SOME COMMENTS CONCERNING THE PRESENTATION AND INTERPRETATION OF CORPORATE FINANCIAL STATEMENTS

Address by

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A well known Philadelphia Newspaper has a slogan "Nearly Everybody Reads the Bulletin." With a slight change it might be applied to corporate financial statements: "Nearly Everybody Interprets Financial Statements." Obviously no objection could be raised to a person's interpretation of anything – even financial statements – for his own benefit, but unfortunately most interpreting is done for someone else's benefit. Financial advisers, banks, newspapers, magazines, industrial organizations, corporation presidents, Chambers of Commerce, government officials, politicians, elevator operators, labor representatives, barbers, Everybody it seems – except possibly public accountants – takes a hand in stating what such and such a corporation's profits were. For some reason radio commentators seem to have overlooked this very fertile field for exercising their flair for analysis and prediction.

All the public accountant does is to examine the financial statements and affix thereto a certificate which states simply, with respect to the income statement, that "it presents fairly the results of operations." This assurance by the accountant, however, that the income statement "presents fairly the results of operations" can only mean, and must mean, that the accountant is satisfied that the statement to which he has lent his name, thereby staking his professional reputation, is not susceptible to misinterpretation by those whose responsibility it is to keep the public informed as to its meaning.

I do not intend to attempt to discuss the relative merits of the many interpreters or their interpretations. I should like, however, to bring to your attention, and comment upon, some of the recent statements I have noticed in newspapers, magazines and financial publications concerning profits reported by corporations, how they got that way and why, allegedly, they are not all that they seem to be.

I think a good starting point is an article which appeared in a New York paper on October 5, 1947 under the heading "big Increase Seen in Industry Profits – Rate is Above

Pre-War Years – One-third of Profits Only on the 'Books.'" The article goes on to state that "While the enormous increase in earnings might indicate 'excessive' profits for many organizations, it should be understood that more than one-third of the reported profits are not real earnings but book profits. Such profits are the result of inadequate depreciation charges and inventory revaluation. Inventory profit appears on the books as a result of the higher value per unit placed on goods in the warehouse or in process of production. When the present inventory is sold at an enhanced value, it must be replaced with new stock bought or produced at higher costs. The unreal character of such inventory profit is recognized by the Department of Commerce, which excludes it from the national income total. Based on its corporate figure for the first half of 1947, at the annual rate of $17,400,000,000, the Department reported that $5,500,000,000 of this represented inventory profits." (Incidentally, I could find no reference in the Department report to the term "inventory profits." Reference is made, however, to "inventory valuation adjustments.") Continuing, the article explains that "The other factor that should be considered in evaluating corporate earnings is the inadequate charge for depreciation. An overstatement of profits, in some cases, has been caused by insufficient provision for depreciation. Replacement of capital assets, such as plant, machinery and equipment, will be far greater than the original cost. In view of the general price rise, such assets are estimated to be about 50 per cent higher than before the war. Inadequate depreciation charges, therefore, would tend to underestimate production costs and correspondingly overstate profits."

In the same paper, on November 3, 1947, under the headline "Profit Figures Held Deceptive," parts of a Monthly Letter issued by a large bank are quoted as follows: "Figures on current corporate profits. . . frequently reflect inventory profit and are overstated through inadequate estimates of replacement costs. . . [they] continue to be a subject of active – at times even bitter – controversy, with criticism ranging all the way from intemperate charges of 'extortion' and 'robbery' to milder suggestions that business is ‘making too much money’. . . .” The letter is quoted as stating further that “The main point to be made, however, is that the profits themselves are not all that they seem. In the first place, they contain or reflect a substantial measure of inventory profit, which represents a highly illusory gain that can be changed quickly to a loss when prices turn down. . . . Second, there is real question as to the extent to which earnings as currently reported are being overstated because of the fact that depreciation charges are commonly based upon original costs of plant and equipment and thus are wholly inadequate in view of the present level of replacement costs.” This article also refers to the Department of Commerce’s national income figures, and states that they include allowance for “the factor of inventory profits.”

The following is quoted from the August 11, 1947 issue of a well known financial publication. “Phantom profits worry foresighted managements. Business executives today, contemplating the big black dollar figures that adorn the last lines of their income accounts, are giving more and more thought to informing their shareholders. . . . that there is a strong tinge of red in the black. Too many profits are in what the late Al Smith termed baloney dollars. . . . His reports, if they follow standard corporate accounting, give his stockholders a false picture of the results of the corporation’s current activities.” The article goes on to point out that increased inventories and insufficient depreciation charges are the principal causes of the “phantom” profits. With respect to depreciation it states, in part, “The money with which to replace a capital asset must come from the earnings of this asset, and nowhere else. Obviously, if the reserve from earnings for this replacement is less than the cost of replacement, capital is being depleted. Assuming that replacement costs remain at their current high level, any corporation that allows for depreciation only on the basis of original cost of twenty or forty years ago is inviting eventual bankruptcy. The impact of proper depreciation, adjusted to present costs, cannot be figured with accuracy. It will vary with individual situations. But, broadly, total depreciation now claimed by industry runs around $4 billion annually. This figure is based on original cost, which, as already stated, often represents costs, of many decades past. Assuming that the average replacement cost, over all, had risen only 50%, then earnings of industry are presently being over-stated by a total of about $2 billion."

Another article appeared in a financial weekly on October 13, 1947 which stated in part that "In some cases the sums [set aside] have been labeled reserves for inventory declines; in others they have been put under the loose classification of 'contingencies,' which means that the business men fear something will happen but can't tell just what. . . . But in all probability some part of the reserves which industry has set aside so generally will be needed sooner or later. Then they will act to minimize the effect of price declines on earnings at that later date, insofar as the statements to stockholders are concerned."

While these and other similar articles no doubt play a significant part in arousing the public interest with respect to current accounting and financial problems, they most certainly cannot be expected to increase the public's confidence in generally accepted accounting procedures. Considering the language used they cannot but discredit the good faith of responsible corporate officials, the competence of independent accountants and the safeguards afforded by a Securities Act which outlaws misleading financial statements. If the financial statements in current use do present a false picture, are deceptive and generally untrustworthy, as these articles seem to imply, then it is about time we reexamine our accounting principles – and by we I mean you accountants and the Commission's staff, for there can be but one set of accounting principles.

Comments such as the foregoing result, of course, from the authors' realization that changing price levels cannot be ignored when interpreting financial statements. While most of the articles I have read deal with only two elements – inventories and depreciation – scarcely a balance sheet or income statement item can escape the effects of continued rising prices. Obviously, if profits shown in current income statements must be tempered to reflect the changed value of the dollar the effect upon all of the elements which go to make up the profits must be taken into consideration.

The position expressed with respect to inventories in the foregoing and other similar articles is that when low cost inventories are disposed of and replaced in a period of rising prices a fictitious profit is shown is there is no increase in the physical volume of the items comprising the inventory. To my mind, the use of the word fictitious or any other word which may imply deliberate misrepresentation in discussing this situation is unwarranted and inappropriate. It seems to me that the purpose of these articles, which I am sure is to inform rather than mislead readers, could best be served by pointing out not that the profits reported are incorrect but that they may be offset by inventory losses when and if prices drop. It should also be made clear (as has been done in some of the articles) that a great many reports are not even subject to this contingency, or are affected only in a minor degree because of the use of inventory methods, such as last-in, first-out, which serve as a buffer against the immediate effect of falling prices.

Furthermore, I think that management must be, and pretty generally is, guided by the influence of changing price levels in buying, selling, inventory control and disposition of profit, and realizes that to the extent that increased profits are correlated with greater demands for working capital their distribution must be avoided or, as an alternative, additional working capital obtained from other sources. If the creation of reserves in anticipation of future price declines will assist in convincing stockholders and other interested persons that profits must be retained in the business, certainly the directors should create such reserves – but not as a factor in determining net income. This same position is taken by A. I. A. Bulletin No. 31. While this bulletin expresses only a preference for the creation of such reserves from earned surplus (rather than as appropriations from net income), in my opinion they should be created from earned surplus and should not be shown on the income statements.

The depreciation problem seems to be the subject of more comment and a much greater variety of treatment than inventories. Various commentators have criticized accounting and accountants for allegedly overstating earnings because provisions for depreciation are based on actual cost rather than on estimated replacement. It seems to be a popular misconception that the cost of replacement of assets at some future date must be provided for by current charges against income. Certainly the effect of currently abnormal costs of plants, machinery etc. should be brought to the attention of all persons interested in financial statements, and discussions in public print are logical media for this purpose. However, if these discussions start with the conclusion that financial statements are deceptive and the profits they reflect are false, and close with the warning that, unless accounting practices are completely revamped corporations may find themselves in bankruptcy, it seems to me that the investing public is, to say the least, left in a confused state.

It is not because the depreciation problem cannot be intelligently explained that it is distorted. An article appearing in the Guaranty Survey dated September 24, 1947 (published by the Guaranty Trust Company of New York) is, for example, in my opinion, a fair presentation of the subject. This article states, in part, that "The rise in profits does, of course, indicate the nature of the problem. What has occurred is a general shrinkage in the purchasing power of the dollar, and this shrinkage is reflected not only in replacement and other costs but also in incomes, demand, sales, inventory values and business profits. The price inflation that has raised replacement costs has at the same time helped to provide the additional profits from which the increase can be met. The essential thing is for management to recognize the necessity of devoting a sufficient portion of the profits to that purpose.

"From the accounting standpoint, it is questionable whether the charging of depreciation on the basis of original cost can be properly termed underdepreciation. To charge depreciation at the old rate, distribute the profits as thus calculated, and finance the increase in replacement cost by the issue of new securities would appear to be a logical and theoretically sound accounting procedure. As a practical matter, however, there are probably few concerns that would not find it preferable to meet the additional replacement cost to the greatest possible extent by reinvesting a share of earnings. . . .

"These questions of accounting procedure are of more theoretical than practical importance. From the point of view of management, the problem is primarily one of finance. Whether the books are kept on the basis of originally invested dollars or of current dollars, management must retain a share of earnings sufficient to meet replacement costs as and when incurred, unless it is prepared to resort to the money market for the necessary funds."

While there are indications that several prominent corporations have, tentatively at least, charged income with provisions for additional depreciation based upon estimated replacement costs instead of upon actual costs, I feel certain that most corporations are adhering to what I believe to be the professional accountants' position. This position is clearly and unequivocally stated in the recent press release of the Institute, which reads in part, "It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time. The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels."

As for our views: We have resisted and will continue to resist any departure from presently generally accepted accounting procedures until we are convinced that conditions warrant a change and an acceptable substitute is found.

Accounting language must be a source of wonder to readers of the financial pages, for no less than half a dozen terms can be found readily describing how much a corporation made. One paper commenting upon an income statement in a four paragraph item used “earnings,” “net profit,” “net,” “net income,” and “net earnings” – all, apparently, to describe the same thing for different periods. Another paper, in connection with the same statement, and using the same figures, referred to them only as “profits” and “income.” Other papers and magazines were found to be just as versatile in their descriptions. One newspaper under the headline “1946 Net Drops 8.5% for Radio Stations” reported that “net income of the standard radio broadcasting industry in 1946 amounted to $76,466,246, down 8.5 per cent from 1945. Net income represents the amount remaining after operating expenses but before payment of Federal income taxes.”

This practice of some financial reporters of being not over meticulous in the use of accounting terms may be attributable, partly at least, to a tendency on the part of some preparers of financial statements to use a variety of captions to describe similar items and to shy away from definitely calling any item on the income statement “net income” – or even to label the wrong item “net income.” Surely if those expert in the preparation of financial statements do not think it important enough to call things what they are and stick to it, financial reporters cannot be expected to do otherwise.

Let us consider United States Steel Corporation’s Consolidated Statement of Income for the first nine months of 1946 and 1947. (These statements are uncertified.) The 1946 statement arrives at a final figure captioned “Income” of $57,467,894 or $4.43 per common share. Half way down the statement appears an item (an addition to income) captioned “Strike and other war costs, less associated current year’s Federal income tax reduction included herein provided for in prior years - $28,299,808.” Without this item “Income” would have been $29,168,086 or only $1.18 per common share. In the 1947 statement the final item, captioned “Income,” amounted to $97,306,461 or $9.01 per share. This amount resulted after a deduction in the middle of the statement of $19,600,000 captioned “Wear and exhaustion of facilities – added to cover current cost.” Absent this deduction, “Income” would have been $116,906,461 or $11.26 per common share for the 1947 period.

I do not propose to discuss here the propriety of either the $28,299,808 credit in 1946 or the $19,600,000 charge in 1947. The point I do want to make is that one New York paper devoted a full column to the report of the corporation's chairman and commented upon sales, outlook, etc., but stated simply, with respect to the foregoing income statements, that "Profit for the first nine months of this year was $97,306,461 or $9.01 a share, against $57,467,894, or $4.43 a share, a year earlier." On the other hand, another New York paper in commenting upon these same statements reported the same dollar and per share results but added that "The June, 1947, net earnings are after an extraordinary provision of $7,100,000 for replacement cost of facilities over actual original cost. For the nine months this item amounted to $19,600,000. For the 1946 nine months, net earnings were after a net transfer of $28,299,808 from contingency reserve to offset actual losses sustained from the steel and coal strike."

In at least two newspapers there appeared recently an advertisement which reproduced the report to stockholders of Spencer Kellogg and Sons, Inc., including a Balance Sheet as at August 30, 1947 and a statement of Profit and Loss and Earned Surplus Account for the fiscal year ended on that date. This latter statement read as follows:

"Net Sales		$141,519,756.95
Less: Cost of Sales		109,162,596.12
Gross Profit		$32,357,160.83
Less: Selling and Administrative Expenses.		5,026,918.33
Net Profit Before Depreciation, Income Tax, etc.		$27,330,242.50
Less:		
Provision for Depreciation . .	$ 537,303.76	
Provision for Contingencies .	4,000,000.00	
Provision for Bad Debts	50,000,00	
Interest Paid	297,419.50	
Provision for Federal Income Tax	10,098,016.47	14,982,739.73
		$12,347,502.77
Add: Other Income – Net . . .		23,650.90
Net Profit for the Year -After Provision for Contingencies		$12,371,153.67
Add: Adjustment of Federal and State Taxes for Prior Periods . .		27,813.56
		$12,398,967.23
Less: Dividends Paid or Declared….		2,719,194.75
Net Increase in Earned Surplus For the Year		$ 9,679,772.48
Earned Surplus – August 31, 1946		8,967,057.39
Earned Surplus – August 30, 1947		$18,646,829.87"

Having previously commented on the practice of providing for depreciation on estimated replacement cost, there is no point in discussing it further here. However, it is of interest to note the explanation contained in the foregoing report concerning the provision of $4,000,000 for contingencies deducted before arriving at the caption "Net Profit for the Year – After Provision for Contingencies," which reads as follows: "One more factor deserves mention in considering the earnings of this company – or, indeed, of most companies – under current conditions. This has to do with the question of depreciation. Theoretically, the amount set aside each year as depreciation on a machine will add up to enough to buy a replacement when the present machine is worn out. But, as we all know, costs are considerably higher than they were before the war; and the depreciation 'savings accounts' being built up on the basis of original costs would be quite inadequate, in many cases, to pay for a replacement at present prices. Some recognition of these factors has been taken through an appropriation for $4,000,000, out of last year's earnings, to our provision for contingencies."

It is not unusual to find a great variety of versions of the net income reported. One article will disclose deductions or additions for extraordinary items, another will not; one will direct attention to appropriations from income, another will be silent on this point; one will attach importance to items which may be carried directly to surplus and another may overlook or ignore them. While this confusing situation exists even when the financial statements are completely informative, it naturally becomes more pronounced if the statements themselves are not all they should be.

I recently had brought to my attention an income statement which showed seven sub-totals, none of which bore a caption, notwithstanding that the statement indicated substantial provisions for decline in inventory prices, for possible loss on merchandise commitments and for inventory and war contingencies, and a reversal of a reserve for inventories and war contingencies set up in prior periods. No item was labeled "Net

Profit" or "Net Income" or "Income for the Year." The final item on the statement was captioned "Balance to Earned Surplus."

Another statement showed a caption "Net profit before appropriation, etc., deducted below." There then were deducted two items, one captioned "Excess of approximate cost of replacement of inventories valued on last-in, first-out basis, involuntarily liquidated in prior years, over the original inventory cost thereof, less estimated refunds of prior years' federal taxes resulting therefrom" and the other captioned "Appropriation for future payments of past service liability under employees' retirement plan, less estimated federal income tax savings attributable thereto." The final item was called "Balance of Net Profit Transferred to Earned Surplus."

Still another statement showed a caption "Net Income before Extraordinary Credits and Provision for Contingencies and Minority Interests," to which was added an item "Extraordinary Profits on Sales of Investment," and from which was deducted an "Appropriation to Reserve for Contingencies of Portion of Profits on Sale of Investment," arriving at a caption "Net Income before Deduction of Minority Interests." The final caption after the deduction for minority interests was "Net Income."

I have not read any published comment on the Spencer Kellogg statement or the other three statements just referred to, but I doubt that there will be unanimity of opinion expressed as to what <u>the</u> net income is in each case.

For more than three years the Accounting Procedure Committee of the American Institute of Accountants has been giving consideration to the determination of those principles which will result in income statements that do not lend themselves to misinterpretation by reasonably informed persons. Many discussions have been had, in which the Commission's staff has participated to no small extent, involving conflicting concepts as to the purpose of income statements. At times during these discussions it has appeared to us that the Committee might not reach a workable solution to the problem, and we have given serious consideration to the desirability of amending our rules to restrict, in a large measure, in statements filed with us, charges and credits to earned surplus.

It has been our position, which we have expressed repeatedly and maintained consistently, that ordinarily all items of income and expense recognized during an accounting period should be included in the determination of net income for that period; that any extraneous items, material in amount, should be clearly explained; that such items might properly be shown in a separate and final section of the income statement but before the determination of net income; and that the final caption of the income statement should be "Net Income."

The Institute has now issued a bulletin entitled "Income and Earned Surplus" – No. 32 in the Accounting Research Series. The Commission, after careful consideration of the views of the Institute and the staff, and being particularly mindful of the points upon which these views differ, approved the following letter, which was sent to Mr. Carman G. Blough, Director of Research of the American Institute of Accountants on December 11, 1947:

> "Dear Mr. Blough:
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> The issuance of Accounting Research Bulletin No. 32 entitled "Income and Earned Surplus" by the Accounting Procedure Committee of the American Institute of Accountants raises several important problems of vital concern to this Commission, as I have indicated to you by letter and in conference from time to time in the course of the development of the bulletin. The procedures recommended in the bulletin seem to be susceptible to abuse and may result in misleading income and earned surplus statements in conflict with published rules and opinions of the Commission as well as of opinions of the Chief Accountant, inasmuch as they:
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> (1) make mandatory the exclusion of certain specified items from the determination of net income "when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom";

(2) permit the items so excluded to be shown either at the bottom of the income statement immediately following the "amount of net income" or as direct charges or credits to surplus;

(3) permit the commingling of the items excluded from the determination of net income with appropriations to general contingency and inventory reserves made from net income, and

(4) prescribe no caption for the final item on the income statement when any of the items referred to in (2) or (3) are shown therein.

Under these circumstances the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32.

It is my understanding that the subject bulletin has been distributed to Institute members and will be published in the January 1948 issue of the Journal of Accountancy. It is suggested that, in order that your membership may be informed of the Commission's views herein expressed, this letter be published in the same issue of the Journal.

Very truly yours,

Earle C. King
Chief Accountant"

The bulletin reiterates, in bold type, the Accounting Procedure Committee's opinion that "there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income." It may be that, with this admonition, very few income statements reflecting the application of the bulletin will be filed which, in our opinion, are misleading. I sincerely hope this will be the case.

The views expressed in the foregoing comments, except of course those contained in the quoted letter concerning Bulletin 32, are mine alone and are not necessarily concurred in by the Commission. My one purpose in presenting this paper has been to emphasize the necessity for extreme clarity in the presentation of financial statements and the necessity for the use of unequivocal language in their interpretation.