Journal of Accountancy

Volume 67 | Issue 2 Article 3

2-1939

Accountants' Reports and Audited Accounts from an Investment Analyst's Viewpoint

Dwight P. Robinson Jr.

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation

Robinson, Dwight P. Jr. (1939) "Accountants' Reports and Audited Accounts from an Investment Analyst's Viewpoint," *Journal of Accountancy*: Vol. 67: Iss. 2, Article 3.
Available at: https://egrove.olemiss.edu/jofa/vol67/iss2/3

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Accountants' Reports and Audited Accounts from an Investment Analyst's Viewpoint

BY DWIGHT P. ROBINSON, JR.

A LARGE part of the work of an investment analyst is devoted to the analysis of factors, other than the accounts, which have a bearing on the problems of investment, such as the general business and monetary situation, and the outlook for individual industries, as to demand, supply, prices, profit margins, and potential earnings. These might be termed "business factors," as distinct from purely financial or accounting factors. Yet they have a bearing on the results of a particular business often way beyond the capacity of management to meet them. True, they will be reflected in the figures which accountants finally evolve from their painstaking examination of a company's operations. But they so affect the figures that, in a full study of sound investment policy at any time, it seems as though the things to be taken into consideration are, first, what is the general economic situation and outlook, second, how a particular industry fits into that outlook, and third, what the figures of companies in that industry reveal as to results attained in the past and likely to be reached in the future. This last factor is most essential and, therefore, your part in the scheme of investment analysis is not only highly important, but absolutely necessary.

Accountants, of course, are concerned with examining a company's books and producing figures that will reflect the asset position at any given time and the operating results during a given period. As I have said, these figures are of the greatest interest and value to the investment analyst, and I shall try to indicate what are some of the points that an analyst would like to have the accountant show up in his audit of a company's accounts.

These remarks are to be applied chiefly to the accounts of industrial corporations, since the accounts of railroads, being prescribed by the Interstate Commerce Commission, and of public utilities, being subject to state and federal commissions, while of great importance and requiring careful auditing, do not seem to me to have such variety of presentation and differences as do the accounts of industrial companies. In making comments on particular companies for purposes of example, I mean to step on no one's toes, but merely to express my own personal views.

CONSISTENCY OF PRESENTATION

Let us start from the general to the specific. In my judgment probably the most important point is that a corporation show its accounts on a consistent basis. This is insisted on by the New York Stock Exchange and the Securities and Exchange Commission in the case of listed corporations, and, I believe, is an accepted fundamental in your profession. Believe me, the more you make sure and insist that it be accepted by your clients, the more the investment analyst will bless you. There is nothing more aggravating or difficult than to try to compare the figures of the same company for consecutive years that treat certain items differently, so that a lot of time and figuring is required to adjust the operating results to a comparable basis.

Take the case of a large chain store as

NOTE.—Mr. Robinson's paper is based on an address delivered before a meeting of the Massachusetts Society of Certified Public Accountants.

an example of a company in which fundamental changes in accounting policy have raised a question as to the consistency of the statement of its earnings from year to year.

In the president's report to stockholders covering the company's accounts for the year 1934, announcement was made of the acquisition of the assets of certain retail companies which had gone through bankruptcy proceedings. For reasons stated briefly in the report, the management decided to adopt the unusual policy of recording the fixed properties acquired (chiefly store fixtures) on the books at nominal amounts, and in lieu of depreciation on these assets, to make certain charges to the income account to provide for their maintenance and replacement.

The policy adopted in 1934 was continued in 1935. In the accountants' certificate covering the 1935 accounts, it was stated that provision for replacement of fixtures, etc., was made by charges to the profit-and-loss account "on a basis consistent with the provision in 1934." In the president's report for the same year it was stated, however, that on the recommendation of the company's accountants, the management had decided to set up values for these properties "more reflective of their worth . . . than the nominal values heretofore used" and "beginning in 1936 . . . to provide for depreciation on valuations established, at rates based on estimates of the useful life of the assets."

Such a change in accounting policy naturally stirs the investment analyst to inquire whether the statement of earnings under the new policy is on a basis consistent with the statement of earnings under the old policy. An examination of the income statement of this company for the subsequent year, 1936, revealed that charges for depreciation in that year (presumably calculated at rates which were fair and reasonable) amounted to $977,000, as compared with charges for and in lieu of depreciation in the year 1935 amounting to $1,185,000, a reduction of $208,000.

It is situations like this which make the work of investment analysts difficult and trying. We appreciate that, in the last analysis, the statements presented to stockholders are those of the company, on which the accountant has simply been asked to pass judgment. We have some appreciation of the problems confronted by accountants in seeking to persuade their clients to follow consistent and generally accepted accounting practices. We urge you, however, to do everything possible to bring about this result and, especially, to explain and emphasize inconsistencies in the accounts if your efforts to obtain consistency and uniformity of treatment are unsuccessful. In the case of the company just cited, the accountants clearly indicated in their certificate covering the 1936 accounts the effect on the earnings statement of the decline in the amount of depreciation provided and charged to income. They further stated, in the customary phraseology, that the financial statements set forth the company's position and the result of its operations, etc., "in accordance with accepted principles of accounting consistently maintained (except as noted . . . above)."

My brief experience with accountants leads me to believe that they are a busy lot. So are investment analysts! And they don't want to waste unnecessary time trying to line up accounts on a comparable basis if accountants can produce that result for them. *Consistency of presentation of accounts*—that seems to me the cornerstone of your philosophy—and the analyst joins you wholeheartedly in that way of thinking.

Clarity of Presentation

It must be hard, however, to keep clients always adhering to that policy of consistency. On occasions when they do

not follow consistent accounting practices, the analyst would like to see you mark clearly the divergencies from former practice. If there is a change, for example, in the handling of intangible drilling costs by oil companies, as has happened in recent years, somewhere in the accounts, or footnotes thereto, or in the auditors' certificate, there should be a statement of how the change affects the earnings.

One large oil company in 1934 put in effect the policy of capitalizing labor and service costs of drilling producing wells, whereas in prior years these so-called intangible drilling costs had been charged as an expense against current earnings. This change was a logical result of proration laws which prevented a company from obtaining a rapid return on its drilling investment and tended to lengthen the life of wells and spread the return over a longer period of years. But because of this change in accounting procedure, the company's earnings in 1934 increased by $2,578,000 or 29 cents per share. The company's annual report showed this clearly by a footnote to its income account in capital letters referring to the auditors' report which stated the difference in accounting method. The change was also brought to the attention of shareholders in the president's letter accompanying the statements.

If clients insist that nonrecurring items of profit or loss be placed in the income account, you can help the analyst by clearly stating the nature of such items and by segregating them, so that he may know the true current operating results undistorted by factors that tend to cloud the real picture. One company showed earnings of $5.80 a share in its 1936 annual report, but that figure did not reflect the real earnings for the year, because a deduction of $1,840,000, equal to 70 cents a share, had been made for a special payment under employees' annuity plan. This was a nonrecurring charge not truly applicable to the single year of 1936. Since it was clearly shown, even though presented as an expense deduction by the company, the analyst has the facts regarding it and can state the actual operating earnings without it.

The second general suggestion, then, from an analyst's viewpoint, is *clarity*. With clarity of presentation, the analyst can produce consistency and comparability of accounts, though he'd much prefer you to do that also.

Basis of Consolidating Accounts

To come now to some specific comments regarding the income accounts and balance-sheets themselves. What does the analyst look for? First, he would like to know the basis of consolidating the accounts (if the company has subsidiaries which are consolidated). Or, if the subsidiaries are not consolidated, it is essential that the investment in subsidiaries be shown clearly in the balance-sheet with exact percentage of the ownership, in order that the extent of control be known. Similarly in the income account, the dividends from the investment in subsidiaries should be definitely stated. Moreover, in the parent company's report, its share of the undistributed earnings or losses of subsidiaries for the period should be given. Only then can the true over-all earnings picture of the enterprise be visualized.

The Income Account

Sales.—In examining the income account the first criticism that can be made of many statements is that they omit the very essential item of sales. The sales figure is basic in any real analysis of the income account. Without it one cannot have any adequate idea of a company's progress in relation to others in its industry, or whether the management is maintaining its efficiency of operation, compared to the previous years and to other companies. Under the influence of the Securities

and Exchange Commission, more and more companies have published sales figures, and the fact that so many companies, both large and small, do publish their sales figures would seem ample answer to the oft-given reasons for secrecy, namely, that publication of sales would give valuable information to competitors and to customers and be detrimental to a company's trade position and profit margins. Any time you are able to persuade your clients to publish their sales figures, you will be doing the analyst a marked service.

Cost of Goods Sold.—Next in the breakdown of the income account is the figure for cost of goods sold, from which, by deduction from sales, you can obtain the gross operating profit, indicating the efficiency of management in its manufacturing operations, compared to prior years and to other companies in similar circumstances. Helpful to the analyst, but rarely available, would be a further breakdown of cost of goods sold into figures showing the cost of raw materials, the manufacturing pay roll (to indicate the importance of labor costs), and the expenditures for maintenance of productive facilities.

Depreciation.—Depreciation charges, of course, should be stated separately, so that their relation year by year, both to the gross and net plant accounts may be examined and judged.

General, Administrative, and Selling Expenses.—The next figure of importance in the income account is that for general, administrative, and selling expenses, to indicate the relative cost of supervising the operations and getting the business. These expenses are controllable by management within limits and should reflect management's ability to obtain sales and produce results.

Net Operating Profit.—General, administrative, and selling expenses deducted from gross operating profit shows the profitability of operations before adjusting for income from outside sources, interest charges (which depend on capitalization), and income taxes.

Other Income.—Of the latter items, other income is often a source of considerable revenue and should be divided carefully so that its sources may be readily ascertained—whether from marketable securities, permanent investments, etc.

Net for Stockholders.—That brings us to the final net income available to stockholders, which measures the real results of operations and can be examined in relation to sales, plant account, and various other accounts to indicate over-all profit margins, the earnings on the investment in fixed assets, etc., both in comparison to prior years and to other companies.

A set-up such as outlined, showing the major items of an income account, namely,

Sales
Cost of goods sold (divided as cost of materials, labor costs, maintenance)
Depreciation
Gross operating profit
General, administrative, and selling expenses
Net operating profit
Other income
Interest charges
Income taxes
Net for stockholders

not only reveals significant changes in a corporation's operating results, but provides the basis for reasonably accurate forecasts of earning power based on various assumptions regarding sales increases, costs of materials, changes in wage rates, etc., when taken in conjunction with studies of industry conditions.

Extraordinary Charges and Credits

Earnings figures are of prime importance to analysts and to the investing

public, since the market value of any common stock is influenced considerably in the long run by the earning power of a company. It is vital that the published earnings, as shown by a corporation's accounts, reflect the true earning power, consistently and clearly presented, rather than a higher or lower figure resulting from extraordinary credits or charges. Accountants here can be very helpful to investors, as well as to analysts. This is of particular importance to the average investor, who is inclined to look at a newspaper headline stating that the ABC Company's earnings are $5 a share, without realizing that perhaps 20 per cent of this figure may be of a nonrecurring nature.

Charges and credits of an extraordinary nature may well be revealed in a presentation of the surplus account, reconciling the surplus figure at the end of the prior year with that for the year just reviewed. The surplus adjustments should be stated clearly enough to enable the analyst to decide whether or not, in his judgment, the items so charged or credited are truly inapplicable to the year under examination. I have in mind such items as profits or losses from the sale of securities or the sale of capital assets. These can scarcely be regarded as operating profits or losses applicable to the year in which they are taken. From the analyst's viewpoint, it seems logical, therefore, to omit them from the income account and include them in the reconciliation of surplus. If unusual charges are made to reserve accounts, such as the contingency reserve, a statement of changes in the reserve account should also be given.

The Balance-sheet

While the income account seems to me to be of first importance in the analysis of any company, the balance-sheet appears, historically at least, to have been given the primary attention of accountants in their audits. It is certainly a highly useful and necessary document for full investment analysis, since it provides facts which are basic to and supplement the income account. What use would the operating results of a company be if not based on accurate inventories, adequate reserves for loss on receivables, a sound statement of fixed assets, etc. In one sense a sound balance-sheet is a primary requisite of any investment analysis, since it is obvious that no one will invest in the securities of a company that can't meet its short-term liabilities and is going bust in a few months. Assets are really good, however, only as long as they can produce earnings.

Current Assets

A good deal might be done by some companies in setting forth the facts more clearly in their balance-sheets. In the current asset category, for example, the item of marketable securities is frequently found, but often no adequate statement is made as to the exact nature of these securities. If government securities, why not so state? If stocks, that should be given. It would be fairly simple to list or classify the marketable securities so that their type and quality would be known.

One company, for example, in its balance-sheet of December 31, 1932, under "Current assets" had an item of $92,000,000 for "United States Government and other marketable securities." That was a sizable sum of money, both actually and in relation to total assets of $408,000,000. As a result of pressure from the New York Stock Exchange and stockholders, the company revealed in its 1933 balance-sheet that United States Governments were $21,000,000 and marketable securities were $70,000,000. Furthermore, the latter item had been removed from "Current assets" and stated under "Investments," and a footnote to the balance-sheet revealed that $31,000,000 of the

$70,000,000 represented holdings of the company's own common and preferred stocks. The balance of $39,000,000 was stated as being securities listed on the New York Stock Exchange and New York Curb Exchange. Two years later, as of December 31, 1935, the company again rearranged its classification of these items, by removing from "Investments" some $23,000,000 of marketable securities and replacing them under "Current assets." At the same time it revealed that these marketable securities consisted of 224,000 shares of United States Steel common and 90,000 shares of Air Reduction. Moreover, it removed its holdings of its own common and preferred stocks from "Investments" and deducted them from capital stock and surplus. Thus the company has made real progress in rearranging its balance-sheet along lines more consistent with usual accounting practice and in giving stockholders information to which they are entitled, although the item of $29,000,000 of "Sundry investments" still remains a mystery.

It may seem academic to suggest that accounts receivable and notes receivable should be included in "Current assets" only if due within a year, but there have been occasions when notes of longer maturity have been so included. A large corporation does this very thing. In its 1936 balance-sheet, it has "Notes receivable" at $1,687,000, of which only $442,000 is due in 1937. Also, of $2,268,000 of "Contracts of sale of equipment," only $245,000 is due in 1937. Out of $17,177,000 of "Current assets," approximately $3,268,000 or 19 per cent is not truly current. Moreover, $2,550,000 of funded debt (i.e., equipment trust certificates) maturing in 1937 is not included in current liabilities. If noncurrent assets were excluded from and maturing debt included in the current accounts, the current ratio would be 1.81 instead of 3.33, as indicated by the balance-sheet. Trade practices, however, sometimes justify the inclusion in current assets of receivables falling due subsequent to a year from the balance-sheet date, in cases where the rate of turnover, by the nature of the business, is less than once a year. Examples of this may be found in such industries as heavy machinery, furniture, etc., where receivables are represented by installment notes maturing over a period of more than a year.

As for the inventory figure, since that is an important item in determining the year's profits, it should be given on the same basis as in prior years, or any change stated in order to bring out the benefit to or reduction made in the income account resulting therefrom. It would also be helpful to have a breakdown of inventory into raw materials, goods in process, and finished goods, in order to provide some guide to the state of the inventory as compared with prior years, and to the extent of forward buying of raw materials.

Fixed Assets

In the fixed-asset account, a division into land, building, and equipment is desirable, with figures for gross book value, depreciation reserves, and net book value for building and equipment. The basis of valuation—whether cost or appraisal—should also be stated. These details for plant account permit some means of measuring the adequacy of depreciation reserves in any year and over a period of time relative to similar businesses. The depreciation charged to current operations should be based not only on rates adequate to amortize the properties over their remaining useful life, but also on the values reflected in the balance-sheet and not a lower figure.

By readjustment of fixed assets in a period of low prices and depressed values, a company may so reduce its depreciation charges, even though accrued at the same rate, that it will show inflated earning power when recovery sets in.

It is interesting to contrast the statements of two manufacturing companies in this respect. It is believed that these two companies have about equal capacity, based upon operations over a period of years. Yet Company A's depreciation charges are about $1,800,000 annually, compared to about $600,000 for Company B. The latter figure, however, is the result of a readjustment of net property account from $62,000,000 to $36,000,000 in 1933 by a charge against capital and a consequent reduction of depreciation charges from $1,400,000 in 1932 to $560,000 in 1933. In the future, earnings of Company B will be overstated by this difference in depreciation charges.

Investments

In the balance-sheet, investments are often lumped into a sizable item which may be of considerable importance both from an asset and an income standpoint. Just as a detailed statement of "other income" should be made, so should a reasonably adequate division of the investment account be given in order that the important items may be known. Here again the basis of the account—whether carried at cost or market or adjusted to the net asset value of the investment—should be indicated.

Change of Financial Position

A most useful and informative statement for investment analysts, as well as the investors themselves, would be a statement of the change of financial position, which is aptly described by my friend, Professor Cole, as a "Where got and where gone" statement. This statement is built up from comparative balance-sheets to show the change in type of assets and liabilities and the sources of funds used. This is a simple device which, when applied to condensed balance-sheets, gives a bird's-eye view of how the major asset accounts have shifted and what types of assets have been increased or decreased at the expense of others.

Comparative Presentation

From the analyst's viewpoint a comparative presentation of accounts is to be commended, since it permits ready examination of changes which may be significant. The comparative form of statement, either with the preceding year or with several prior years, is even more advantageous to the average shareholder, who usually has no facilities for making a comparison and has probably thrown the prior year's report in the wastebasket. A notable example of comparative presentation of figures was provided by a company which gave in its 1936 annual report condensed balance-sheets and income accounts for eleven years, together with adjustments of earned and capital surplus for the same period.

Frequency of Reports

The frequency of corporation reports is a matter of very great interest to the investment analyst, and in the industrial field is still subject to widely varying practice, ranging from the archaic policy of reporting only once a year to the more modern plan of giving out quarterly and even monthly figures. The present trend, of course, is towards more frequent reports. This has been fostered by the New York Stock Exchange and by the Securities and Exchange Commission, and is in my judgment a desirable, sound practice from the shareholders' viewpoint. You would think that up-to-date management would realize this, but many fine companies which are ably run and are thoroughly modern in their operations, still cling to old-fashioned ideas about giving information to their shareholders. They offer such excuses as the inability to show a true interim statement without taking a physical inventory, the seasonal character of their business, and the far-flung extent of

their operations. These objections may have some merit, but the point is that a large number of big corporations with seasonal operations actually do make quarterly statements available rather promptly. These corporations have similar accounting problems, but they realize the obligation to their shareholders of informing them frequently and promptly of the results of their operations. In Massachusetts Investors Trust, one of the cardinal principles adopted from the very outset in 1924 was to tell our shareholders all the important facts about our operations every quarter, or more frequently if anyone made inquiry. This policy of publicity regarding our operations is, we feel, a source of strength in guiding our decisions and a great safeguard to our shareholders. As large stockholders in other companies, we think that the same applies in their relation with their shareholders.

Conclusion

In conclusion I want to say once more how very important the profession of accounting and auditing is in the present economic scheme. In the capitalistic system the aim is to operate at a profit. The profit system, when unhampered, carries within itself the checks and the incentives which tend automatically to guide the investment of capital, and hence the development of different industries to meet the needs of society. The accounting profession has the guiding hand in stating whether profits or losses are truly being registered. It is interesting to observe the widened scope and significance of its operations and influence. Thirty or more years ago accounts were audited primarily for a company's management to provide information about operations or as a check upon the accuracy and honesty of the company's own books. As the ownership of securities became more widespread, audited reports came to have more importance from the investment viewpoint.

Today, with the trend toward more scientific management of investment funds by trust companies, investment counsel firms, and investment trusts, and under the Securities and Exchange Commission regulations requiring far more detailed financial statements than ever before, the accountant is of even greater value and importance to industry and finance. It seems to me that this trend is likely to continue and that the profession will have an increasingly influential and important role in the future.