FOR RELEASE UPON DELIVERY OF SPEECH

“SOME PROBLEMS IN PRESENTATION OF FINANCIAL INFORMATION TO INVESTORS”

ADDRESS

of

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The constantly expanding capital requirements of industry and the accompanying increase in the number of investors in corporate securities have resulted in countless thousands of security holders who have little or no part in management.

It is well known that effective control of most large American corporations is not exercised by the stockholders who, together, own a majority of the stock. On the contrary, the control is usually exercised by a relatively small group commonly referred to as "The Management."

The average stockholder today casts his vote by proxy, or he does not vote. Most small stockholders cannot attend the annual meeting. Those who do attend are likely to find themselves ignored or ruled out of order if they attempt to voice an opinion concerning the policies of the management.

The practical effect of this is that the principal judgment the average stockholder has to make is much the same as that which faces the bondholder, i. e. shall he buy, hold or sell. The financial data, upon which the present investor has to base his determination to hold, sell or buy more of the company's securities and upon which the prospective investor has to decide whether to part with him money, must come from the management. From this data he must satisfy himself as to the financial condition of the enterprise and the successfulness of its operations.

Under these circumstances, the investor certainly is entitled to a complete and accurate exposition of the affairs of the company and the results of its operations for a reasonable period.

Some managements have been very conscientious in the presentation of pertinent information to present or prospective investors in the securities of their companies. In their prospectuses and in their regular annual reports, often supplemented by regular interim reports, they have sought to inform the investors as fully as possible. Unfortunately, however, the managements of other companies have not been as careful in this respect as they should have been, while still others have deliberately withheld or misrepresented facts that are essential to a sound investment judgment.

Some companies have filed information of major significance with the Securities and Exchange Commission, where it is a matter of public record, but have omitted it from their published reports. The apparent conclusion is that such managements do not wish their investors to be informed.

One of the primary purposes of both the Securities Act of 1933 and the Securities Exchange Act of 1934 is to bring about the dissemination of significant information to investors and prospective investors. The truth, the whole truth and nothing but the truth comes very close to expressing the aims of these Acts with respect to furnishing financial information. However, it must be recognized that the data filed with the Securities and Exchange Commission is not intended to supplant the annual report of the corporate management to its security holders. Of necessity, the information filed in the annual reports to the Commission does not usually go directly to the individual investor. Although available to all, it must be examined in one of the Commission's offices or a fee must be paid for obtaining photostatic copies. This makes it

practicable for institutional and other large investors, security-rating houses, security analysts and investment consultants to obtain the information directly but the effort or expense is prohibitive to the smaller investor. He, in turn, obtains the benefits indirectly through the greater accuracy and helpfulness of the reports of investment counsel, rating agencies, etc. For any intimate and detailed report regarding the affairs of the corporation, the smaller investor must depend upon the company's annual reports to its stockholders. It is hoped that the increased amount of information now being filed with the Commission will raise the caliber of the annual reports of registered companies and that those companies not filing with the Commission will tend to keep step.

As comptrollers, you are responsible for the preparation of the basic financial data included in the prospectuses and annual reports of your respective companies. It has been my experience that men in your positions are usually on the side of those wishing to include more complete and helpful information in case there is any difference of opinion within the management. Accordingly, I am certain that the large majority of you are very much interested in anything that will improve the usefulness of published financial information to your investors.

Not many years ago, accounting authorities spoke of the balance sheet as "the most important accounting statement." Today, the balance sheet has lost some of its prestige and, according to the American Institute of Accountants, "it is generally recognized that earning capacity is of vital importance and that the income account is at least as important as the balance sheet." As long ago as September 1932, a committee of the Institute said, "…the income account is usually far more important than the balance sheet." This shift in the emphasis placed on financial statements is largely due to the significance that has been placed upon earning capacity in valuing corporate securities.

Because of the major importance attached to the Profit and Loss Statement and the Statement of Surplus, I shall comment chiefly upon matters relating to them.

DISCLOSURE OF SALES AND COST OF SALES

Despite the increased importance attached to the income accounts, some concerns disclose little more than earnings per share in reports to stockholders. Earnings per share must not be confused with earning capacity. Disclosure of earnings per share is a bare statement of past results and cannot be considered a reliable guide to the future. Judgments formed by analysts, investment counsellors and financial writers are based mainly upon forecasts of earning capacity. In making a calculation of this nature, it is essential that the investor have complete information regarding not only the results of past operations but also the manner in which such results were obtained.

An analyst's forecast is prepared, in many respects, in a manner similar to a company's budget. The starting point is sales. As a student of business and economic conditions, the analyst first forms opinions regarding the trends of business in general and within specific industries; then he translates his opinion into a forecast of the sales volume that a particular company should obtain. In order to forecast sales volume, the analyst must have a record of the company's past sales.

The trends of wage rates and material costs are readily available. By measuring past costs in terms of present cost trends, the analyst may estimate the cost of anticipated sales. Here again, the forecast is based upon historical facts.

Where anticipated sales and cost of goods sold have been calculated in this manner, the profit remaining after deducting all expenses from sales--in other words, the earning capacity--can be forecast with reasonable accuracy if there is a sufficient break-down of the expenses of past years to afford a basis for projecting them into the future. On the other hand, if a forecast is, of necessity, based only on the amount of net profits reported for prior years, it will be of very little value.

The management and the controlling stockholders of a company have access to all the facts, whereas the other interested investors, as previously mentioned, must depend upon the management to furnish them with the necessary data. In numerous instances, the management has been unwilling to disclose such pertinent information as sales and cost of goods sold and there are plenty of instances in which they have refused to do so. The arguments most frequently advanced in such cases are that disclosure of such information may damage the competitive position of the company or subject it to serious pressure from customers. I find it difficult to give credibility to these arguments in most cases.

It is common knowledge that competitors often have more information concerning each other than is disclosed in the best of reports to stockholders. Some of this is obtained from private or secret sources and some from an astute use of public sources. Quite often, information may be obtained from state franchise and income tax reports. Competitors and customers to whom the information is important can afford to take the time and trouble to get it from these and other sources. The ordinary investor cannot. A company's cost accountants can prepare reasonably accurate cost estimates of other companies' products and, as selling prices are not secret, the per cent of gross profit realized on sales also can be estimated. Salesmen, through their contacts with the trade, usually have a pretty fair idea of the proportion of the market supplied by the products of their competitors. Upon this and other available data the sales volume of competitors can be approximated.

Frequently, the officers and directors of a company act as directors of other companies or of banking or investment houses and through such dual capacities obtain confidential data relating to competitors. No doubt many of you know of instances where the management of one concern, through cost studies, market surveys, interchange of employees, interlocking directorates or other sources, has obtained confidential information regarding other companies. Under such circumstances it is difficult for me to attach great significance to the usual protests against revealing such basic financial data as sales and cost of sales.

The trend for years has been away from keeping significant financial data secret. When public participation in corporate stock and bond issues was first solicited on a large scale, managements were inclined to consider operating data as private information to which they alone were entitled despite the fact that in many instances they owned only a small interest in the enterprise. Since then there has been a steady improvement in corporate reports although there is

still much to be desired by investors who are outside of the management group. The insider has the benefit of all corporate information including current reports of earnings before they become public knowledge and budgets of future periods. Some inequities are of necessity bound to continue but at least the outside investor should be given all the useful information that reasonably can be given.

It is estimated that in 1920 less than 15% of the manufacturing, merchandising, extractive and service companies whose securities are now listed on the New York Stock Exchange disclosed both sales and cost of sales in published reports although the form recommended by the Federal Reserve Board in 1917 and other forms recognized by accounting authorities at that time were designed to provide for the disclosure of such information. In fact, over 25% of this group of companies did not even publish statements of profit and loss for 1920. In order to determine the trend in the form of statements of profit and loss, we made a study of the annual reports to stockholders by a sample group of industrial companies for the years 1920, 1925, 1930, 1932, 1934 and 1936.

Of the statements examined for 1920, 11% disclosed sales and cost of sales; 35% disclosed sales. The statements disclosing sales, or sales and cost of sales, increased in each of the years considered excepting 1932. Approximately 40% of the statements for 1936 disclosed sales and cost of sales and 75% disclosed sales. The increase in statements disclosing sales and cost of sales in 1936 over 1934 may be due largely to the influence of the Securities and Exchange Commission. However, it is apparent that there was a trend toward greater disclosure of operating data in statements of profit and loss long before the enactment of the Securities Exchange Act of 1934. This trend reflects the increase in public participation and public interest in security transactions in industrial enterprises that has been experienced since the beginning of this century.

Information with respect to sales and cost of sales is available in the public files of the Securities and Exchange Commission for practically all registered companies. Obviously, many companies that have filed this information have not disclosed it in their annual reports to stockholders. Because of this practice, the New York Stock Exchange has found it advisable to prepare a form letter relating to the items of sales and cost of sales, pointing out that "since the information is now available to anyone else interested, we feel that it should be made known to stockholders to whom it is of great consequence."

OPERATING STATEMENTS FOR PROSPECTUSES

There has been considerable discussion regarding the proper method of preparing a series of profit and loss statements for prospectus purposes. Three possible methods occur to me. First, statements may be submitted in the form in which they were included in the annual reports to stockholders without submitting additional comments, reconciliations or adjustments to indicate the results of subsequent events affecting the individual years for which statements are included. For example, suppose a company infringed a patent in 1933 and in 1935 was forced to pay as damages the profits resulting from the infringement. The infringement having been unknown in 1933, no charge would have been made against income in the annual report for that year to provide for the damages. In 1935 when the damages were determined and paid, the

charge would have been made to surplus on the ground that the expense was attributable to prior years. Under these circumstances, if the profit and loss statements used in a prospectus were the same as those used in the annual reports, they would not show the actual net profits for the three years period. A substantial amount would have been charged to surplus and the income statements would carry no notice of what had happened.

The second method is identical with the first concept that under it, the 1933 statement would be accompanied by footnotes, or parenthetical statements would be inserted, explaining the effect of the 1935 adjustments on the 1933 income.

The third method would be to adjust the profit and loss statement for 1933, including in it the proper charges for the damages attributable to that year.

The first method seems to me to be quite unsatisfactory. It is known at the time the prospectus is prepared that profits for 1933 were overstated and that these particular charges to surplus in 1935 were chargeable against the earnings of 1933. Accordingly, it would appear that the statement for 1933 should present the corrected figures. The choice is then narrowed to the second and third methods. To the general investor the third method would seem preferable, for unless he is reasonably skillful in accounting technique, he is unable to adjust the figures to reflect the correct result.

On the other hand, there have been objections to this third method. Directors and officers who have previously signed an annual report containing financial statements, prepared at the close of the year to give effect to all the then-known information available, and the auditors who have certified to such statements, are sometimes reluctant subsequently to sign a prospectus or a registration statement showing a different net income for the same year. When proper care has been taken in the preparation of the annual report and subsequent unforeseen events necessitate adjustment, I feel certain officers and directors have little need to be apprehensive in subsequently signing statements that differ from the annual report provided the facts accounting for such differences are clearly revealed.

Another objection to this third method is heard from experienced investors who fear that if these corrections are made by recasting the statements, the prospective investor will not be able to detect errors in the judgment of the management or its failure to anticipate and provide for expenses or losses; that the management will be made to appear infallible in its accounting and its statements indicate an absence of need for adjustment entirely out of keeping with the history of the enterprise; and that as a result, investors will be misled into believing that subsequent annual reports will be as accurate as the reports contained in the registration statement appear to be.

It seems to me the problem of presenting as accurate a statement as possible and, at the same time, revealing the changes that have taken place since the annual report, may be solved by the submission of an adjusted statement followed by a reconciliation of the adjusted net income with the net income shown in the annual report. This type of presentation would, it seems to me, be useful and informative to all parties concerned. The investor who is not an accountant could read such a statement more accurately than he could if any other method were followed and the

experienced investor would have a basis for reconciliation with previous statements and for judging the efficiency and foresight of the management.

NON-CASH EXPENSES

Possibly one of the most unsatisfactory phases of an annual financial report is the manner in which charges for non-cash expenses such as depreciation, depletion and amortization of tangible and intangible assets or deferred charges are presented. Often such charges are included in cost of sales or merged with other accounts and consequently the investor cannot ascertain their amounts. Since this type of information is needed for security valuation, particularly in attempting to ascertain the company's cash requirements or in accounting for the disposition of its funds, the amounts of such non-cash expenses should be revealed in the financial report even though they are not shown separately on the face of the profit and loss statement.

The annual charges for most of these non-cash expenses are fixed by the management and are therefore subject to change at its will. Policies of depreciation, depletion and amortization should be established after careful study and these should be followed consistently until the program has been carried out. If there is a shift in policy resulting in a change in the program of write-off, the facts with respect to this change should be clearly set forth so that any one who reads the statement may be fully informed. It is one thing to learn that a particular corporation has earned $5.00 a share this year as against $4.00 a share last year through the increase of its sales or the improvement of its efficiency, but it is quite another thing to learn that this change in earnings per share was brought about through the reduction of the depreciation charge. Depreciation, depletion and other types of amortization often constitute such a large proportion of the company's expenses that information with respect to them is vital to sound analysis.

I should like to speak about another phase of these non-cash expenses. Accountants and business men have often taken the position that for the sake of conservatism it is preferable to write off or reduce the carrying values of certain assets. Thus in many published reports we find that companies have followed this practice with respect to debt discount and expense, patents, property, plant and equipment, natural resources, etc.

Possibly this interpretation of the meaning of conservatism is wholly in line with the emphasis customarily placed on the balance sheet, but if the profit and loss statement is to be given proper recognition, practices of this kind are not as conservative as they might appear at first blush, but rather to the contrary. With every write-down of property subject to depreciation, depletion or amortization, annual charges to expense are reduced and the company's operations from that point on appear to be more profitable than they actually are, so that unless the investor is fully aware of what has happened, he is likely to be seriously misled.

The problem is even more serious when the charge reducing the carrying values is made not to earned surplus but to surplus arising from restatements of capital stock or some other form of capital surplus. In such cases the effect of the charge-off may be to impair the equity of the stockholder, and in future years his dividends may not be distributions of income but rather a return of capital.

Where there have been write-downs or write-offs of assets resulting in the distortion of subsequent operating statements, such facts should be clearly indicated to the interested investor. It seems to me the statements should at least disclose what has been done and the effect upon the current year's operations and surplus. It may be worth considering whether under such circumstances the income account should be charged with the amount necessary to write off the original cost of assets and the appropriate surplus account credited with the portion attributable to the part previously written off. In this way the balance sheet would be made to appear conservative without inflating the results of operations. Of course such a procedure would be highly distasteful to those who have written down their assets for the purpose of improving their showing of income rather than for conservatism.

The point I want to emphasize, however, is not a particular method of accounting for such items but the absolute need of the investor for this type of information.

In connection with depreciation, depletion and amortization it is also important that information be revealed with respect to maintenance, repairs, and retirements. Such charges vary according to whether the enterprise is old or new, owned or leased, and according to economic conditions and rate of capacity at which operations are carried on. Closely related to these charges are the rent, property tax and royalty charges. If all these items are revealed, the investment analyst is in a position to intelligently compare a company's annual costs for the use of plant facilities, patents, etc. With similar costs by the same company in prior years and with similar costs of other companies and to more accurately forecast costs of future years. It seems desirable that schedules furnishing information of this kind should be included in the annual report and that they should be accompanied by a statement of the company's policy with respect to the provisions or lack of provisions for these items and of any changes in such policies.

SURPLUS VS. PROFIT AND LOSS

Since earning capacity is highly significant to the investor, it is quite important that all items affecting earnings be clearly revealed in such a manner as to permit them to be allocated to the year to which they apply. The least that can be done, it seems to me, is to include in the profit and loss statement all items of income or expense and profit or loss, attributable to the current year's business even though they may be extraordinary and non-recurring in their nature and to clearly describe the items carried to surplus so that the investor may recast the results of the company's operations. Of course it goes without saying that extraordinary and non-recurring items should be set out separately as such and their nature clearly revealed.

The earned surplus represents the accumulated undistributed earnings of the past and direct charges and credits to that account should be only those having some relation to the past. It is unfortunately not uncommon to find surplus charged with items that properly belong in the profit and loss statement, either as ordinary operating charges or as extraordinary and non-recurring charges. These practices, of course, distort the current statement and result in a false determination of the earnings for the year. True, no sound analyst is going to take the results of the profit and loss statement alone in forming his judgment but, unfortunately, less informed investors may do so.

Inasmuch as adjustments of accumulated earnings in some cases are made directly through earned surplus and are not reflected in the income account for any year, the two statements should be considered together. A number of suggestions have been made for the improvement of annual statements in this respect. One suggestion is that where surplus is adjusted, statements for prior years should be included in the annual report giving effect to the charges or credits made through surplus in the current year. Another suggestion is that adjustments of accumulated earnings should be reflected in the profit and loss statement with proper designation and only the net balance carried to surplus. Still another suggestion is that the profit and loss statement and the surplus schedule should be combined and presented as one statement. Any of these methods, and more particularly the last two, would probably tend to curb the inclination of management to defer questionable items inasmuch as they would have to be reflected in the income account or a combined statement in a subsequent year. (Apropos of this question, may I suggest that you read the interchange of opinions by Professor Sanders of Harvard and Professor Greer of Chicago in the March, 1937, issue of the Accounting Review.)

RESERVES

Companies that would hesitate to charge current losses to surplus often seem to find no objection to doing the same thing by indirection, i.e. by charging them to reserves created by transfers from the surplus account.

Conservative accounting requires the anticipation of losses, and it is a sound policy to provide for them. If provision is made by appropriation of surplus, the reserve so created should be returned to surplus and the loss charged to operations when it is ultimately sustained. Otherwise it will not be charged against the operations for any year. The primary purpose of a reservation of surplus is to indicate that surplus is restricted because of the possibility of a loss, not to provide a burying ground for items the management would like to forget.

Because of the variety of ways in which reserves are created and used, it is essential that a complete story of the reserves be available. It is not unreasonable to expect the annual reports to include an analysis of all surplus reserves in which there have been changes during the year.

SEGREGATION OF SURPLUS ACCOUNTS

Another matter of moment is the segregation of surplus into its various components such as paid-in surplus, appraisal surplus, other capital surplus and earned surplus. To those who advocate a single surplus account surplus is surplus, and it makes no difference whether it arises through earnings, through donations or contributions of stockholders, through restatements of capital or through the appreciation of assets. They point out that in many states dividends may be paid out of surplus however created and there is, therefore, no reason for any segregation.

There appear to me to be several important reasons for requiring segregation. For example, I feel that all contributions by stockholders should be accounted for as capital and clearly reflected as such in the balance sheet. Any person who is, or is to become, financially interested in an enterprise is entitled to know what part of its surplus has been contributed by

stockholders, and what use is made of it. Consequently, paid-in surplus should be separately stated in the balance sheet.

It is difficult for me to justify merging any credit arising from appreciation with earned or paid-in surplus. It is questionable whether appreciation should ever be recognized on the books, but if it is, the surplus created thereby should, at least, be shown separately on the balance sheet.

Very significant facts may be concealed from the investor if all surpluses are thrown together. A company that has suffered operating losses in excess of its earnings accumulated in prior years may conceal the effect of such losses by combining its surplus accounts.

It is sometimes stated that when a deficit has been created in earned surplus, it is permissible to write off the deficit by transfers from paid-in surplus and, accordingly, there is really no significance in keeping a segregation of the two accounts.

While under certain circumstances, there is probably no objection to the use of paid-in surplus in this manner, yet if this is done, any surplus subsequently created through earnings should be distinctly designated as having been earned after the date upon which the deficit was written off. By this means, the investor is put on notice that as of a given date, no earned surplus existed and there is no danger of his mistaking capital surplus for an accumulation of earnings.

CONSOLIDATED FINANCIAL STATEMENTS

If a corporation is a holding company, its financial statements alone cannot adequately portray the affairs of the enterprise as a whole. Hence, the need of consolidated financial statements.

These statements present a statistical concept of the parent and its subsidiaries as one, disregarding all the legal entities. By the elimination of inter-company transactions, profits, obligations, and stockholdings, the affairs of the entire affiliated system are presented as one unit.

For example, a parent selling goods to a subsidiary at a price in excess of its cost will show, in its accounts, profits which, in fact, will not be realized by the enterprise, as a whole, until the subsidiary has disposed of the goods. Again, the financial statements of a company may not reflect the fact that its subsidiaries have incurred substantial losses since their acquisition; however, this condition must be taken into consideration in consolidation.

Consolidated financial statements must be used with discretion. They should not be used without the individual statements of the parent, and attention must be given to the principles followed in their preparation. In this connection, it is important to know what principle was followed in determining the subsidiaries to be included in, or excluded from, consolidation, e.g. were the profitable ones included and the unprofitable excluded; were only those subsidiaries included in which the parent owned all of the capital stock; were subsidiaries in bankruptcy or reorganization excluded; were foreign subsidiaries, particularly those in countries having restrictions upon export of funds excluded; or have subsidiaries engaged in unrelated and widely

different industries been included? Such information is highly important to the analyst and should be carefully revealed.

The practice that has been noted in some instances, particularly in the oil and non-ferrous metal fields, of handling inter-company and even inter-departmental transfers of the products at market price without elimination of inter-company or inter-departmental profits from the published statements seems to me to be particularly undesirable. There may be reasons for the practice in the recording of the various transfers but I find no good reason for failure to make the elimination in the preparation of the final statements.

Before leaving the subject of consolidations, I should like to emphasize the fact that, while consolidated statements are of definite assistance to the investor, they do not reflect the affairs of a legal entity and it is imperative that their limitations be recognized. This is particularly true in ascertaining equities of outstanding securities of the consolidated group. For example, within a single legal entity, creditors' rights take precedence over those of stockholders but for a consolidated group, this may not be the case. Assets of a subsidiary are not likely to be available to the creditors of the parent until the rights of the preferred and minority stockholders of the subsidiary have been satisfied. Similarly, consolidated surplus, to the extent that it is comprised of the surpluses of the subsidiary companies, may never become available for dividends on stock of the parent.

EXPLANATORY FOOTNOTES

During recent years, the tendency has been to present statements in greater detail and to accompany them by comprehensive footnotes where clarification or elaboration is necessary or desirable. Probably this is due in part to the insistence of the Securities and Exchange Commission that statements filed with it be as informative as practicable. The increase in the number of footnotes has been definitely a move in the right direction, but a multiplicity of footnotes may be made to confuse rather than assist the investor. If, by including numerous comments concerning items of little or no importance with only a few that are material, the investor is confused and his chances of picking out those that have real significance are greatly reduced, the company has not rendered him a service. Care should be taken that footnotes are clearly and concisely stated and that those serving only to confuse are not included. In general, I should say it is better to err on the side of having too many rather than too few footnotes; however, no amount of flat contradiction in the footnotes can avoid the effect of improperly applied principles in the preparation of the statements themselves.

CONCLUSION

It has not been possible to deal with all of the ways in which many annual reports of corporations to their stockholders could be materially improved. However, if corporate managements will adopt the philosophy that they are fiduciaries operating their respective enterprises for the benefit of the investors, their annual reports will be increasingly helpful and informative to those for whom they are intended.

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