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The contents of this paper do not justify its preannounced title. In the first place, it is manifestly impossible in the time available to discuss, in sufficient detail to warrant their mention, the wide range of subjects implied in the title—such, for example, as the basis of providing for depreciation of producing equipment and the basis of valuing inventories. Upon those two subjects alone there exist, and not without reason, wide differences of opinion between equally competent and well-informed groups and any discussion would lead into the entire field of cost accounting and by no means ignore the field of economics—to say nothing of the possibilities inherent in the subject of valuation of producing properties and its corollary, depletion.

It is, therefore, proposed to confine the present discussion to a consideration of some of the more important matters which should be disclosed in the financial statements in order that the reader may have adequate information concerning them. As these matters are by no means peculiar to oil companies, the title of this paper is again belied.

However, it is believed that a discussion of these matters is particularly timely in view of the action recently taken by the New York stock exchange, the New York curb exchange, and other similar bodies looking to what might be termed more adequate disclosure of the bases upon which financial statements have been prepared.

As you are probably aware from notices appearing in the public press, the president of the New York stock exchange recently addressed a letter to all companies whose securities are listed on that exchange. Although many, if not all, of you may be familiar with the contents of that letter, I shall take the liberty of reading it as it bears so directly upon the principle of "adequate disclosure." The letter reads as follows:

"The New York stock exchange has recently announced its intention of requiring audited statements in connection with listing applications made after July 1, 1933. The public response to this announcement indicates clearly that independent audits are regarded by investors as a useful safeguard.

"If, however, such a safeguard is to be really valuable and not illusory, it is essential that audits should be adequate in scope and that the responsibility

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assumed by the auditor should be defined. The exchange is desirous of securing from companies whose securities are listed, and which now employ independent auditors, information which will enable it to judge to what extent these essentials are assured by such audits. In furtherance of this end, we should be greatly obliged if you will secure from your auditors, upon the completion of the audit for the year 1932, and furnish to the committee on stock list, for its use and not for publication, a letter which will contain information on the following points:

"1. Whether the scope of the audit conducted by them is as extensive as that contemplated in the federal reserve bulletin *Verification of Financial Statements.*

"2. Whether all subsidiary companies controlled by your company have been audited by them. If not, it is desired that the letter should indicate the relative importance of subsidiaries not audited as measured by the amount of assets and earnings of such companies in comparison with the total consolidated assets and earnings, and should also indicate clearly on what evidence the auditors have relied in respect of such subsidiaries.

"3. Whether all the information essential to an efficient audit has been furnished to them.

"4. Whether, in their opinion, the form of the balance sheet and of the income, or profit and loss, account is such as fairly to present the financial position and the results of operation.

"5. Whether the accounts are, in their opinion, fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.

"6. Whether such system, in their opinion, conforms to accepted accounting practices and, particularly, whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto.

"I shall personally appreciate very much your prompt consideration of this matter and any coöperation which you may extend to the exchange in regard thereto."

The accounting principles referred to in the sixth question of the letter and set forth in a statement attached thereto were identified on that statement as certain accounting principles recommended by the American Institute of Accountants' special committee on coöperation with stock exchanges and read as follows:

"1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing house industry) in which, owing to the impossibility of determining costs, it is a trade custom to take inventories at net selling prices which may exceed cost.

"2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

"3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries: nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

"4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

"5. Notes or accounts receivable due from officers, employees or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable."

It will be observed that point number five in the letter from the stock exchange relates to the "basis of consistent application of the system of accounting regularly employed by the company" and that point number six goes on to ask whether such system conforms to accepted accounting practices. No reference is made to a system of accounting regularly employed by the industry in which the company is engaged—the essential thing is consistent application by the individual company of a system of accounting which conforms to accepted practices.

For example, there are unquestionably two or more ways of determining costs of refined petroleum products which conform to accepted accounting practices. Methods "A" and "B," although resulting in substantially different money values when applied to an inventory, might be equally defensible in the light of accepted accounting practices; but the application of method "A" to the inventory at the beginning of a period and of method "B" to the inventory at the end of a period is certainly indefensible, unless accompanied by adequate disclosure of the change in method and of the sum involved in such change. It is perhaps needless to add that no degree of disclosure would justify repeated changes from method "A" to method "B."

It also follows that adherence to a consistent basis of applying the rule of "cost or market, whichever is lower" is essential if that term is to have the significance it implies. The choice between cost or market should not be made at one time on the basis of each separate item in the inventory and at another on classes of commodities or on the inventory as a whole. Similarly, market should not be determined at gross selling prices in one instance and selling prices less direct selling expenses in another.

It has not been an uncommon practice for oil companies to revalue their producing properties (and sometimes other capital assets) at amounts in excess of cost; nor has that practice been confined to oil companies. The resultant appreciation should be, and usually is, credited to capital surplus and disclosed in the financial statements in such manner as to indicate at least the portion thereof which has not been realized through subsequent depletion charges; sometimes the financial statements disclose both the original amount of appreciation and the portion subsequently realized through depletion charges, which, to my way of thinking, is more informative. In either event, the reader of the financial statements is clearly supplied with information which it is universally conceded he is entitled to have—namely, that certain assets of the company are carried at blank dollars in excess of their depreciated, or depleted, cost to the enterprise.

But what is the position if, as has sometimes been the case, the enterprise, for one reason or another, changes its corporate identity after the assets in question have been appreciated? To adopt a simple illustration, assume that company "A," having net assets of $1,000,000 which includes $250,000 of unrealized appreciation, transfers those net assets to company "B" in exchange for the latter company's capital stock having a par, or stated, value of $1,000,000. Company "A" then distributes to its shareholders as a final liquidating dividend the stock of company "B." No change has taken place in the enterprise or its ownership; yet company "B" is technically entitled to drop all reference to the appreciated value of the properties in question inasmuch as those values represent cost to it in capital stock. However, it is my personal view that the status of that enterprise would not be adequately disclosed unless those properties were described in the balance-sheet of company "B" as representing appraised values to the predecessor company.

It may be mentioned that where instances such as that cited have occurred, there has been a marked tendency of late to reduce the par or stated value of the stock, thereby creating capital surplus against which to write down the properties so as to relieve future earnings of charges for depreciation or depletion based upon the appraised values to the predecessor company, rather than upon cost. If the amount by which the assets are written down is limited to the unrealized appreciation there can be no objection to the practice as, in effect, it merely corrects (as far as it can be corrected) the earlier mistake of capitalizing unrealized appreciation. Indeed, it may be perfectly permissible, and even highly desirable, in certain circumstances to go a step further and write off against capital surplus created by reducing capital stock a portion of the excessive cost of assets purchased at peak prices if full disclosure is made, the sustaining theory being that such excessive costs can not be recouped through earnings and therefore constitute a capital loss. However, to go beyond that point in writing down capital assets against capital surplus clearly violates a cardinal principle so well defined in the foregoing recommendations made by the American Institute of Accountants' special committee that it will bear repetition:

> "2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization."

It has grown to be customary for a corporation owning all, or nearly all, of the stock of one or more subsidiary companies to consolidate its own accounts and those of its subsidiaries and present consolidated financial statements which do not in any way reveal the financial position of the respective constituent companies. Whether such consolidated financial statements disclose fairly and adequately the affairs of the enterprise to all interested therein depends altogether upon the circumstances. If the subsidiary companies are, in effect, merely departments of the parent company and were separately incorporated primarily to facilitate operations, consolidated statements may be sufficient, assuming, of course, that intercompany transactions and profits have been properly eliminated. If, however, the subsidiary companies have separate issues of funded debt and/or other obligations not held by companies within the group, consolidated statements alone may not, and frequently do not, suffice to disclose all necessary information. For example, a bondholder of a subsidiary company can form no opinion from the consolidated figures alone of the net book values of the assets of the issuing company, whether the interest requirements have been earned by that company or whether indenture requirements have been met with respect to the margin of working capital to be maintained. By the same token, a bondholder of the parent company is in a similar position, as he can not determine from consolidated figures the net book value of the assets of the subsidiary companies which are subject not only to prior liens of bondholders of those companies but to the prior rights of general creditors—the amount of which he does not know.

It would appear that a situation such as that described can best be met by setting forth in columnar form the balance-sheets and income accounts of the constituent companies, together with the consolidation eliminations and the consolidated figures. Should there be numerous wholly-owned subsidiaries which are in effect departments of the parent company, or of principal operating subsidiaries, the figures of those companies might with propriety be included with those of their respective parents and so indicated in the accounts.

The creation of reserves which are unnecessary or excessive may work as great an injustice upon shareholders as reserves which are insufficient. And reserves once created should be held inviolate for the purposes for which they were created and not used to absorb charges in no way related to them—a practice too frequently followed where a reserve for contingencies has been provided during prosperous times. After all, a reserve for contingencies is, or should be, provided for specific purposes, although the occurrence of the losses it is designed to anticipate may not be predictable or measurable with as much accuracy as, say, losses from bad debts.

Attempts are often made to justify accounting practices on no more logical a premise than that they are "conservative"—which is perhaps the most overworked and loosely used word employed in accounting terminology, the first definition of which is given in a dictionary as "Having power or tendency to preserve in a safe or entire state; conserving; preservative." (It may be remarked parenthetically that another definition is "tending or disposed to maintain existing institutions or views; opposed to change or innovation.") Conservative accounting, within the true meaning of the term, is a virtue, but like all other virtues it can be, and sometimes is, carried to the point where it becomes a vice. Thus, it would obviously be more conservative, in the loosely used sense of the word, to record no income from sales until the selling price has been collected; also, to charge all expenditures for plant and equipment against income in the period in which the expenditures are made instead of in the periods in which the plant and equipment are consumed in income producing operations. However, the conservatism of such a practice would be difficult to justify to a shareholder who had purchased his shares on the strength of the results reflected by an income account prepared on that basis for a year in which collections had been excellent and capital expenditures relatively immaterial. He might very well question whether the accounting methods had "power or tendency to preserve in a safe or entire state" his investment in the company.

Some oil companies write off intangible development expenditures against income of the period in which the expenditures are made, while others capitalize those expenditures and, broadly speaking, write them off, through depletion charges, against the income which they have been the means of producing. The first method is permissible under federal income-tax regulations and there are still many eminently competent accountants who favor it—not merely because it might be termed "conservative." However, it is believed that the second method, which is also permissible under federal income-tax regulations, is rapidly gaining ground, as it results in an income account which sets forth more clearly the earning capacity of an enterprise during the period to which it relates.

The list of specific matters which might require special consideration to ensure adequate disclosure could be expanded indefinitely. However, in addition to those previously described, it may be well to mention the following:

Capital assets not used in the business should be shown separately in the statements if their amount is a factor in relation to the accounts.

Abnormal commitments for capital expenditures requiring fairly immediate cash outlays should be disclosed.

Investments in and advances to (or from) affiliated companies should be shown separately.

Other investments or advances which by nature or circumstance are more or less permanent should be described as such and not included in current assets.

The basis of the valuation at which marketable securities are carried should be disclosed and, if that basis is cost, a marginal notation or footnote should disclose the quoted (or in the absence of quotation, the fair market value) of such securities.

Advances to companies known to be wholly or substantially owned by officers and/or employees should be disclosed in the same manner as though the advances were made directly to the officers and employees.

Cash on deposit with suspended banks should be set forth separately if the amount is sufficient, in relation to the accounts, to justify such treatment; otherwise it should be carried in miscellaneous accounts or claims receivable—not as cash in bank. That caption should clearly include only cash balances subject to immediate (or relatively so) withdrawal by cheque.

If assets and liabilities of foreign subsidiaries or branches are included in the accounts, the basis of their conversion into dollars should be shown; if the amounts included in current assets and current liabilities are relatively considerable they too should be shown.

If any assets have been hypothecated that fact should be disclosed on the balance-sheet.

The portion of funded debt and other obligations not included in current liabilities which matures within, say, one year should be disclosed.

The balance-sheet should contain a note of any arrearage of sinking-fund requirements or of cumulative dividends which have not been declared or of unissued stock which is specifically reserved for conversion or other purposes.

The income account should set forth separately:

Operating income
Income from companies controlled but not consolidated and the nature of such income
Other recurring income
Extraordinary credits
Depreciation and depletion
Intangible development expenditures written off, if not written off through depletion
Abandonments of properties
Interest charges
Income taxes
Extraordinary charges
If stock dividends received have been credited to income the basis of computing the credit should be shown.

The income account should also disclose in a note or otherwise the company's proportionate interest in the undistributed profits or losses for the period of companies controlled but not consolidated.

Reference has previously been made to certain accounting principles recommended by the American Institute of Accountants' special committee on coöperation with stock exchanges. It seems appropriate to mention that throughout the report which that committee has thus far rendered (and also in the letter written by the president of the New York stock exchange) the emphasis is laid upon the consistent application of a system of accounting which conforms to accepted accounting principles so as to set forth fully the basis upon which the financial statements have been prepared. There is no suggestion that that end could be accomplished by formulating a set of hard and fast rules for any class of business enterprise—quite the contrary, in fact. It is also significant to note that the federal income-tax regulations state that "it is recognized that no uniform system of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose" and that the law itself contains a provision that net income shall be computed "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer" unless such method does not clearly reflect income. It is equally significant to note that a taxpayer is not permitted to change his method of accounting without the prior consent of the commissioner of internal revenue.

In the final analysis, the adequacy of the information disclosed by financial statements must, beyond certain elemental essentials, depend to no small degree upon the judgment of the person preparing them. It is suggested that perhaps that judgment might best be exercised by endeavoring to view the statements objectively from the standpoints of the respective classes of persons who may be interested in it—creditors, bondholders and shareholders, present and prospective, as well as the management and governmental and other regulatory bodies.