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"Are Present Forms of Financial Statements Satisfactory?"*

By Leland Rex Robinson

There is apt to be much "unimpeachable inaccuracy," if we may borrow a phrase from Kipling, unless the question of adequacy or inadequacy in corporate reporting is dealt with in more concrete terms. "Satisfactory"—for what purposes? "Satisfactory"—from whose point of view? This can be determined by reference to the chief uses of corporation reports, after which it remains to be seen whether such uses necessarily conflict with each other or whether certain standards of adequacy are properly to be applied to them all.

The Corporation: Servant or Master?

Modern corporations, whose legal entities set up to make profits from producing and distributing goods and services, are like machines, also products of man's ingenuity, in seemingly having a life apart from their creators. The impersonal nature of modern business, as conducted by means of corporations, led one writer to say that "Not even God can put a corporation in Hell"—this, despite the obvious fact that, apart from church and state, no more effective device than the corporation has ever appeared to bring about coöperation in the activities of men.

For all of us are directly or indirectly involved in several of the half-dozen kinds of relationships between the entities known as corporations and the economic and legal world in which they function. These varieties of corporation contacts may be put down as investor and banker; executive or administrative; public authority; competitor; purveyor of materials or services; laborer; distributor and consumer. In all of these relationships, and particularly for the first three, accurate and adequate corporation reports resulting from the work of accountants and auditors are indispensable for intelligent action. In the measure that marketing of raw materials, labor relations, distribution and consumer use become organized along lines of effective economic service will more exacting requirements appear for corporation reports.

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Economic Progress Presupposes Sound Accounting

We are primarily concerned, however, with corporation reports as the link between bankers and investors on the one hand and the great majority of business enterprises on the other. To investors, present and prospective, creditors and shareholders and to the analysts who serve them is released this overwhelming flood of printed matter pitched to the disclosure of actual operating results and current position through the marshalling of statistics. Qualitative descriptions of business hinging upon volume and performance are subordinated, in the impersonal era of the corporation, to quantitative descriptions of results from the purely acquisitive point of view, crowded into the confusing subdivisions of accounting terminology and all preceded by the dollar sign. Prospective profits are both the mainspring of business activity and the chief determinant of the flow of capital. It is important as never before that accountants' figures be more than mathematical abstractions and that "profits," as modern business accounting defines them, measure the economic services of business at least approximately.

The foregoing is, of course, a truism which may hardly seem worth repeating. Until it is accepted as a truism, however, by investors, business men and accountants there can be no proper understanding of the close relationship between securities markets and business activity or, more concretely, the dependence of a healthy economic system upon a realistic, and, therefore, a healthy, market for corporation stocks and bonds. There are many reasons for this, all too little explored in economic writings, but in driving home the force of this last remark I shall emphasize three: first, the present ownership distribution of American stocks and bonds; second, the imminent threats to the stability of their markets; and third, the evidences of maldistribution of the nation's capital in "financing finance" rather than "financing business."

Straining at a Gnat; Swallowing a Camel

It is one of those curious paradoxes of history that an almost religious devotion to technological efficiency in individual business establishments is accompanied by indifference toward and well-nigh complete ignorance of what may be called "social efficiency." Thus we run down to the last ton the output of pigiron but know little even now about the output of jobs and the actual state of employment. We calculate to a nicety under various systems of cost accounting the portion of overhead and other manufacturing outlays chargeable against each product, but are slow in applying such acid tests to marketing, that is, to selling and advertising costs. We think we know exactly how savings from technological improvements are applied in increasing net earnings or reducing prices, but we ignore the immediate costs in wage losses of displaced workers, their reduced consuming power and the resulting burdens imposed upon the whole community. We figure out with what may be called "spurious accuracy" the "per share earnings" of stocks (even unto the most humble at the very end of the leverage scale of a complicated capital structure) but have comparatively little real interest in the nature, spread and stability of ownership of the corporation's securities. The demands of social accounting beat incessantly upon the shores of business accounting, but it is as though the inhabitants were only aware of the sea at those times when occasional tidal waves or violent storms wreak havoc along their coasts. So it is that an appalling volume of statistics having to do with physical production and private earnings is used only in a grubbing sort of way because any systematic attempt to reduce to quantitative terms the significance of these things in their broader economic environment is lacking.

Who Own American Stocks and Bonds?

Here we come back to the first of three earlier factors in any grasp of the importance of realistic security market appraisals, namely, the present ownership distribution of American stocks and bonds. Information is wholly inadequate in view of the revolutionary changes in the last two decades. The bureau of the census, for instance, could be of great service in tracing the geographical spread and the distribution among income groups of ownership in American securities, but it has hitherto been more interested in radios owned and similar data. The British income tax is more serviceable than ours in disclosing the people's sources of income as the obligation of direct support to the government reaches residents far down the financial scale.

We have good reason for believing, however, that stockholders in the United States are rapidly approaching, if they do not now exceed, the number of twelve million; and that their ranks have increased more than one hundred per cent. since 1927.[1] No doubt this multiplication of shareowners has been greatly speeded in tempo during the past fifteen months of almost uninterrupted advance in share prices. The number of different bondholders is probably less by four million or more. The total book value of all corporate stocks (stated values of preferred and common stocks plus surplus account) has been calculated in Moody's *Manual of Industrials* as $161,000,000,000 for 1930. This is based upon balance-sheets filed with the bureau of internal revenue by some 400,000 corporations representing, it is believed, considerably more than 90 per cent. of all corporate assets. In this same year total funded corporate debt outstanding amounted to about 30 per cent. of the above; while this face value of bonded debt, when added to outstanding government debts and public and private foreign obligations owned in this country, totalled approximately $90,000,000,000, or roughly 56 per cent. of the stock total. How these figures and ratios may stand in 1936 as compared with 1930 is so largely a matter of guesswork that we must accept the earlier position as not too great a distortion of the present picture.

Business Looks to Stockholders

Now the significant fact is that so much larger a proportion of capital engaged in business has been raised by sale of securities representing equity interests than by issuance of bonds—well over three times the amount. Furthermore, the American people, directly or indirectly, have (or had in 1930) some 75 to 80 per cent. greater stake in the capacity of business to produce profits than in the capacity of governmental and corporate debtors combined to earn and pay interest on their bonds. I say "indirectly" because of course a vast volume of securities belongs to institutional investors such as banks, insurance companies and investment trusts which are in turn owned by shareholders, depositors and the insured. From this condition emerge two interesting facts: (1) that major institutional holders of bonds are banks, insurance companies and foundations, whereas holding companies and investment trusts are the principal corporate owners of stocks; and (2) that individual shareholders, whose numbers threaten to approach those of depositors in mutual sav-

[1] See "The Security Markets" (Twentieth Century Fund, Inc., New York, 1935, p. 60).

ings banks, are in possession of more than twice as much stock as all corporations put together.

The mutual financial dependence of corporations and the growing army of investors should not be underestimated by reference to the concentration of stockholdings in the hands of the public. It is doubtless true, as the Twentieth Century Fund has pointed out in its study on *The Security Markets*,[2] that not more than a tenth of the total number of stockholders owned fully three-quarters of the corporate stock in individual hands in the years 1925 to 1929. Rising living standards and the redistribution of wealth, which are making headway with business improvement and government expenditure, will doubtless reduce this concentration somewhat in the years ahead. Mass psychology, often the determining factor in market trends, acts through extensive rather than intensive demand and the marginal buyer frequently sets the price. Moreover it is not improbable that some 20 per cent.[3] of all the nation's stockholders, comprising almost exclusively small investors, are to be grouped as customer and employee owners, the division being about equal between the two.[3] It is to be expected that corporations will increasingly seek capital funds from their employees, their customers and their existing stockholders, as they will redouble their efforts to make customers out of the owners of their shares. Thus many a humble stockholder will come more and more into contact with the business in which he has a minute interest through means other than occasional dividend cheques and the often, to him, unintelligible reports. His importance to the corporation can not be measured by the smallness of his claim on the profits.

Market Appraisal the Chief Financial Suffrage

However, separation of ownership from control and management, which distinguishes modern corporate activity from the simpler ways of a few decades ago when all these functions were often bound up in the same persons or families, can not be bridged by devices of customer, employee or executive stock subscription. The really effective way in which modern owners of business can make their opinions and wishes register with managements, which are only nominally beholden to them, is through their actions in buying or selling securities. Volume of turnover and trends of prices for corporate shares are of paramount importance in shunt-

[2] Ibid, page 55.

[3] Ibid, page 56–57.

ing capital toward productive or wasteful uses. This is only another way of saying that circumstances determining the appraisal put upon stocks by buyers and sellers will largely channel or dam the flow of funds into enterprise.

New Threats to Market Stability

If purchase of stocks were only for purposes of investment, and if investors were intelligently guided, there would not exist in such measure the imminent threats to the stability of security markets which were cited a few minutes ago as a second reason for the dependence of a healthy economic system upon sober and realistic markets for corporation securities. The dominance of speculative or "professional" interests at many critical junctures of stock-exchange history, however, shows what a superstructure of opinions, hopes, fears, rumors and lop-sided calculations will be built upon the foundation of corporation reports, as long as human nature remains what it is. These misinterpretations are constantly being made of the most complete and clear reports. How much further from a sensible valuation must the actions of markets stray if reports are incomplete or misleading!

Especially is this so during these days when rapidly rising business activity acts in conjunction with an ill-conceived tax policy to force far larger dividend distributions than could reasonably have been expected a year ago under the most favorable assumptions. As the banks are choked with government obligations, artificially low interest rates and huge excess reserves have brought high-grade bonds to unprecedented levels, and this fact encourages commitments in stocks. Corporation earnings are apt to be capitalized at higher and higher coefficients as net profits mount and as payments at the expense of earned surplus tempt speculators to borrow and to plunge. The securities markets may, I fear, be pushed to dizzy heights by these cumulative factors of overvaluation; and when there are realized changes in tax laws, reversals in interest rates or severe checks to business recovery, the crash in stock prices now in building is apt to prove a sharp reminder of 1929 and its demoralizing effects upon business and employment.

"Financing Finance"

A third reason why a healthy state of commerce and industry in these days presupposes a "safe and sane" market for corporation securities has been earlier described as the tendency to use investors' funds for financing finance rather than for financing business. These misusages of capital thrive in periods of market optimism, fatten upon inadequate or misleading corporation reports and find a ready instrument in those investment trusts and holding companies, which, we have seen, are the chief institutional owners of stocks and have often been run in our country rather as repositories for high-priced issues than sleuths on the search for undervalued securities.

The Brookings Institution in its study (1935) on "The formation of capital" presents data compiled by Moody's investors' service that "reveal the proportion of new financing which went for new capital construction annually from 1922 to 1933," that is, a "comparison of security flotations with productive financing." The ratio of the latter to the total fell from 76.3 per cent. in 1922 and 77.5 per cent. in 1923 to 34.7 per cent. in 1929 in a continuous decline; it rose to 71.3 per cent. in 1931 and fell to 36.8 per cent. in 1933 as "a direct reflection of the large government flotations for purposes of deficit financing."

For the earlier decline in ratios of so-called "productive financing" the huge flotations of investment and holding companies may be held accountable. Had capital thus placed for the public gone more into neglected or undervalued situations not suffering from a glut of working funds; had investor demand been shunted into pioneering or newly productive fields rather than to a piling of Ossa upon Pelion in bidding up the prices of already overvalued stocks, there would have been less use of "other people's money" during the late-lamented "new era" to finance finance and more use to finance the needs of commerce and industry, thereby causing goods to move and people to gain employment.

Bounds of Helpful Speculation

This is not to condemn speculation or to attempt the impossible in setting it wholly apart from investment. Where speculation is conceived and carried out as a means of making profits by anticipating changes in business conditions and in earnings of corporations, i. e., where the purchase and sale of stocks and bonds is based upon an attempt at sober business judgment, there can be little doubt that it is economically constructive in that it encourages in the long run the capitalization of business in accordance with its needs for long-term credit. Where, however, speculation is conducted rather as a means of taking advantage of purely technical market movements over short periods or snatching profits from pronounced variations in market prices of securities due to movements of mass psychology, it would appear that the function of speculation in its sound economic sense may be overlooked. The extent to which this occurs has much to do with the adequacy, intelligibility and degree of use of corporation reports.

How Do We Stand Today?

To summarize, then, we find the following:

That stocks are the principal means of financing business today and will continue to be so in the future;

That they are held to a larger extent by individuals than by corporate or other institutional investors;

That the number of individual stockholders has been increasing rapidly;

That holding companies and investment trusts are the chief institutional owners of stocks, in contrast with bonds, which are held mainly by banks and insurance companies;

That the intervention of investment and holding companies between their individual subscribers and the stocks bought by these corporations has often inflated rather than steadied market quotations, diverted capital from productive uses and encouraged pyramiding to an extent wholly unwarranted by basic earning power, and

That market quotations for stocks, which are intangible wealth, dependent upon the outcome of future business transactions as these may be predicated upon past performances, promise extreme instability.

Well, then, here is the situation against which we must measure the adequacy or inadequacy of financial reports of corporations. The title of this address poses the question "Are financial reports in their present form satisfactory?" The answer is "No." Lest we should fail to recognize the signal advance made in recent years, and the fine examples set by some of our leading corporations, let us qualify this negative by the Gilbertian hedge "Hardly ever!"

In briefly commenting upon a few of the seeming defects, of omission and of commission, you must regard me as less a critic of the accounting profession, whose standards are hardly open to question, than of corporation managements; and as less a critic perhaps than one of those dissatisfied and not always practical idealists whom Pope had in mind in the lines:

> "Hope springs eternal in the human breast
> Man never is, but always to be, blest."

Importance of Gross Revenue Figures

We start with that item of information which more than any other single figure shows the extent of a corporation's contact with the public. This is its gross revenue. The importance of knowing the total volume of receipts from all sources, investment as well as business, and representing every aspect of the corporation's activities and interests is at least four-fold. First, it is only by comparing such figures from time to time, with due allowance, of course, for drastic changes in prices charged, that any satisfactory conception may be formed of the rising or falling volume of the company's business. Second, only when gross income is disclosed may the chief components of that income be revealed, thus permitting from period to period an analysis of the relative or changing importance in the picture as a whole of each major activity and interest. Third, the giving out of net, rather than gross, figures prevents a proper breaking down of costs—raw material, fabrication, depreciation, distribution and sales—against the various sources of total income. Last, without gross it is impossible to rate the efficiency of the business as a money-making machine engaged in converting the raw material of aggregate receipts into the finished product of net profit on all capital, borrowed and share, employed in the business. Thus technical considerations in determining a corporation's real position and prospects square with the reasonable demand that a business should render the public an accounting for the use of every dollar which it takes from the public.

In my studies of "Corporate earnings on share and borrowed capital in ratios of gross income,"[4] an attempt was made to develop this significant measure of corporate earning capacity over the entire post-war period (1918–1935). It is to be expected that ratios of net profit to gross income will vary greatly from one type of business to another, depending upon such factors as average rates of turnover, importance of processing as compared with raw material costs, distribution as compared with production outlays,

[4] Journal of the American Statistical Association, March, 1934; and September, 1936 (Vol. 31, pages 481–490.)

labor costs as against material costs, and so on. But as a means of weighing the purely business efficiency of one concern against another in the same field, or as a measure of the changing rates of earning ability from year to year for the same company under rising or falling volume or prices, these net-profit-to-gross-income ratios are perhaps more satisfactory than ratios of net earnings on share capital (where changes in capital structure such as alterations in proportions of borrowed and share capital directly affect such ratios) or than calculations of earnings expressed in percentages of capital employed (capitalization being often as much a reflection of established or prospective earning power as it is of funds actually at work in the business; and in the confusion of legal devices with sound financial principles, being often distorted by write-ups, write-downs, surplus items, par and stated values, and so on).

Inadequacy of Federal and Corporate Figures

Now in tracing such net-profit-to-gross-income ratios in an attempt to see what part of the consumer's dollar goes to capital and how worthy of the investor's confidence different companies and industries may be, I have run against the reluctance of many companies to give out any gross figures. Not even the federal statistics of income, that basic source of information on corporation earnings, gives satisfactory figures of gross from the hundreds of thousands of companies reporting to the bureau of internal revenue. Returns and allowances, instead of always being taken from gross, are at times accounted for under miscellaneous expenses. The concern of the revenue authorities being to obtain a correct statutory net income, no uniformity in accounting has been enforced in determining a figure which will be the same under a variety of ways of handling income and deductions that are different for companies in the same categories and are altered at times by the same corporation. Miscellaneous income may include items of net profit or it may not.[5]

The gross income from federal figures is, therefore, not only a mixture of gross and net items depending upon variations in accounting practice from company to company and even from time to time for the same companies, but it is anywhere from two to three years late. In analyzing reports of representative indi-

[5] For a technical discussion of the inadequacy of federal figures, see "Income Forecasting by the Use of Statistics of Income Data," by Ebersole, Burr and Peterson, in *The Review of Economic Statistics*, November, 1929.

vidual corporations as a means of checking and forecasting the complete federal figures we find our choice decidedly limited by the views of many business executives that disclosure of gross receipts invites competition or encourages withdrawal of orders where profits are generous, and that it may injure the business in public estimation if sales are rapidly declining. While perhaps more than half of the leading corporations whose shares are actively traded on the New York stock exchange report real gross income, certainly only a minority of the nation's corporations do so. Quite possibly valid objections exist in some cases to publication of real gross, but it must be candidly admitted that the reasons usually advanced against this are the very reasons why, in any sound policy, the figures should be disclosed. It is discouraging for a security analyst to find some automobile companies giving gross and some not, while oil and textile enterprises and businesses in almost every other kind of activity split on this practice. The time has come, in my opinion, to exact uniformity in the reporting of gross revenues.

"Straining" the "Quality" of Earnings

It has been pointed out that the chief lines of a company's business are obscured and expenses are sketchily handled when gross is not fully reported, as happens in many profit-and-loss statements. This means that the "quality" of earnings is not "strained." Starting with net income, not an unknown practice, is like opening the front door to find yourself in the back yard. When a corporation is highly capitalized, owners of its junior equity at the very end of the see-saw are agreeably surprised by the quick increase in "per share earnings" following business improvement. They shortly come to expect miracles by invoking the blessed force of "leverage." When the turn comes a sudden contact with earth from their dangerous perch in the air destroys their confidence and turns them against big business and the stock exchanges.

Companies which offer "per share earnings" worked out to the last cent are simply taking the public "for a ride" if in gross income for the period in question non-recurring or precarious items not frankly disclosed in the report bulk largely, or if expenses are charged incompletely or in careless and inconsistent ways. The more complicated the capital structure, the more misleading are the equity earnings on both the up and the down sides. I have read many reports in the blessed "new era," especially of financial corporations, whose earnings per share of junior stock were so inflated by extraordinary items in gross that it seemed the public was being invited to get vistas from towering heights while the building rested partly on quicksand.

"Capital Profits": Impresario of "Leverage"

Let us be specific in these matters. I refer to the quality of earnings as these trickle through to the public. Perhaps the best of many illustrations that might be given of the danger of lumping all gross earnings in an inclusive figure is that of investment companies which in their heyday sometimes failed to segregate capital profits, although in the United States these profits were usually included in their income. The result was an absurd capitalization of fantastic earnings in 1928 and 1929. It was not made clear that over certain periods profits on turnover of investments were many times interest and dividends received on holdings, and that, were it not for these evanescent profits, earnings on common in some companies would have been less than nothing and the debenture service undermined. In Great Britain it is true that investment trusts do not show their profits. But it is also true that such profits are never put into income and this more than any other circumstance explains why the investment trusts of England and Scotland neither soared so high nor fell so low.

Despite the influence earlier exerted by the New York stock exchange in the direction of running realized profits through surplus rather than income accounts, managers of investment companies are now confronted with a tax law forcing distribution of these profits which a half century of British experience shows should be put into reserves to absorb future losses. The United States government is thus deliberately encouraging unsound practice and making all the more important a clear-cut distinction, for corporations in all categories, between fortuitous and stable sources of earnings.

If financial statements cut down through the layers of capitalization to show the precise extent of earnings overflow for each type of bond and stock outstanding, it is more than ever before pertinent to enquire, first, to what an extent the coverage for debt service and the amount available per share for dividends would be reduced, if not completely absorbed, by a drastic drop in some revenues more spectacular than steady; and, second, by what percentage gross receipts from all sources would have to fall to eliminate earnings on the stock and threaten the interest coverage.

"Times Earned" as a Half-Truth

We have all come across specious calculations of "times earned" which are so often used for naïve comparisons between securities. Such and such a preferred showed its dividend earned five times, and another had an earnings margin of only 25 per cent. over requirements. How much does this in itself mean as a real test of strength, if a drop of 10 per cent. in the gross will eliminate all preferred earnings in the first case but will still leave a margin in the latter? It is a matter of fifth-grade arithmetic to demonstrate that the sensitiveness of net earnings to changes in gross varies with remoteness of claim, ratios of debt to equity interest and the normal rates at which receipts are "covered" into profits. Yet where do we find any simple statements of this sort worked out in reports for security owners and public? Many a corporation executive could profit from this sort of arithmetic test applied regularly to the circulatory system of his profits.

The point is that earnings per share and calculations of "times earned" should not be presented in financial statements for securities of junior rank or for fiscal periods marked by irregular revenue intake without candid allowance for the effects of "leverage" in distorting the relations between gross and net and for the part played by windfalls in swelling the latter. Otherwise "times earned" is a trap for the unwary, and exact earnings per share are an accounting fiction. This is perhaps a counsel of perfection. It is unlikely that one company would add such interpretations to its financial statements unless most of its competitors did so. Nevertheless there is nothing else, in my opinion, which would do more to bring common sense into the reading of corporation reports.

The Nature of "Inventory Profits"

Among those forms of income which come under the heading of windfalls at one time or another, inventory profits stand out. Of course, this cuts both ways, now to puff up the showing and now to wipe out what good management may have accumulated over a considerable period. The importance of inventory does of course vary greatly from one type of enterprise to another; but even in the "years of the locust" not a few companies in merchandising, textile manufacturing, tobacco processing and meat packing show over half of their current assets so employed. How is inventory broken down? What part is raw materials? How much is fabricated or only partly wrought? How is inventory valued? If at cost or market, whichever is lower, when were the purchases made and how is the market figure computed? Has inventory been written down by charging against reserves? If so, against reserves from earnings? The reader is still left largely in the dark, by many financial statements, as to the true nature of a company's earnings. If it is pointed out that the submission of such facts is too expensive, the natural retort is that managers themselves must be in possession of this information to steer a proper course. If advantage to competitors is alleged as an objection, the answer can be made that all companies should be required to disclose some such data as long as they look for capital to public shareholders who depend upon printed reports to form their judgments.

Distribution Outlays: The Cinderella of Cost Accounting

Another variable in income which is rarely set forth in an acceptable way is the outlay for marketing activities. Cost accounting has made great progress on the manufacturing or production side but must go far to catch up in the breaking-down and proper charging of selling and distribution expenditures. The three or four hundred manufacturers associations in this country which have recommended to their members standards or forms for uniform cost accounting have had a gratifying response in several fields where the minority of their members accepting such standards represents the bulk of production. It is not astonishing, however, that selling costs have come in for much less attention than fabricating costs and that probably less than three-score important producers have really grappled with them in an intelligent way. Perhaps the greatest contribution of accountants in the next ten years will lie in the scientific study, searching test and proper statement of distribution costs. Certainly increasing attention is being given to this important field of costing, which may show that results obtained for shareholders are not always in proportion to bally-hoo in advertising.

Unlike some other omissions from most published income statements, then, the failure to separate marketing from production costs and to break down marketing costs into selling and distribution charges often indicates a lack of such data properly organized. Yet its importance is obvious—to people analyzing earnings statements with due regard to inventory and other highly variable factors; to executives concerned with economical sales performance; to consumers who seek value for their money; to leading companies in any industry which wish to raise the levels of competition for the entire group.

There is a vast uncharted field in modern business where the well-oiled mechanisms of production make countless haphazard contacts with the agencies of distribution. Sometime perhaps a fusion will be so far effected that manufacturers will produce to carefully plotted public need and demand rather than to stock which must be disposed of regardless of sales expense. In making possible this transition the accountant may well assume the dominant rôle as chief technician to business, while production efficiency is more or less taken for granted.

Confusion in Depreciation Practice

However, of all expense deductions which befuddle the analyst and defy a close calculation of comparative earnings from company to companies in the same field and occasionally from year to year in the same company, allowances for depreciation and obsolescence are the most puzzling. Some companies do not even separately state their depreciation charges, much less the different kinds of items against which they apply and the method of fixing them. Depreciation is too large a field to enter within the limits of this paper, save to point out the need for greater uniformity and franker disclosure in financial statements. The influence of the bureau of internal revenue has been thrown on the side of conformity of practice among companies in the same industry, with such variations in rates as the actual experience of different enterprises warrants. Railroads follow standards set by the interstate commerce commission. Public utilities, though their accounting practices and reports are prescribed by state regulatory bodies, are far from following the same forms. It is doubtless too much to expect the speedy acceptance throughout industry of uniform standards in depreciation, but it is at least reasonable to exact uniformity among public utilities, especially electric light and power companies. Too much is now at stake in the determination of rate bases, costs of governmental as against private operation and earnings and tax-paying capacity under the two systems to allow indefinite continuance of the present confusion.

Something may be said in extenuation of the practice of numerous companies which have varied depreciation charges with total volume of business. But it is inexcusable for far-reaching changes to be made from one fiscal period to another without such explanation in the reports as will permit due allowance in sizing up the earnings. General Motors, whose financial statements are in some respects models of clarity, sets a good example in its 1932 report. Having written down unused plant to its salvage value and taken an equal amount from its reserve for depreciation, the company announced that, as production was stepped up to warrant a restoration of any of the cut figure, proper corresponding depreciation charges would be made against income.

Unless this business of depreciation is handled with frankness and a stark sense of realism the surplus account becomes hopelessly entangled with profit and loss. Much credit should go to the New York stock exchange for its quiet pressure upon listed companies to keep distinct the fund and the flow. Heavy write-downs charged to surplus items have been discouraged where the effect has been unduly to enhance current net earnings. Similar vigilance will be called for in restoring stated plant values and proper depreciation charges as business continues its upward course. It is as much a distortion of earnings to move depreciation charges arbitrarily up and down by hoisting or depressing plant valuations through surplus entries as it is to hide the actual cost of borrowing by writing unamortized bond discount and expense off reserves.

The Way of Procrustes

Figures are good slaves but bad masters. Unless a term is given a concise and accepted meaning and unless the item so labelled in surplus and reserve accounts really lives up to this meaning, better be less elegant and conventional and dub it what it really is. Whitefield, it is said, could move his audiences to tears by merely repeating the word "Mesopotamia." Many of us have more often been moved to tears (of exasperation) at the way a surplus account is sometimes used to conceal the facts which it is intended to reveal. You recall the marauder Procrustes, fought by Grecian Theseus, who fitted all strangers to his iron bed by stretching the short ones and lopping off the long ones.

The trimming of some items in certain surplus accounts reminds one more of Procrustes than of the technique of double-entry bookkeeping.

Entangling of "Surplus" with Income

Surely the surplus account is the least satisfactory part of many financial statements. By some corporations it is used now as a sink-hole and now as a grab-bag. Many years must elapse in this country of conflicting state incorporation laws before surplus and reserve accounts reach any standards of theoretical fitness, but there are certain near objectives for which we can work. We can insist that surplus be always broken down between capital and earned. We can ask for a description of the sources of capital surplus. We can ask for an understandable reconciliation of surplus to balance-sheet and profit-and-loss. We can oppose stated values for preferred at less than rights in liquidation, with the balance appropriated for capital surplus. We can call for statements in such form that the source of dividends shall be evident. We can make known our conviction (if we share it) that stock dividends should be visibly charged to earned surplus and at not less than their asset values or a reasonable capitalization of their earnings. We can look for a clear description of reserves, their purposes, their origin, and their actual significance with reference to the assets side of the balance-sheet—that is, Do they represent a segregation of assets, as is customary with reserves for sinking-fund requirements or to meet contractual obligations, or are they merely bookkeeping entries, as is true of many reserves? We can hold out for candid explanation of some of the absurd legal technicalities, especially relative to no-par stock, which make a joke of provisions against capital impairment. We can expect operating deductions to come out of the same place whence operating receipts flow. In brief, we can keep up a fight for that kind of surplus statement which will not interfere with an honest disclosure of actual operating results.

Current Assets and Property Account

This is all closely related to the description of property account and current assets in the balance-sheet. A minority of financial statements is satisfactory in this respect. Perhaps the banks have been as bad as any class of corporations in the niggardliness of information made public about their investments. But at least it can not be said of the banks, as it can be said of some industrial and investment companies, that their funds were invested in their own securities to the benefit of surplus or the enhancement of their income upon profitable resale. The change in reports of Allied Chemical and Dye Corporation between 1932 and 1933, it will be recalled, brought out the fact that the most important item in its holdings of non-governmental securities consisted of its own preferred and common stocks, dividends upon which were nevertheless fully deducted from surplus. How many situations of this kind still exist, especially among companies not under the scrutiny of the New York stock exchange?

Progress in the Last Five Years?

Perhaps enough has been said to point out the unsatisfactory nature, from one or more of many points of view, of the bulk of corporation financial statements. I now have to submit to you, in illustration, a check made within the last week of the reporting practices of the thirty industrial stocks going into the Dow Jones market index over the six-year period 1930 to 1935 inclusive. Bear in mind that these are among the nation's leaders and that their accounting practices are, or ought to be, like Caesar's wife, above suspicion.

The seven questions are as follows:

I. How many of these companies showed gross sales in such a way that the ratio of "operating net income" to "sales" could be computed?

The answer is "Fifteen in the 1935 reports, as against fourteen in 1930." This certainly shows a discouraging rate of progress.

II. Is the investment account so itemized as to break down into principal categories the securities owned?

All distinguish, of course, between marketable securities owned (current assets) and investments in affiliates, affiliated accounts and subsidiaries. Only three of the thirty companies gave any satisfactory breakdown of the latter figure in 1935. Of marketable securities owned that year only four gave a passable idea of their make-up, as against five in 1931.

III. Is the property account given in any detail in figures shown in the balance-sheet?

The answer is "No" in every one of the thirty companies.

IV. Are selling and distribution costs revealed apart from fabrication, raw material costs and other costs?

The answer is "No" in every one of the thirty companies unless in a spirit of generosity we concede some slight illumination in five.

V. Does the surplus account clearly distinguish among capital surplus, earned surplus and reserves?

The answer is "Yes" for twenty-eight of the thirty companies in 1935 and for twenty-three in 1930. This is better!

VI. Is reasonably full information given as to how depreciation is computed and allocated?

The answer is an unqualified "Yes" in one company throughout a five-year period; and a conditional "Yes" for three companies the texts of whose reports give an idea of policies followed, two of them back to 1930 and one only back to 1934.

Their percentage of annual depreciation charges to cost of plant, it might be added—for those nineteen companies for which the figure can be computed from the statements of 1935—vary from 1.9 and 2 per cent. to 14.8 per cent. For the nineteen giving adequate data in 1931 the range was from about 2 per cent. (for the same companies showing the lowest 1935 depreciation rate) to 11.4 per cent. for the company showing the highest rate in 1935.

VII. Is information given concerning

(1) the nature of goods carried in inventory; and

(2) the methods employed in valuation of inventory?

The answer to the first of these two questions is "No" for twenty-six of the thirty companies throughout a five-year period, and a qualified "Yes" for three of the remaining four.

The answer to the last question is "Yes" for all but one of the companies in 1935, and for only twenty-three in 1930. Here again is progress.

In view of the foregoing I do not hold it unreasonable for the Twentieth Century Fund to report in its thorough survey of *The Security Markets* (1935) that "we have found that, despite some improvement during the past few years, a majority even of those companies whose issues are listed on the New York stock exchange do not disclose enough information to render their balance-sheets and their income accounts intelligible to the average well-informed investor." (Page 601.)

ARE MANAGEMENTS PROPERLY INFORMED?

Of the seven questions asked a few moments ago, several are also of great importance to groups other than investors. Failure to disclose important data in financial statements sometimes suggests that even directors and executives are working in the dark. Gross receipts, of course, are always known. But are investments being closely followed? Are sales expenses gobbling up too much operating profit? Is manipulation of surplus giving even the insiders a false notion of earning power? Are depreciation charges and standards reasonable as compared with those allowed by competitors? Are gyrations in inventory values bulking too large in profit-and-loss for the latter to have any core of stability? Perhaps management may be excused for not divulging such facts in detail to competitors, but it can not be excused for not having its hand continuously upon the pulse of facts so vital in steering a proper course.

How far data of this sort should be made available in a form useful to competitors is a problem of business statesmanship. Doubtless trade associations will continue to expand such services, with or without the direct encouragement of government. But of one thing we may be certain: Companies publicly owned must feel themselves under obligation to make their published reports intelligible, even though this may conceivably undermine certain competitive advantages. To this extent the interest of the average investor squares with good general business policy.

SOCIAL IMPORTANCE OF ACCOUNTING

Consumers' and producers' coöperation will probably greatly increase in our country over the next decade. Will these undertakings live peaceably with private enterprise capitalized in the conventional ways? Or will blind antagonisms fed on false assumptions create an unwholesome atmosphere? Whether economic or political motives come out on top will depend in large measure upon the availability of information concerning margins of profit under one system or the other.

Labor, too, will assert its right to some knowledge of the real condition of the business. The idea of social security has taken such a hold that employers are now giving some thought to proper charges upon earnings for human obsolescence, to physiological "wear and tear." Once admit that investment of labor and personality in an enterprise is entitled to some of the consideration hitherto exclusively accorded investment of capital and the importance of financial statements to the personnel needs no further arguing.

Governmental authorities exert conflicting influences upon standards of corporation reporting, depending upon the authority and its functions. Charter-bartering states have spread chaos in their competition for incorporation fees and have given sanction to some legal monstrosities in accounting. The bureau of internal revenue is concerned only with tax-paying capacity of corporations, and statutory definitions often obscure accounting realities. Various regulatory bodies, such as the federal reserve board, the interstate commerce commission, the public-utility commissions of the states, the federal trade commission and, above all, the securities and exchange commission are working single-mindedly toward greater clarity.

The several motives of different public authorities epitomize the several points of view from which financial accounting may be approached. There is the purely acquisitive, which would frame statements to magnify profits, minimize losses and obscure operating methods, taking every advantage of legal technicalities often enough adopted by lawmakers to attract incorporation fees. There is the wholly technical interest in sound reporting for the benefit of investors, consumers and public. This is the professional accountant's sphere. There is the viewpoint of social accounting that broadens business costs to include some money equivalent for human wear and tear which increasing federal taxes for social security are bringing home to business men.

All this may seem to imply the need of future published financial statements so complicated as to be meaningless for the average investor. I think not, however. A little thought will show that much simplification may be effected in many unimportant items concurrently with a greater emphasis upon the things that count. A vast improvement in the usefulness of many reports would follow from non-technical definitions of terms such as, for instance, Canada Dry Ginger Ale, Consolidated Gas, Electric Light and Power Company of Baltimore and the Corn Exchange Bank Trust Company of New York give to the public.

The American Institute of Accountants has done much in collaboration with the New York stock exchange to bring realism into accounting. Perhaps the next great service will be to bring realism into textual reports. There is quite a difference between medical charts and a general health report, though the latter be based upon the former. If auditors were answerable directly to stockholders, as they are in England and Germany, it might be less probable that consolidated statements would go unaccompanied by comments upon the actual availability of earnings to the parent company. It would be easier to put professional responsibility behind press releases. And it might prove feasible to give out, in addition to the comprehensive report, an abbreviated form with textual interpretation which would "hit off the high spots" without involving the ordinary reader in a confusing mass of details.