of reasonable amount in connection with a stock issue. If such circumstances exist in connection with stock issued for an acquisition, why not estimate carefully the minimum amount which may be reasonably required as capital surplus, set it up frankly as such and without any relation to the previous earned surplus of the acquired company, either as to amount or otherwise? If this were done, an item that is almost bound to be misleading would be entirely avoided. The argument as to the necessity for continuity of dividends during process of consolidation is, of course, a familiar one. If unavoidable it can be met frankly in other ways instead of misleadingly by treating as earned surplus what is not in fact such.

The question of capital surplus is too lengthy to be treated here in detail. While admitting the necessity of a substantial capital surplus in certain types of financial institutions and of a reasonable amount of capital surplus to cover certain anticipated contingencies in other cases, it is somewhat questionable in most types of business whether the setting up of a large item of initial capital

surplus is not coming to be regarded as equivalent to saying, "We hope we shall never be forced to be unconservative and that we shall never have losses large enough to impair the capital with which we started business, but should these things occur we are placing ourselves in a position where the matter can be handled with a minimum of disclosure."

There is one among other abuses of capital surplus to which attention should be called. This is the practice of charging against this account items that should be charged against earnings or earned surplus. This is particularly apt to occur in charging unamortized discounts against capital surplus. These charges should properly be made against current earnings. To charge them against capital surplus is unsound and results in an over-statement of future earnings and of earned surplus.

Except for the fact that it is omitted so frequently, it would be unnecessary to say that reports are never complete nor fully informative unless both the earned surplus and the capital surplus (if any) at the end of the preceding period are tied in with the corresponding items at the end of the reporting period and any large debits or credits directly to surplus account itemized.

Stock Dividends Paid

The question of accounting for stock dividends paid or received is an acute one. On September 11, 1929, the governing committee of the exchange approved a report of a special committee on stock dividends (exhibit B hereto) and on April 30, 1930, it approved a further announcement on stock dividends (exhibit C hereto). Leading up to these actions were the following considerations among others:

Under the laws of various states, great latitude is allowed as to the accounting for stock dividends on the part of the issuing company. Many accountants have apparently felt themselves obliged to give unqualified approval to entries, in themselves misleading, because such entries were not out of conformity with transactions permitted by law. The term "stock dividends," as actually used, has a very broad scope, covering every shade of transaction between the split-up pure and simple in the form of a stock dividend and the proper capitalization of actual earnings. Much of the confusion which has existed on the subject arises from this lack of an exact terminology and is accentuated by the

present-day practice of crediting a greater or less proportion of the consideration received for stock to a capital surplus account which, as already stated, is available for either cash or stock dividends under the laws of many states.

Stock dividends paid may be classified broadly under three heads:

1. The occasional large dividend, which is in reality a split-up in the guise of a stock dividend. This applies usually to no-par stocks, inasmuch as the same object may be achieved with stocks having a par value by a reduction in par-value.
2. The occasional large stock dividend evidencing the equity of the stockholder in previously accrued earned surplus. This applies to stocks with or without par value.
3. Current periodical stock dividends, whether quarterly, semi-annual or annual. These also apply to stocks with or without par-value.

The first two categories need not give us great concern, as they are not likely to be subject to misconception. When a stockholder receives two shares of stock where he held one before, or three shares where he held two, he necessarily knows that, other things being equal, the value of his holdings per share has been correspondingly diminished and it does not occur to him to regard the additional shares so received as representing, as to any part thereof, current income. He is, of course, entitled to know, even in the case of large occasional stock dividends, whether such dividends represent a split-up, pure and simple, or whether they represent the capitalization of earned surplus.

The third category, the current periodical stock dividends, presents the real problem. Two major questions are involved; first, whether or not they have been currently earned; second, whether or not they are properly accounted for. It is perfectly possible that a stock dividend may be fully earned, but insufficiently charged against the earned surplus account.

As an illustration of the wide range of accounting practices, we have found the following nine methods in actual use for periodical stock dividends:

1. The issuance of the additional stock described as a stock dividend, without the transfer to capital of any sum

whatsoever, either from capital surplus, from earnings, or from earned surplus;

2. The transfer to capital account from capital surplus of a nominal sum per share issued;

3. The transfer to capital account from capital surplus of an amount per share issued equal to the theretofore stated value or par value of the stock, per share;

4. The transfer to capital account from earnings or earned surplus of a nominal amount per share issued;

5. The transfer to capital account from earnings or earned surplus of an amount per share issued equal to the theretofore stated value or par value of the stock per share;

6. The transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued equal to the theretofore stated value or par value of the stock per share, plus the theretofore capital surplus per share;

7. Particularly with companies having large uncapitalized tangible or intangible assets, the transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued greater than the sum of the theretofore capital per share plus capital surplus per share and less than the market value per share;

8. The transfer to capital account and/or capital surplus from earnings or earned surplus of the theretofore entire book value per share, including earned surplus; (note—if earned surplus were 100% of capital, this method would exhaust earned surplus upon payment of a 50% stock dividend);

9. The transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued equal to the market value of the stock upon some convenient near-by date.

From an accounting standpoint, in the case of a large occasional split-up in the guise of a stock dividend, there appears to be no necessity to make any charge against earned surplus not compulsory by law, so long as it is clearly stated to stockholders that the dividend is to be regarded as in the nature of a split-up.

A different question is presented in the case of small or periodical stock dividends. The stockholder, unless otherwise clearly

informed, has every reason to believe that such dividends represent earnings. They do not, however, represent earnings in their entirety unless they are not only charged against earnings at some rate, but charged against earnings at a proper rate. In view of the usually arbitrary nature of the distinction between capital and capital surplus (which would for most purposes be much better defined as "stated capital" and "unstated capital") the minimum measure of this proper charge against earnings or earned surplus appears clearly to be the sum of the theretofore capital and capital surplus per share, for each share issued as a dividend. This sum purports to represent the consideration actually received for or represented by the stock, exclusive of its equity in true undivided earnings and, unless at least this minimum is charged, the true capital per share is diluted by the stock dividend, whether or not the increment in earned surplus is sufficient to offset such dilution. If less than this amount is charged the amount remaining in earned surplus will be fictitiously large and may thereafter be used for duplicate payments of dividends, from the same earnings, either in stock or in cash.

As an illustration, take the case of an actual company whose initial stock issue was sold for $100 a share in cash. One dollar per share was set up as capital and $99 per share as capital surplus. Let us suppose that this company earned $10 per share in the first year. That is 10% on the consideration received for the stock. Assume that this company wished to declare a 10% stock dividend. If the stock has been capitalized at the consideration received and if a charge were made against earnings on the basis of such capitalization, the first year's dividends would exhaust the first year's earnings. The same would be the case if each share issued should be charged against earnings at the sum of the capital and capital surplus per share theretofore existing. This would be a correct result. Ten per cent. has been earned upon the consideration received for the stock; ten per cent. in stock dividends has been paid. Nothing is left in earned surplus and no further dividends may be paid from earnings until a further sum has been earned. Assume, however, that instead of the procedure outlined, $1 per share issued, the amount of the stated capital per share, is charged against earnings and credited to capital. This would amount to a charge of 10 cents against earnings, for each share upon which such dividend is paid, leaving $9.90 in earned surplus out of each $10 originally earned. Thereafter, without

any further earnings, if this method of accounting be correct, the corporation could go on for approximately 25¼ years, paying a ten per cent. stock dividend each year and stating that such dividend was paid out of earned surplus. The result is, of course, absurd.

This criterion of the proper charge to be made applies with as much force in the case of par value stocks as in the case of no-par value stocks. It makes no difference in the result of the above illustration whether the $1 assigned to capital account was a par value of $1 or a no-par stated value of $1. In either event, if there is a capital surplus, the amount of it per share should enter into the computation of the amount to be charged against earnings or earned surplus. As applied to par-value stocks this thought is something of an innovation, it is admitted. That fact makes no difference. The question is whether the innovation is a needed one.

Necessarily in the case of par value stocks with a capital surplus and optionally in the case of no-par stocks with a capital surplus, the credit made against the charge to earnings or earned surplus may be partly to capital account and partly to capital-surplus account.

It is submitted for consideration, that if these views are correct, it is questionable whether an accountant should approve, without qualification, the accounts of a company paying periodic stock dividends and accounting for them on a basis less than that stated.

The above stated minimum charge against earnings or earned surplus should be increased to a figure, reasonable in all the circumstances, in cases where there are substantial uncapitalized tangible or intangible assets. As an illustration, there is a listed company having a combined capital and capital surplus per share of only $3.53 and earning annually over $7 per share. It seems manifest that if this company should declare periodic stock dividends, a charge against earnings or earned surplus per share issued of only $3.53 would be meaningless. A ten per cent. stock dividend in such a case would involve a charge against the $7 per share earned of only three and one-half cents. There appears to be no mathematical basis for the determination of the correct charge in such a case. It might well be determined by basing it upon the figure at which stock would be offered to stockholders if they were to be given rights to subscribe.

It should be remembered that a stock dividend may have been fully earned by the issuing company and yet improperly accounted for. Thus, in the foregoing illustration of the stock of one dollar stated value, $99, capital surplus and $10 per share earnings, a ten per cent. stock dividend would be fully earned quantitatively, but if only $1 per share issued is charged against earnings the accounting is wrong and the earned surplus remaining is fictitiously large and remains as a temptation to unwarranted future dividends, all of which, without further earnings, would be mere split-ups.

To sum up this phase, stockholders are entitled to know whether so-called stock dividends represent current earnings, a distribution of surplus previously earned or a split-up and the extent of each and accounting and accountants certificates should, it would seem, be adapted to aiding them in securing this information in the clearest possible manner.

The treatment of so-called optional stock dividends or optional stock interest transactions seems equally clear. Without prolonging this paper unduly it may be said that the official position of the exchange is that the amount of the cash alternative surrendered measures the minimum amount to be charged against earnings or earned surplus.

Stock Dividends Received

No position which the exchange has taken is so thoroughly unpopular as the statements it has given out regarding the accounting treatment on the books of the recipient company for stock dividends received. These statements are in the following language:

> "At the present time, it appears as if the exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus account by the paying companies."

A later statement reads:

> "The exchange will not knowingly list any of the securities of a corporation which takes up as income upon its books

> stock dividends received at a larger figure than the proportionate amount charged against earnings or earned surplus by the issuing company."

An agreement which applicants for listing must sign reads:

> "Not itself, and not to permit any subsidiary, directly or indirectly controlled, to take up as income, stock dividends received at an amount greater than that charged against earnings, earned surplus or both of them by the issuing company in relation thereto."

These statements, of course, can not be read as recommending that a credit to income should be made upon the receipt of stock dividends. It is, however, beyond question that they do give a tacit approval to such entries if confined within the limits stated.

This attitude has aroused a most beautiful controversy. From lawyers, corporate officers, economists and publicists (but not from accountants) who advocate the taking up of stock dividends received at market value upon day of receipt, there have come criticisms of the hide-bound conservatism of the position taken. From accountants, corporate officers and others we have received complaints of the disruption of accounting and business morals and the financial ruin of the public involved in our highly unconservative attitude. We have received enough copies of the decision of the supreme court of the United States in the case of *Eisner* v. *Macomber* to serve any reasonable man for the rest of his life. Perhaps, as in some other cases, the truth lies in a position between extremes, such as has been taken.

I have called the controversy a beautiful one because there is a certain degree of difficulty in defending a position attacked from diametrically opposite standpoints.

For this present purpose the contention that stock dividends received should be taken up at market value upon the date of receipt may be disposed of relatively briefly because, so far as I know, no accountant has yet espoused that cause.

Among the most commonly accepted of accounting conventions appears to be that no earnings should be taken up in any given period excepting such as may have been realized within that period. Even past earnings erroneously omitted at the time are usually credited to surplus rather than to distort current year's earnings by adding them thereto. The actual process of earning may have extended over years. It is only upon realization that

the profits are shown upon the books. To depart from this convention would mean chaos.

Realization, however, does not necessarily imply the receipt in cash. There are expenses, such as depreciation, which are not incurred in cash at the time of entry and there are many forms of realized profits, properly accounted for on the books, but not representing cash realization. For the sake of the argument and subject to further proof we will assume that stock dividends received represent realized profits to exactly the extent that such stock was charged against earnings or earned surplus by the issuing company. The stock received may be intrinsically or market-wise worth either much more or much less. Usually it would be worth intrinsically more, because of its equity in the earned surplus of the issuing company, which equity does not usually enter into the computation of the charge against earnings. Any further profit or loss in respect of such stock depends, however, upon transactions with third parties which have not taken place and which may never take place. Such further profit or loss has not been realized at the time of the receipt of the stock dividend and should not be recorded until the transaction which gives rise to it has taken place.

In the case of chains of companies holding either majority or minority interests in stocks of other companies there is the possibility of dangerous pyramiding of unearned paper profits, progressing geometrically, not arithmetically, if stock dividends are accounted for by the receiving company on a higher basis than that charged against earnings or earned surplus by the issuing company.

There is attached to this paper as appendix D an algebraic computation showing the results of this geometrical progression. Briefly it shows that, under perfectly normal conditions, given an operating company and three holding companies in chain, each holding nothing but the stock of the company below it and all declaring stock dividends taken up upon the books of the receiving company at market value, the earnings of the parent holding company, based upon nothing whatever but the earnings of the operating company thus passed on to it, are apparently and appear upon its books as 3⅜ times the actual earnings of the operating company.

If this practice should ever become widely prevalent it would do more to destroy confidence in the integrity of America's financial system than anything else of which I can think.

So much for the defence from the standpoint of the charge of over-conservatism in opposing the taking up of stock dividends at more than the corresponding charge against earnings or earned surplus. Next comes the question of unconservatism in not objecting to the entry within this limit.

It is admitted that under supreme court decisions stock dividends do not constitute taxable income and that the approved practice of accountants has been to treat such dividends as merely reducing the cost per share of the stock held without any entry to income. The question arises, therefore, as to what, if any, is the necessity for disturbing the situation or for giving it any consideration at all?

There are several reasons. In the first place there is an entirely respectable, sincere and influential body of opinion that stock dividends received should not only be taken up as income, but that they should be taken up at the market value upon the day of receipt which is often many times the charge made against earnings or earned surplus by the issuing company. While, as above stated, it seems demonstrable that this view goes too far, the wide divergence between this view and ordinary current practice demands careful consideration as to where the truth lies.

Next, it is a matter of common knowledge that the average small investor who often gets his stock dividends in scrip sells them and regards the proceeds as income for all purposes. Frequently the corporation does not issue scrip, but sells the shares in which fractional interests are held and the small investor gets cash and cash alone. It is important to determine whether he is wrong in regarding this as income. Should he treat it as a return of a part of his capital? Manifestly if it is a stock dividend which has been declared, it does not affect the problem whether he has sold what he received himself or whether the corporation has sold it for his account. If he received a cash dividend with an option to purchase stock at a corresponding price which he failed to exercise it is admitted that the cash received is income. If a stock dividend is declared and it is sold for his account by himself or others and he receives the same amount of cash it is declared, as to part of it at least, not to be income. Is this entirely logical? It may be objected that this begs the question as a completed transaction with a third party, the sale of the stock, is here involved. This is true, but the question still remains as to the proportion of the cash received which is income and the proportion which is a return of

principal. Under one theory substantially all that he receives is income; under the other only the difference between the adjusted average price per share of his holdings and the price per share received is income. Which is right?

Last we come to the problems of the large and important corporations, investment trusts or otherwise, which hold a portion of the securities of stock-dividend-paying companies. It may well be that the holdings of some particular investment trust may consist preponderantly of the stock of such companies. To satisfy their own stockholders these investment trusts must, sooner or later, themselves declare dividends in some realizable form. The individual stockholder can not pay his own bills by declaring a stock dividend upon the appreciation in value of his holdings caused by the withholding of dividends by the prosperous investment trust whose stock he owns. An investment trust with holdings largely of this character can not obtain the cash with which to pay cash dividends without selling the stock received as stock dividends and taking up the realized cash profits.

At any given time it may be bad business policy to dispose of shares for this purpose. If, therefore, the stock dividends received do constitute true realized income as to any portion of the value of the shares received, it is important to recognize this fact in order that the investment trust may itself be in a position to declare stock dividends against the revenue so earned.

Bear in mind that only small or periodical stock dividends are under discussion. No one contends that a stock dividend representing a split-up, pure and simple, with no charge against earnings or earned surplus is income as to any portion of it. No one contends that a large stock dividend representing the capitalization of earnings over an extended period of time represents income to the recipient as to that portion of it which is based upon earnings prior to the date of his acquisition of the stock. We are concerned here with small regular stock dividends based upon current earnings.

There are several tests which must be applied by a corporation to determine whether it is wise for it to embark upon a policy of stock dividends or not. With most of these this discussion has nothing to do. The question is when a stock dividend is declared whether it is a true earned stock dividend or not. The test of a true currently earned stock dividend is that after its payment the total book value per share shall be (with due adjustment for intervening

financing) as great as or greater than the total book value prior to the accumulation of the earnings upon which the stock dividend is based—in other words, ordinarily, that the book value per share after this stock dividend shall be as great as or greater than after the last stock dividend.

Applying the accounting rule, as outlined in an earlier portion of this paper, that the charge against earnings or earned surplus should not be less per share issued than the sum of the theretofore capital and capital surplus per share, this means, of course, that after the declaration of a particular stock dividend the earned surplus remaining per share should not be less than the earned surplus per share immediately after the preceding stock dividend. This in turn means that there must have been earned during the period of accumulation not only enough to permit the charge in question without reducing the earned surplus at the beginning of this period but, in addition, enough to provide a similar amount of earned surplus per share on the shares about to be issued as a stock dividend.

If this condition has not been met the propriety of the periodical stock dividend is open to grave question, except, perhaps, for short periods during which what is believed to be a temporary diminution of earnings has taken place and where there is sufficient previously accumulated earned surplus to stand the charge.

If this condition has been met there is clearly no dilution of the stock; the capital has been preserved intact and the stock dividend represents a negotiable evidence of the stockholders' equity in the earnings of the company and not the mere possession of a greater number of pieces of paper than he had before. The position is the same as though he had received a cash dividend of like amount, with or without the opportunity to reinvest such dividend in the stock of the company at the price represented by the charge against earnings or earned surplus.

It should be pointed out, however, that to justify the declaration of a stock dividend of a given percentage, slightly higher earnings are necessary than to pay a cash dividend of an equivalent number of dollars measured by the percentage relation of the dollars to the capital plus capital surplus per share. This is due to the necessity of accumulating, during the period, to avoid dilution a surplus per share to be issued equal to that at the beginning of the period per share then outstanding.

It is said that in the case of a stock dividend the corporation has distributed nothing, that it still retains the undivided title to the earnings upon which the stock dividend is based and that the stockholder is no better off the moment he receives the stock dividend than the moment before.

The corporation has, however, distributed something—namely, a negotiable evidence of the stockholder's rights while leaving his original capital unimpaired. It does retain title to the profits, but, to the extent that it has made a charge against earnings or earned surplus it has frozen them so that they now represent capital, evidence as to the title to which is now in the stockholder's hands separate and distinct from the evidence of his title to the capital represented by his original investment. It is true that he is no better off the moment after he received the stock dividend than he was the moment before, but exactly the same is true in the case of a cash dividend and no one denies that a cash distribution of earnings is income. The point is that with either the cash dividend or the stock dividend, and to the same extent with each, he is better off than he was at the moment of the beginning of the accumulation of the earnings represented by the dividend and he has the tangible evidence of that fact in his hands to do with as he wills.

This fact constitutes realization to the extent that the earnings capitalized have been rendered unavailable for further earned dividends and, although some modification of accounting conventions generally accepted may be necessary to permit a corresponding entry upon the books, no violence to the underlying basic principles upon which those conventions are based is involved.

The case of *Eisner* v. *Macomber* so often referred to in this connection is not convincing, because the question under discussion was not apparently before the court. That case seems to have dealt with a stock dividend paid out of the earnings of an extended period of years. The courts do not seem to have passed upon a case where the stock dividend represents the periodical evidence afforded to the stockholder of his equity in current earnings and these are the cases with which the stock exchange ruling in question is mainly concerned.

That the antecedent earnings of the corporation, evidenced by a stock dividend are not income to the stockholder is, of course, true as stated by the court. That the current earnings so evi-

denced are not income is another question and does not seem to have been passed upon. However this may be, while there are numerous reasons why stock dividends should not economically be regarded as *taxable* income there appear to be no sound reasons why within the limits stated, they should not be regarded as income. The proportionate equity theory I mention only to dismiss. We are not concerned here with questions of corporate control, but of the receipt by a stockholder of a negotiable evidence of earnings which leaves that which represents his original nvestment undiluted and intact.

Over-conservatism in Accounting

This paper is already far too long. It will be impossible to extend it to the point of attempting a discussion of all the problems which come within the scope of its title. It must have been immensely fatiguing to listen to. To those of you, if any, who have had the stamina to keep awake throughout it, and perhaps particularly to those of you who pride yourselves upon your high sense of professional ethics I have only one more suggestion to make—drop some of your over-conservatism! As I see it, it is not the job of an accountant to be conservative. It is not his job to be unconservative. It is his job to be simply accurate and to see that the statements to which he subscribes convey a true picture to the average investor.

When accounts were kept primarily for the information of creditors and of a management-ownership fully familiar with all the details of the business, there may have been some degree of justification for inaccurately large depreciation charges, for charging additional plant to operating expenses, for setting up abnormal reserves for contingencies, for under-valuing inventories and for all the other devices by which both profits and net worth may be made to seem smaller than they really are. At least no one was then deceived to his detriment, though even so it is difficult to see the advantage derived by the management-ownership from deliberately fooling itself.

Today, however, there is the investor to consider in addition. It is almost, if not quite, as harmful to publish inaccurate accounts leading him to believe that his investment is less valuable and profitable than it actually is as it is to delude him in the opposite direction. He is entitled to know the facts, whatever they are. It is the business of the management, not of the accountant, to

stand up against pressure to pay too large a proportion of the real earnings in dividends. It is the proper business of neither to evade taxes by reporting less than the true earnings.

Instances are known where during periods of market depression old established stable industries without any history of rapidly increasing profits have sold at 25 times earnings and five times book value and where some such or larger ratios have been maintained over considerable periods of time, evidencing the fact, that, if these prices were based upon hope of larger future earnings, only disappointment has so far resulted. In such cases it must be surmised that there are facts as to the past performance of the company known to some individuals but not disclosed by the financial statements, which show no evidence of concealed earnings. This is not fair to the stockholder. It hurts him in one of two ways. Either he can see no justification for the market price and sells his stock when, if he had known the real facts, he would have held it; or else he surmises that there is some factor affecting true earnings and assets not known to him, and, being wholly without measure of its degree of importance, he overestimates its true bearing upon values and so tends to continue to hold his stock at prices at which he should sell. Apart from its bearing upon the fortunes of individual stockholders this tends to pave the way to inflation and so to market panic.

It is even questionable whether the growing practice with types of companies which really possess a substantial item of goodwill, of writing down that item to "the conservative valuation of $1" is not to be deplored. While the value of goodwill is variable, it is the most vital asset of some lines of business and, objectionable as any overstatement of this item is, a more accurate picture is presented by its inclusion at a reasonable amount where it exists. If desired the offsetting item could be in the capital surplus account, thus providing the means of a certain degree of flexibility if the necessity should occur for making a change.

In concluding, therefore, I wish to leave with you the question as to whether, when an accountant sees evidence of inaccurate conservatism in accounts, it is not his duty and obligation to the investor to make some suitable reference to it in his certificate.

Assuming that all that has been said here is correct, as far as it goes, it is not to be presumed that it constitutes the last word to be said. Men change, methods change, social, financial, indus-

trial and commercial practices change. These changes have affected accounting in the past, they should affect it in the present and they will continue to affect it in the future. We can foresee that future only dimly and so our planning for it must be subject to correction as the need for correction occurs.

If what has been said here should prove to be correct, much of it will seem inadequate after the passage of a few years. It is offered merely as a contribution towards the outlining of those things which seem wise and practical to do in order to cope with the conditions of here and now. If we can do that successfully, we are warranted in hoping that, as conditions change and develop in the future, we may be able so to change and develop our own thought as fully to meet them.

To the end that these new conditions may be met adequately as they arise and that the old ones, here set forth, may be so treated as to arrive at some consensus of opinion, the stock exchange would welcome, should you see fit to do so, the appointment of a committee on coöperation with the exchange for the consideration of all such problems.

Appendix A

Hypothetical case illustrating possible large effect upon apparent earnings of an apparently small variation in appropriation for depreciation. For the sake of simplicity only capital obligations affecting net plant in service have been shown, and depreciation percentages have been related to net plant instead of to gross plant as would be proper.

Assume a structure which, as to the items significant for this purpose, is as follows:

Net plant		100
5% Bonds	60	
6% Preferred stock	25	
6% Minority stocks of subsidiaries	5	
Common stock parent company	7	
Surplus pertaining to common stock of parent company	3	
		100

Assume that the correct composite rate of depreciation on the net plant is 2½% and that the total earnings before depreciation

are 7.3. If the correct charge for depreciation is made, the earnings, as stated would be distributed as follows:

Depreciation	2.5
Bonds (60 x .05)	3.0
Preferred stock (25 x .06)	1.5
Minority stock (5 x .06)	0.3
Available for common stock of parent company	0.0
Total earnings before depreciation	7.3

This, it will be seen, leaves no earnings available for the common stock of the parent company. Assume that instead of making the correct appropriation for depreciation (2.5) only 1.8 is actually appropriated. This would leave the difference (0.7) available for the common stock, or 10% upon the valuation assigned to it. If the appropriation for depreciation were to be still further reduced to 1.1 (instead of 2.5, the amount assumed as correct) the apparent earnings available for parent company common stock would be 20% of the valuation assigned it, whereas its true earnings would be nothing.

Exhibit B

REPORT OF THE SPECIAL COMMITTEE ON STOCK DIVIDENDS

New York stock exchange

In the requirements for the listing of investment trusts recently promulgated by the stock exchange, a provision was incorporated to the effect that investment trusts should not include stock dividends in their income accounts. In recent weeks, the wisdom of this ruling has been the subject of discussion between the stock exchange and representatives of many companies affected by its operation, and a special committee has been looking into the question of stock dividends from the point of view of the exchange with a view to clarifying the issues involved.

Based on the report of this committee to the governing committee, the following statement of position is made: The interest of the stock exchange in the method by which companies account for stock dividends arises out of its consistent policy of attempting to obtain, in connection with corporate returns, such a clear disclosure of the relevant facts as will enable the investor to properly appraise the listed securities in which he is interested.

The stock dividend has, in late years, become an important instrument in the financial policy of American corporations, and there can be little doubt that its use is still in the early stages of development. In particular is it of value to corporations in growing industries requiring the use of large additional amounts of capital, as it permits them in some measure to obtain this capital in the simplest manner from their own stockholders, and, at the same time, permits these stockholders, if they are so inclined, to realize upon their share of current or past earnings so capitalized.

Coincident with the development of the stock dividend, there has taken place the development of the less than $100 par and of the no-par-value stock, together with the practice of having large capital or paid in surpluses; and

these relatively new conceptions have led with increasing frequency to the corporate practice of partial or complete recapitalization through the form of so-called "split-ups."

As a matter of definition from the point of view of the exchange, a true stock dividend represents the capitalization, in whole or in part, of past or current earnings; while a split-up has not of necessity any relation to earnings and may mean nothing more than a change in the form in which ownership in an existing situation is expressed.

Accounting practice, in striving to adapt itself soundly to these important developments in corporate procedure, has not yet reached the point where a mere perusal of the year's accounts will suffice to reveal to the average investor in what manner he has been affected by action taken during the year in the matter of stock dividends. On this account, it is felt that the exchange is justified in seeking to obtain wherever possible for the benefit of the investor such supplementary information as may assist him to a correct understanding of the accounts themselves.

Applications for listing which involve questions relating to stock dividends will be considered in the light of the foregoing. In view of the large and constantly increasing number of listings on the exchange, either originating in stock dividends or involving questions that have to do with stock dividends, an effort will be made to obtain for the investor such information as may place him in the position to determine in connection with stock dividends received by him, to what extent they constitute true stock dividends representing the capitalization of current or past earnings, and to what extent, if at all, they represent merely split-ups involving an expression in a new form of what was already his. In any event, it is felt that the individual investor should make such independent investigations as seem desirable in order to be quite sure that he understands in each instance how he has been affected by the declaration of a stock dividend.

When stock dividends are received by investment trusts, holding companies or other corporations, the manner in which these dividends are accounted for by the receiving company presents a problem somewhat different from that attending the accounting for the payment of stock dividends by the declaring company. Current practice varies all the way from the policy of ignoring stock dividends in their entirety in the income account of receiving companies, to the policy of taking them into the income account whether they have been realized upon or not at the full market value on the date received.

Uniform accounting practice today seems to favor as sound procedure the ignoring of stock dividends in the income account of receiving companies. However, it has been urged on behalf of investment trusts, holding companies and others, with what seems to us to be some measure of justification, that a technical interpretation of the nature of stock dividends may operate to hamper management in the adopting of perfectly reasonable and proper dividend programmes of their own, whether in cash or in stock, and may even under certain circumstances force them as recipients, for technical reasons, to realize upon stock dividends which for business reasons they would have preferred to hold.

It may be that accounting practice will undergo certain modifications in the light of these new tendencies, but it is too early to form an opinion as to the direction that this modification is apt to take. It is possible that a schedule of all stock dividends received will suggest itself as a desirable addition to the annual report of investment trusts, holding companies and others; or, conceivably, a new departure in accounting theory may permit the inclusion of stock dividends in some form or other in the income accounts of receiving companies.

At the present time, it appears as if the exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus

account by the paying companies. The manner in which receiving companies account for stock dividends received by them and realized upon during the period under review is a matter which the committee will pass on in connection with each specific instance.

RICHARD WHITNEY,
FRANK ALTSCHUL,
ROLAND L. REDMOND,
J. M. B. HOXSEY.

September 4, 1929.

Recommended to the governing committee by a joint meeting of the law committee and the committee on stock list, held September 9, 1929.

ASHBEL GREEN, *Secretary.*

Adopted by the governing committee, September 11, 1929.

ASHBEL GREEN, *Secretary.*

EXHIBIT C

NEW YORK STOCK EXCHANGE

Further announcement on stock dividends

The following statement supplements and extends but does not alter the report of the special committee on stock dividends adopted by the governing committee on September 11, 1929.

In the study of the questions leading up to that report and in considering the problems arising out of giving effect to it, the committee on stock list has reached the following definite conclusions, which it seems well to make public for the information of corporations desiring listing:

As recognition of the importance of earnings in the evaluation of securities tends to be emphasized, the importance of an accurate segregated statement of earned surplus in the balance-sheet does so likewise. Accounting should be adapted to the end that this account should show at any given time the exact amount of realized undistributed earnings, either from date of organization, or, in the event of recapitalization, from some fixed stated date. The fact that state laws may permit stock dividends to be paid without any charge against earnings or earned surplus or with only a nominal charge has no bearing upon the correct accounting procedure to be followed.

An occasional large split-up, made for convenience in the form of a stock dividend and capitalized at a nominal amount, whether charged against earned surplus or capital surplus is not objectionable, if accompanied by a statement that it is in effect a split-up.

The issuance of periodical stock dividends with either no charge or with an insufficient charge against earnings or earned surplus, while not illegal under the laws of some states, is apt to mislead stockholders and is not regarded as good practice. If such dividends are declared they should be accompanied by a statement clearly indicating either that they are not true earned stock dividends, or, if actually earned but insufficiently charged against earnings or earned surplus, that the method of accounting leaves in earned surplus an amount which may be again used for dividends without further earnings.

In the accounting for stock dividends upon the books of the issuing company, whether for stock with par value or without par value, capital and capital surplus should be regarded together as the consideration, other than earnings, represented by the stock. The sum per share of these two accounts is the minimum amount, per share to be issued as a stock dividend, which should be charged against earnings or earned surplus in order that such dividend may be termed a true earned stock dividend properly accounted for and in order that earned surplus may not include a fictitious amount available for further dividends without further earnings.

In cases where there exist substantial uncapitalized assets, tangible or intangible, the amount of the charge against earnings or earned surplus should be larger than this minimum amount.

In cases where stock is issued either as interest upon funded debt or as a dividend upon stock of another class with a cash alternative, the amount of such cash alternative measures the minimum amount properly to be charged against earnings or earned surplus. The effect of issuing stock as interest or dividends upon other securities should be merely to conserve cash and not to add to the apparent earnings or the apparent earned surplus, as contrasted with the effect of the cash alternative.

The exchange will not decline to list, for the present at least, ordinary periodical stock dividends insufficiently charged against earnings or earned surplus, providing proper disclosure is made of the nature of such dividends. Stock issued as interest or as dividends upon other securities with a cash alternative will not be regarded as available for listing if it is to be charged against earnings or earned surplus at less than the amount of cash surrendered, excepting as to further issuance of stock under such conditions in cases where such application or applications for listing the senior securities bearing such alternative stock dividends, may have been approved before the objections to the practice were clearly apparent, or unless accounting procedure should develop in a direction which can not now be foreseen, in such manner as to warrant considering full disclosure as adequate protection to security holders of all classes.

The exchange will not knowingly list any of the securities of a corporation which takes up as income upon its books stock dividends received at a larger figure than the proportionate amount charged against earnings or earned surplus by the issuing company. Where the issuing company declines to give this information, objection will be made if the receiving company regards such stock dividends as income to any extent whatever.

Attention is called to the fact that in the rapidly changing conditions of modern business, the exchange is frequently called upon to consider from a listing standpoint an accomplished fact in corporate finance, upon which immediate action is imperative, without adequate time for the consideration of the new problems involved. Such action will not be regarded as creating a precedent upon which reliance may be placed, if further consideration indicates that the action taken is not in the best interest of the public and of the exchange.

Recommended to the governing committee by the committee on stock list, at its meeting held April 28, 1930.

Robert Gibson, *Chairman.*

Adopted by the governing committee, April 30, 1930.

Ashbel Green, *Secretary.*

Appendix D

Computation showing effect in a chain of companies of taking up stock dividends received as income to a greater amount than the charge against earnings by the issuing company.

Assume an operating company, a portion of whose stock is held by another company, a corresponding portion of whose stock is held by a third company, and so on in chain. Call the total number of holding companies in the chain "N."

Assume, also, a fixed coefficient by which the apparent earnings of each company are multiplied to determine market price. Call this coefficient "A."

Assume that the operating company declares all of its earnings as a properly capitalized stock dividend, and that each holding company in the chain declares its stock dividend against all stock

dividends received by it, and taken into its income at their market price.

Call the capital per share of the operating company "B."
Call the earnings per share of the operating company "C."

Let $\frac{B}{C} = D$

Then the apparent earnings of any holding company in the chain, insofar as based upon stock dividends resting upon the original stock dividends by the operating company would be

$$C\left(\frac{A}{D}\right)^{N}$$

The market value of the stock of any holding company, so far as based upon its holdings tracing back to the original operating company would be

$$B\left(\frac{A}{D}\right)^{N+1}$$

It is manifest that if "A" is greater than "D" a geometrical progression takes place in the apparent earnings, and in the corresponding market value of the stock of the holding company.

If the coefficient by which the apparent earnings of each company are multiplied varies instead of being constant, the general result, though not the exact amounts, is the same, as long as each such coefficient is greater than the capital per share of the operating company divided by its earnings per share.

In case that less than the entire earnings are declared as a dividend, the geometric effect is still apparent, provided that the ratio of dividends to earnings is greater than $\frac{D}{A}$

As an illustration in figures, assume the shares of the holding company and the shares of the operating company to have been exchanged share for share, all earnings being declared as stock

dividends, the capital of the operating company being $30 per share and its earnings $3 per share, and a fixed coefficient of 15 being assumed as the ratio of market price to earnings per share.

Then the value of the operating company's stock would be 15 x $3 or $45 per share. The apparent earnings per share of the third holding company in chain, although representing nothing but the $3 earnings of the operating company would be

$$3\left(\frac{15}{10}\right)^{3} = 3 \times 3.375 = \$10.125$$

The market value of the stock of the third holding company in chain, though intrinsically no more valuable than the stock of the operating company, would be

$$30\left(\frac{15}{10}\right)^{4} = 30 \times 5.0625 = \$151.875$$