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Corporate reporting and speculation fever : credibility in tomorrow's financial statements

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CORPORATE REPORTING and SPECULATION FEVER

Credibility in Tomorrow's Financial Statements

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SPRING IS HERE AGAIN, and back in Connecticut where I live, tulips will soon be coming up in the garden.

Sometimes when I see the green leaves and the red or yellow flowers, I think of the man who had a tulip worth $4,000.

This tulip wasn't made of gold or platinum—it wasn't a piece of jewelry at all. It was a real, live tulip, growing in the ground, and someone was willing to pay —and did pay—the equivalent of $4,000 for the bulb from which it grew.

As you probably surmise, the transaction I refer to is not contemporary; it took place in Holland in the 1630's.

But that sale was not an isolated transaction. On the contrary, there were thousands of sellers and thousands of buyers exchanging tulip bulbs at fantastic prices. There is a record of one sale that took place not for cash but by a swap of goods, and the purchaser paid for a single bulb: 4 oxen, 8 pigs, 12 sheep, 4 barrels of beer, 1,000 pounds of cheese, one complete bed, and a suit of clothes.

The buying of tulip bulbs—not to plant and enjoy the flowers but to sell to someone else at a higher price—lasted for three years. Then the fever passed. In a matter of weeks, prices for bulbs fell to three-quarters, a half, one-quarter their previous quotations. Thousands of people were bankrupted.

This classic example of speculation became known as tulipomania—look that up in your Funk & Wagnall's—and you will find it listed there today. Tulipomania was a manifestation of what we would now call "commodity trading." Another hundred years had to pass before financial sophistication reached a point where speculation could take place with pieces of paper standing as symbols for values less tangible than a commodity.

IN ECONOMIC HISTORY, the first instances of modern speculative finance were the South Sea Company organized in England in 1711 and the Occidental Company organized in France in 1717. The basic idea was similar in both cases. The companies would assume a large part of the debt obligations of the respective governments in return for certain monopoly privileges—trade with South America and the Pacific islands in the case of the English venture, exploitation of natural resources in the Mississippi Valley in the case of the French venture.

Shares were offered to the public, and the aura of romance surrounding the South Seas and the New World made the stocks real glamour issues. The prices rose giddily, with the result that the stock could be used as collateral for bigger and bigger borrowings. The promoters issued additional shares, which were used to acquire more properties. Within just a few years, the price of South Seas stock rose 700 per cent. People from all levels of society scrambled to get aboard.

The only catch was that the underlying assets were not worth what the stock was selling for, nor could they be worth so much in the foreseeable future.

The South Sea Bubble burst in England, and the Mississippi Bubble in France, in the same year—1720. A few lucky speculators who had taken their profits earlier made fortunes. But thousands upon thousands of people lost everything they had.

The stock of the Bank of England itself fell by half in four months. Many lesser banks failed. There were government investigations. Some people who feared investigation or who could not meet their debts fled abroad. Panic reigned.

THAT WAS LONG AGO, and conditions change. Thus, it was many years later when one of the best known economists in the United States could allay the worries that a few people felt by declaring, "Stock prices have reached what looks like a permanently high plateau."

The economist was Professor Irving Fisher of Yale, and the time of this pronouncement was 1929. Nor was Professor Fisher alone in his belief. It was shared by other academic economists and by such prestigious figures as John J. Raskob, who had just resigned as chairman of the Finance Committee of General Motors to become chairman of the Democratic National Committee, and Charles Mitchell, president of the National City Bank in New York.

And why not? During 1928 the price of Allied Chemical stock had gone from 154 to 250; Chrysler from 63 to 132; General Electric from 136 to 221.

In relating these events, I cannot help remembering that in a speech to the House of Burgesses in colonial Virginia, Patrick Henry said: "Caesar had his Brutus; Charles the First his Cromwell; and George the Third . . ."—whereupon there were cries of "Treason" from his fellow-members—and he went on ". . . and George the Third may profit from their example. If this be treason, make the most of it."

Like Mr. Henry, I am not pushing any parallels to conclusions. If persons in the audience wish to do so, that is up to them.

My reason for recalling episodes of history is that businessmen are generally so engrossed in dealing with the affairs of today and in planning for the future (as indeed they should be) that they seldom have time to think seriously about anything that happened prior to their own business lifetimes. Yet, as George Santayana has noted, "Those who fail to understand the lessons of history are condemned to repeat its errors."

All of us today realize that in the past few years the stock market—or at least certain sectors of it—have been, shall we say—*exuberant.* Whether the exuberance is of such a degree as to imply a widespread danger, I am not enough of a prophet to say. In recent weeks the market has drifted downward but concern over speculation remains. Just a few days ago the new chairman of the SEC testified before a Congressional committee about the causes and results of speculative activity in the market, and recently another SEC commissioner spoke of "the undesirable effects of the super-heated speculative fever now existing in our markets."

I would remind you that some new-issue offerings of stock in franchised restaurants, nursing homes, and so on—presumably priced by the underwriters at levels regarded as reflecting fair values—have risen two, four, or even eight times the original price in a matter of months. Stocks of some old-line companies, with millions of shares outstanding, have leaped sharply in reaction to take-over bids. It is difficult to believe that a company which has had a market valuation in the neighborhood, say, of $400 million for the past year or so is suddenly worth 50 per cent more.

OCCURRENCES OF THIS SORT should concern all businessmen, since if excessive exuberance were to lead to excessive reaction, it would be bad for all business.

And such occurrences concern certified public accountants not only because of their function of reviewing the financial statements of companies whose shares are traded but because, as professional men, they have a public responsibility.

The accounting profession has taken some positive actions to meet its responsibilities in this respect, and it is trying to take more.

Let me make clear that CPAs are not dogmatically against speculation. They fully realize that, within reasonable bounds, it plays an economically useful role. CPAs realize, too, that the roots of speculation lie in mankind's age-old desire to get something for nothing, and they have no hope or intention of trying to change human nature.

At the same time, however, CPAs realize that speculation has undoubtedly been stimulated by some corporate accounting practices, and they want to keep speculative fever from being aggravated by inadequate or potentially misleading corporate financial data. They want such data to be as reliable as possible and as revealing as practicable. If large numbers of the public do not read the information or, having read it, choose not to heed it, that is their decision.

To return for a moment to my reference to the speculation in 17th Century Holland, if people want to pay ridiculous prices for tulip bulbs, okay. But they should have the means for knowing whether they are buying tulip bulbs or onions.

Today, the tulip bulbs are convertible preferred stocks, convertible debentures—and the latest darling, warrants—which some business journalists have called "funny money." And the investor would be well advised to tip-toe carefully through these tulips or he may end up in the onion patch. All of this is part of the current emphasis on "performance" and the creation of "instant earnings."

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS is in the forefront of those trying to establish fair standards of corporate reporting in the face of the ingenious kinds of securities, and packages of securities, conceived by imaginative financiers. The Institute's efforts in this direction take the form largely of Opinions of its Accounting Principles Board. The efforts have had the general support of the SEC, the stock exchanges, and a good many bankers and businessmen. They have also encountered business opposition.

Probably everyone in an audience such as this is familiar with the several Opinions which the Accounting Principles Board has issued in the past couple of years or which it has proposed and circulated to the business community for comment. But let me tell you briefly about one problem area of special significance.

As we all know, the one figure in a company's annual report which the average stock-buyer pays more attention to than any other is the company's earnings per share. This is the figure that is reported prominently in the newspapers; and, of course, it is a figure that not only amateur investors but the sophisticated ones also take into account.

So it's important to note that the recent pronouncements made or proposed by the Accounting Principles Board bear on the earnings-per-share figure one way or another.

Two years ago last January the Board issued Opinion 9, which did several things. For one, it said that extraordinary gains or losses should be included in a company's reported net income. Previously, as you know, a company might add a nonrecurring gain to, or deduct a nonrecurring loss from, its net income figure, depending on whether management felt it desirable to raise or lower the figure. Conversely, if management did not want the gain or loss to affect the reported net, it could credit or charge the amount to retained earnings, which would not show in the income statement but in the analysis of retained earnings. It was more common to see an extraordinary gain in net income and the extraordinary loss in retained earnings. Obviously, this option could hamper comparison of a company's earnings from one year to another, or comparison as between two different companies. That option has now been closed.

Opinion 9 did something else. Customarily, a company's formal financial statements have shown net income as a *total* figure—the *earnings per share* figure has been somewhere else in the report to stockholders, probably in the President's Letter and the "Highlights of the Year," which are in the opening pages.

An auditor renders his opinion only on

the formal financial statements—not on the President's Letter or any other part of an annual report. Opinion 9 "strongly recommended" that the per-share figure be on the face of the financial statements. Although this was only a recommendation, many companies promptly adopted the practice, and it is now contemplated to make inclusion of the per-share figure necessary if an auditor is to give a so-called "clean" opinion on a company's financial statements.

Further, Opinion 9 recommended that reports for companies having potential dilution in earnings applicable to common stock should carry two earnings-per-share figures that is, a so-called *primary* earnings per share, and also a *fully diluted* figure to show what the earnings would be if all convertible securities and other contingent issues were to be exchanged for common stock.

Still further, it said that the number of common shares used as the divisor in computing the *primary* figure should include the number of shares which could be demanded by holders of convertible securities which derive a substantial part of their value from their convertibility. These were termed residual securities in recognition of their substantial equivalence to common stock.

In a nutshell, the *primary* earnings-per-share figure would be based on the number of common shares outstanding *plus* the number of shares assignable to convertible securities having "common stock equivalency"; and the *fully diluted* figure would be based on the outstanding common plus *all* convertible securities, whether or not they met the criteria of "common stock equivalency."

Opinion 9 came at an opportune time, for a wave of complicated securities was rising, often in connection with mergers and acquisitions. Some securities were so imaginatively conceived that earnings per share computed by the traditional method could be enhanced simply by issuance of the security. For example, common stockholders might be offered in exchange for their shares a so-called convertible preferred stock paying no dividend but carrying the right to convert back into common stock at a rate increasing over the years. Although the value of the preferred would depend entirely on its substantial equivalence to common stock, earnings per share computed by the usual method would be increased because of the reduced number of common shares outstanding. This was a situation the Board felt required correcting.

Opinion 9 did that, but experience with it has revealed a need to expand and clarify the meaning of residual securities. The Board is now doing that.

LAST NOVEMBER THE BOARD EXPOSED another proposed Opinion on earnings per share, one that is drawing heavy opposition from some corporate managements. With the exposure period over and comments received, the APB will consider further action on this matter.

Whereas virtually everyone is agreed that some convertible securities have so many of the market attributes of common stock that they ought logically to be included with common in computing earnings per share, the criteria for determining common stock equivalency can be framed in different ways. The problem lies in how and where to draw the line between gimmicky securities which might give rise to misleading reporting and solid senior securities with reasonable added attractions. A lot of deep thinking and debate are taking place on the subject.

Very likely the Accounting Principles Board will arrive at the conclusion that a convertible security—either debenture or preferred stock—will be considered as the equivalent of common stock when its terms are substantially equivalent to those of the common stock, or when its yield at the time of its issuance is such as to preclude its classification as a senior security. Thus, if the cash yield of a convertible security is far below the prevailing rate for non-convertible long-term debt or non-convertible preferred stock of the same corporation, the security would be considered as a common stock equivalent.

Further establishment of a minimum rate of demarcation for common stock equivalency would go far toward clarifying the general principle laid down in Opinion 9. But even without this needed clarification, Opinion 9 has served to effectively limit the ability of imaginative financiers to use convertible securities to aid in reporting "instant earnings." Recently, *The New York Times* said that John M. Hartwell, president of the Hartwell & Campbell Fund, in connection with his fund "pronounced the benediction on the conglomerates which he said were hurt when the American Institute of Certified Public Accountants changed the rules to require conglomerates to report their earnings on a fully diluted basis."

The attention given in Opinion 9 to convertible securities, and the *lack* of attention to warrants, have fostered a marked increase in the use of warrants to accomplish instant performance. This presents a new challenge to the Board, and it is about to respond by pronouncing that warrants—and options and rights as well—should be regarded as common stock equivalents at all times until they are exercised or expire. Where warrants are outstanding, earnings per share (primary and fully diluted) should be computed by adding to the common shares outstanding the number of common shares issuable upon exercise of the warrants, less the number of common shares that could be purchased with the proceeds from the exercise of all warrants.

THE OBJECTIVE HERE is not to stop the issuance of warrants but to stop the reporting of earnings per share without giving appropriate recognition to the heavy impact of potential dilution.

But this is only a part of the story of the warrant, a truly wondrous security—if it can be called that—because of its leverage and speculative advantages.

Some companies have issued warrants to present stockholders in exchange for nothing. The New York Stock Exchange, with the agreement of the accounting profession, has made this ploy less appealing by requiring the warrants to be accounted for as if they were stock dividends. That is, retained earnings must be capitalized in the amount of the fair market value of the warrants. Since this requirement has been made known, some companies have withdrawn proposals to issue warrants. Incidentally, the Exchange has a policy of refusing to list long-term warrants because of the problems they have historically created.

Warrants also have been issued in connection with takeovers of other companies, and issuing companies have tried to apply pooling of interests accounting to the transactions. The accounting profession has prohibited this practice by a less formal means than an Accounting Principles Board Opinion.

All these actions and proposals have come about, not because accountants like to make life more complicated than it is already, but because businessmen themselves have devised complicated ways to acquire and finance companies. CPAs do not take a stand as to whether acquisitions and conglomerations are good, bad, or indifferent from a standpoint of economic or social principle. But they have been confronted with tough problems of how to handle these matters in financial statements in a way that will be fair to the investing public.

THE ACCOUNTING PROFESSION feels these problems have to be dealt with because financing has come to involve such a large number of warrants and convertible issues (including some with conversion rates which change at different periods of time) that the customary way of computing earnings per share is no longer adequate. Some financing arrangements have been so structured, in fact, as to result in what might be called "ersatz earnings."

Convertible securities have been issued particularly to form conglomerate companies, a phenomenon which is drawing increasing attention from Congress and the SEC. No less than six Congressional committees are investigating conglomerates this year and competition for star witnesses is likely to grow intense. Also the popular press has found conglomerates to be newsworthy; a recent cover story in *Time* magazine dealt with the subject.

In attempting to shed light on conglomerate companies, the American Institute of CPAs proposed in September, 1967 that highly diversified companies undertake an experimental reporting of revenues and earnings by broad industry segments as a means of helping investors appraise corporate operations. Last fall the SEC proposed regulations that would require product-line reporting in registration statements related to new filings, and at that time the Institute agreed with the objective but not with some of the details for implementation.

A few weeks ago the Commission announced a revised proposal, which gives effect to most of the suggestions made by the Institute. The Institute now endorses this proposal, except for one feature which appears to be ambiguous and potentially incapable of being implemented. The Accounting Principles Board is now considering the need for an Opinion dealing with product-line figures in financial statements reported on by CPAs.

The conglomerate movement has led the profession to take a new look also at the pooling concept. In the fall of 1968, the Institute released a research study in which the authors took the position that, except in certain specified and relatively infrequent circumstances, all acquisitions should be treated as purchases. Not everyone within the accounting profession or outside it agrees with this, and the subject is under continuing study.

Nearly everyone agrees, however, that some tightening of accounting rules is needed in this area, even though there is a wide diversity of views. At one extreme, some would add mild restraints but essentially preserve the status quo. At another extreme, some favor abandoning pooling entirely, and requiring the capitalization of goodwill and subsequent amortization by systematic charges to income.

Many contend that pooling-of-interests accounting fails to provide a fair accounting for the cost of an acquired company. By carrying forward old historical amounts from the books of the acquired company, the combined enterprise avoids the capitalization and subsequent charge to income of high acquisition costs in terms of cash and securities. If poolings were outlawed and purchase accounting required, with amortization of all costs including goodwill, the merger movement would be significantly curtailed. Many if not most acquisitions could not be justified in terms of future flow of income if earnings had to be charged for the full costs involved.

As matters now stand, however, the tax laws and accounting concepts, taken in conjunction, present a situation in which Company A, whose stock has a high price-earnings ratio in the market, can issue new shares in exchange for the stock of Company B, which sells at a lower P/E; and Company A's stock will instantly show higher earnings per share even though the actual dollar-amount of earnings by the combined companies is unchanged. Isn't this the kind of mirage-value that attached to the tulip bulbs?

With pooling accounting, an acquiring company can sell investments or other assets which are undervalued on the books of the acquired company and report instant earnings of sizable amounts. With this kind of earnings magic possible, it is no wonder that soundly-managed, conservatively-financed companies of all sizes have become targets for takeovers. Even some of our very largest banks have been sought by relatively small conglomerates.

AND THIS SAME PHENOMENON has prompted a predictable defensive course of action for managements of target companies who look over their shoulders and see some one gaining on them. One defensive tactic is to revalue assets upwards to the extent possible within the range of generally accepted accounting principles. In 1968, there were more voluntary changes from one acceptable accounting method to another than in any year in recent history. All such changes that have come to my attention have been from a conservative method to a liberal method—from accelerated depreciation to straight line, from deferral of investment credit to flow-through, from expensing of research and development to capitalization, from lifo inventory valuation to fifo. These changes all have the effect of reporting higher asset values and higher current income.

That these alternatives exist is a huge problem area for the Accounting Principles Board, which is dedicated to narrowing the range of acceptable accounting methods. But with the complexity of the many specific problems, alternatives in some accounting areas are going to continue unless and until criteria can be established for determining when specific methods should be used.

IN THE ACCOUNTING PROFESSION'S DRIVE for improved corporate financial reporting, the banking community has been for the most part a staunch ally. Bankers have offered much encouragement and cooperation to the Accounting Principles Board in its efforts, and occasionally bankers have been among the sharpest critics of accounting, followed by business in general. But these same attitudes have not always prevailed when it comes to accounting and reporting for banks

Of particular interest to banking groups are the discussions which representatives of the accounting profession have been having lately with representatives of the banking business and of the regulatory authorities. As you know, the reports of banks to their stockholders, with a few prominent exceptions, speak of Net Operating Earnings the way other businesses speak of Net Income. For example, if the President's Letter to the Stockholders refers to a new record in "earnings", Net Operating Earnings is what is meant. If an earnings-per-share figure is shown on the face of the income statement, it is based on Net Operating Earnings.

Banks do not present a figure for "net income." But net operating earnings do not reflect provision for loan losses or gains and losses on sales of securities. Bank income statements follow a format required for reporting to regulatory agencies, who are concerned mainly with solvency and protection of depositors. But even for this purpose, no one can justify the omission of a loan loss provision from net operating earnings. A preferential income tax treatment complicates computation of reasonable provision for loan losses, but it does not make it impossible. Loan losses are operating expenses of banks, just as they are operating expenses of all businesses that grant credit. Thus, the operating results of an entire industry are overstated. Investors in bank stocks need a fair presentation of income and the Accounting Principles Board is trying to fill that need—in the face of considerable opposition. It is not far-fetched to say that the way banks now report to their stockholders could be the basis for a conundrum like this—Question: "When is a loss not a loss?" Answer: "When it happens to a bank."

Both the bankers and the CPAs are in quite close agreement conceptually, however, and although there are details of application to be worked out, I believe this can be done and that the reporting by banks to their stockholders will soon be more in accord with that of the business world generally. This development is the more important because of an apparently growing interest in bank stocks among investors.

MY COMMENTS HAVE BEEN FOCUSED ON problems of financial reporting and efforts of the APB to deal with these problems. This is only one aspect of the program of the American Institute to improve financial reporting and the professional standards of performance of its members. These efforts and the self-regulation of stock exchanges and other institutions in the financial community are essential if the free enterprise system is to continue as we know it.

History shows that the free enterprise system can fall into disfavor as a result of lack of foresight, self-discipline and responsibility. Such episodes are unfortunate not only because the system is the most efficient for producing goods and providing services but because it is the one most consistent with individual freedom. The price of maintaining the system is constant vigilance against excesses and laxity. Every one of us who plays a responsible role in it must do his part.

ADDENDUM

A few days after Mr. Savoie's address, the Institute's Accounting Principles Board approved two new Opinions and reached general agreement on a third.

> ...*Commercial banks must now report a net income figure, including provisions for loan losses and results of security transactions.*
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> ...*No accounting recognition is to be given to the conversion feature of convertible debt, because of the inseparability of the debt and equity features. A value should be attributed to detachable warrants, however, determined at or shortly after time of issuance.*
>
> ...*Substantial agreement was reached on an Opinion dealing with earnings per share; in particular that earnings per share figures should appear on the face of the income statement and that the determination of the common stock equivalency of a convertible security should be made only at time of issuance.*

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