# NEW TRENDS IN PUBLISHED REPORTS

Address of

Earle C. King, Chief Accountant

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<u>New Trends in Published Reports</u>

The subject I have been asked to discuss is “New Trends in Published Reports.” You will appreciate that this topic is an extremely broad one; for published reports can mean not only those made public through filings with the Securities and Exchange Commission but also those issued by corporation officials, usually in the form of annual reports to stockholders, newspaper and financial service versions of these reports and paid advertisements appearing in the public press likewise based upon, although sometimes worded differently than, the reports to stockholders.

If the reports coming to the attention of the public today, regardless of the media, were all substantially the same, my task would be comparatively simple. But, unfortunately, this is not the case. It should be observed at once that the stockholders reports of most industrial companies are not subject to the jurisdiction of the Commission and therefore, insofar as the Commission is concerned, these reports provide a free medium for experimentation in form and content assuming, of course, that divergencies between statements included in such reports and those filed with us are not so great as to raise questions as to the propriety of certification of both sets of independent accountants as fair presentations of the data involved. It follows, of course, that newspapers and other financial publications are, and obviously can only be, free to comment upon financial data in the light of their own conceptions of significant disclosure. Furthermore, unless a corporation having securities listed on a national securities exchange has filed a registration statement recently pursuant to the Securities Act of 1933 in connection with the sale of securities, or has filed financial statements or its report to stockholders in connection with a proxy solicitation, we are without definitive knowledge of that corporation’s current accounting practices; for such corporation is required to file its income statement, balance sheet and supporting explanatory schedules with us annually only. This filing is not due until 120 days after the close of the corporation’s fiscal year so that, except in those relatively few instances in which a corporation's fiscal year ended prior to December 31, 1947, and in a very few cases where a corporation whose fiscal year ended on December 31, 1947, filed before the close of the 120 day period, we did not have available for examination the bulk of 1947 corporate annual reports (some 2500 or more) until the first of this month – just a few days ago. Obviously not much as been accomplished to date in determining what new trends, if any, are reflected in the 1947 statements filed with us.

I have emphasized this situation because I think the public generally does not realize that the reports of corporation earnings for 1947 currently appearing, or commented on, in the public press or in statistical services may be different in some important respects from those subsequently filed with us.

My comments will be confined to those reports which have come to my attention by way of the press, financial services and annual reports to stockholders. From these I have discerned several changes in reporting practices but I find some difficulty in determining which of these changes constitute definite trends and which are merely the expression of temporary doubts concerning our economic future.

It is my impression that what appears to be the most significant trend is really not a trend at all but only the manifestation of management's alarm over the unusually large dollar amount of reported corporate profits. I refer, of course, to the minimization of profits, either by direct charges thereagainst or appropriations therefrom, reflecting management's desire to retain in the business sufficient resources to cope with the inflationary aspects of our present economy.

While various means have been adopted to accomplish this purpose the principal procedure has been to make appropriations to reserves for anticipated losses on inventories due to future price declines, for "excessive construction costs. . . in anticipation of an eventual reduction in the level of over-all construction costs . . ." to cover "excess of future replacement cost of machinery and equipment over original cost," for "accelerated depreciation of postwar additions to facilities by the short-term amortization of the estimated excess cost thereof above the prewar price level," or for general contingencies.

These reserve provisions have been shown in numerous ways on the profit and loss or income statements. For example, one corporation's profit and loss statement was presented in part in the following form:

| | | |
|---|---|---|
| Net profit before depreciation, income tax, etc. | | $x,xxx,xxx |
| Less: | | |
| Interest paid and provision for depreciation, bad debts and Federal income tax (in detail) | $xxx,xxx | |
| Provision for contingencies | xxx,xxx | x,xxx,xxx |
| Net profit for the year after provision for contingencies | | $x,xxx,xxx |

The earnings statement of another corporation, contained in its annual report to stockholders, showed the following:

| | |
|---|---|
| Operating income – net after taxes | $x,xxx,xxx |
| Dividends and other non-operating income | xxx,xxx |
| Provision for excess construction cost (deduction) | (xxx,xxx) |
| Total Net Income | $x,xxx,xxx |

Another corporation reported to its stockholders "Net Earnings" after deductions which included "Provision for depreciation." In the president's letter it was explained that "Because of the disturbed price levels, it has been decided to modify at this time the Corporation's depreciation policies by accelerating the charges for the early years of productive use of facilities acquired since the war, amortizing on a short time basis the excess cost of such acquisitions over prewar price levels. The effect of this and certain other relatively minor changes in depreciation policies has been to increase 1947 depreciation charges by $- - - - -."

Still another corporation's profit and loss statement disclosed an item captioned "Appropriation toward excess of future replacement cost of machinery and equipment over original cost" immediately following the caption "Net profit for the year." The final item on the statement was captioned "Amount of profit transferred to earned surplus."

An "appropriation for inventory price decline reserve" was shown following the caption "Consolidated net profit for the year" by a corporation in its profit and loss statement which concluded with the caption "Balance transferred to earned surplus."

Another corporation dealt with the inventory reserve problem in its profit and loss statement, the final captions of which were "Net earnings for the year," "Less appropriation for inventory price decline" and "Balance of earnings unappropriated."

While these are only a very few of the profit and loss statements which have come to my attention whereon appropriations are shown for reserves of the types just discussed, they are, I think, a fair sample of the methods currently being used by management to indicate its disinclination to accept as realistic profits determined in accordance with accepted accounting principles which contemplate adherence to cost and the matching of expired actual costs against revenues.

There is no doubt in my mind that the creation from income (i.e., charges against income) of such reserves violates presently accepted accounting principles. In fact, Accounting Research Bulletin No. 28 issued by the A.I.A. Committee on Accounting Procedure in July 1947 contains the following statement:

> "The Committee is therefore of the opinion that general contingency reserves, such as those created:
>
> (a) for general undetermined contingencies, or
>
> (b) for a wide variety of indefinite possible future losses, or

(c) without any specific purpose reasonably related to the operations for the current period, or

(d) in amounts not determined on the basis of any reasonable estimates of costs or losses,

are of such a nature that charges or credit relating to such reserves should not enter into the determination of net income."

In Accounting Research Bulletin No. 31 issued by the A.I.A. Committee on Accounting Procedure in October 1947 the following position was taken:

"The Committee is therefore of the opinion that inventory reserves, such as those created:

(a) for possible future inventory losses on inventories not on hand or contracted for, or

(b) without regard to any specific loss reasonably related to the operations of the current period, or

(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income and that they should not be used to relieve the income account of any year."

And in December 1947 the Committee on Accounting Procedure in its Accounting Research Bulletin No. 33 expressed the view that "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 writedowns of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels."

It has been, and will continue to be, our policy to consider as deficient those profit and loss statements filed with us which treat reserves of the type just discussed as charges against income.

A somewhat different situation exists, however, when such reserve provisions are shown as appropriations of net income. Bulletin 28, referred to previously, stated that "when such a [contingency] reserve is set up it should be created preferably by a segregation or appropriation of surplus; it may be created by an appropriation of net income but this is less desirable." Bulletin 31 expresses the opinion, also, that "if a reserve. . . [for inventory losses such as described in the bulletin] . . . is set up . . . it should be created preferably by a segregation or appropriation of surplus . . ." Bulletin 33 contains the following paragraph: "When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels."

It will be noted that Bulletin 28 and 31 expressed a preference for creating contingency and inventory reserves, respectively, from surplus but Bulletin 33 did not even indicate a preference as between net income and earned surplus. I think it extremely unfortunate that the Committee did not take a firm position in each of these bulletins that the creation of the types of reserves under discussion <u>should be treated only as appropriations of earned surplus</u>. For I have found that newspapers, statistical services and comments in reports to stockholders pretty generally treat the final item appearing on a profit and loss statement as the Net Income regardless of how it may be captioned and translate the amount there shown into "earnings per share." Although in three of the examples cited earlier a clearly captioned net profit "for the year" was first arrived at, published comments with respect to all five of these statements used the final figure to determine "earnings per share."

There are, however, exceptions to the practice of ignoring, in published reports, all but the final figure shown in profit and loss statements. I have seen comments which calculate "earnings per share" before appropriations for reserves but, unfortunately, some other commentator almost invariably has used the figure after these appropriations in his determination of "earnings per share" for the same company. In one instance an amount almost exactly equal to half of the amount shown as "Net profit for the year" was appropriated for future inventory losses. As a result "earnings per share" were either $2.80 or $1.40 depending upon the reporter.

This somewhat confusing situation is complicated further by the practice permitted in A.I.A. Accounting Research Bulletin No. 32 of showing in the profit and loss statement following a caption "Net profits for the year" not only appropriations to reserves such as those I have just discussed but also charges and credits extraordinary in nature and amount "when their inclusion [in the determination of net income for the year] would impair the significance of net income so that misleading inferences might be drawn therefrom."

It is to be hoped that if management continues to use the profit and loss statement to reflect its apprehensions concerning the finality of the results of current operations, published comments thereon will distinguish clearly those things which have happened from those which may or may not take place.

And we are not alone in being disturbed over this situation. In an editorial in the February 1948 Journal of Accountancy entitled "Appropriations of Income and Earnings Per Share," it was stated that "Recent reports of a number of companies . . . have violated the spirit and intent of this well considered accounting convention [that provisions for vague or highly discretionary reserves should not be permitted to affect the reporting of net income], even while appearing to observe its letter. When a reserve of the type under discussion is provided as an appropriation of the current year's income, rather than of surplus, the wording describing the provision, and the balances before and after its deduction, become highly significant. When the final balance transferred to surplus is so captioned as to appear to be the net income, or is elsewhere cited as though it were the net income of the year, or is used as a basis of computing earnings per share, the purpose of excluding the provision from the determination of net income tends to be defeated." * * * And that ". . . The basic principle which requires the exclusion of 'appropriations' from the determination of net income is clearly violated when the computation of earnings per share is based on the balance remaining after their deduction. At best this practice is confusing; at its worst it can be seriously misleading."

For our part we have a job to do. We are charged with the duty of passing upon the effectiveness of the statements filed with us in light of their primary function – to place unequivocally and impartially before the public the financial condition and progress of the reporting companies. Under the Securities Act of 1933 and the Securities Exchange Act of 1934 the responsibility rests squarely upon the Commission to prohibit the dissemination of financial statements in connection with the sale or registration of securities on an exchange, if, in our opinion, they are erroneous or misleading. It follows that profit and loss statements filed with us must be in such form that there can be no doubt as to what the net profits for the period covered by the statement are.

There is, I think, a very definite trend toward simplification of financial data as indicated by changes in style or forms of dress which have developed in published financial reports in the last few years. This situation may be approached and subdivided in accordance with the language of Rule 3-01 of our Regulation S-X, a document which should be familiar to all public accountants, particularly those having clients whose securities are in the hands of the public as contrasted to close corporations. The rule in section (a) provides that "Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto."

Article 5 of Regulation S-X governs the form and content of financial statements for all persons except investment companies, insurance companies, committees issuing certificates of deposit, banks, and companies in a developmental or exploratory stage for which special instructions are provided in the regulation or in the forms required to be filed. The form, order and terminology adopted in this article for the balance sheet and profit and loss statement may, I believe, be considered a proper reflection of generally accepted practice at the time of its adoption (1940) as the regulation was subjected to extensive and intensive criticism by all interested parties prior to promulgation.

The balance sheet is presented in a current-to-fixed order and the profit and loss or income statement presents a showing, in order, of sales; cost of sales; (or operating revenues and operating expenses where appropriate); other operating expenses; selling, general, and administrative expenses; other income; income deductions – arriving at net income before and after provision for income and excess profits taxes. An analysis of surplus is required either as a continuation of the related profit and loss statement or in the form of a separate statement of surplus.

It should be observed at this point that sections 7 and 10 of the Securities Act of 1933 require a registration statement and prospectus to include the financial statements prescribed in Schedule A of the Act. This schedule permits the Commission considerable latitude as to form and detail of the financial statements but requires specifically that the profit and loss statement shall "differentiate between any recurring and non-recurring income and between any investment and operating income." The Securities Exchange Act of 1934 in Section 13 with respect to periodical reports provides that the Commission may prescribe similar requirements. Under the 1933 Act serious consequences may result if the financial statements contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements not misleading. A similar admonition appearing in the 1934 Act provides penalties in case a statement at the time and in the light of the circumstances under which it is made is false or misleading with respect to any material fact.

It will be recognized that the Regulation S-X option of combining the profit and loss and surplus statements in one statement is in accord with the trend at the time as reflected in Accounting Research Bulletin No. 8, issued by the A.I.A. Committee on Accounting Procedure in Feburary 1941. This bulletin, however, warned against the danger of obscuring the net income figure. With the publication of Accounting Research Bulletin No. 32 in December 1947, this warning becomes extremely important since, as I stated in a letter to the Director of Research of the Institute, dated December 11, 1947, which was published in the January 1948 Journal of Accountancy, the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of this bulletin.

Developments during the war in the method of doing business, in many cases practically complete conversion to war contracts, and a growing inquisitiveness on the part of labor concerning facts about the business, put pressure on corporate officials and their accountants to devise a new form of profit and loss statement and a substitute for the balance sheet form of statement of financial condition. The “single step” form of profit and loss statement was the first to come to our attention and to be given serious consideration.

This new form of profit and loss statement was offered by several prominent and large corporations as full compliance with Regulation S-X, Rule 3-01 relating to form, order, and terminology being cited in justification for the departure from the forms previously filed in the form set forth in Article 5 of the regulation. A group of leading independent accountants appeared informally before the Commission to urge that Regulation S-X be amended so as to permit wide freedom in the form and order of the profit and loss statement. After study of the matter the Commission reached the conclusion with respect to this proposal that its rules as to form and order of statement should not be changed.

Three reasons were given. First, it was felt that a convincing case had not been made in favor of the proposed new form and order. Second, it was believed that the new ideas had not yet gained sufficient recognition in actual practice to warrant adoption by the Commission in the face of its own doubts. And, third, the opinion was held that the proper place for experimentation of this kind was not in reports required to be filed with the Commission, but rather in the annual reports furnished by companies to their stockholders.

The Commission emphasized that it did not wish to be regarded as opposing constructive changes, as such, that it was receptive to proposals of this character, and that if and when the proposed form of profit and loss statement became generally accepted its decision would be reconsidered.

The staff has applied these principles to the current proposals as to changes in the form of the balance sheet. It was agreed, however, as in the case of the profit and loss statement, that no objection would be made to the filing with the Commission of financial statements prepared in a form other than that required by Regulation S-X, provided that such statements were not misleading and were furnished as supplementary data and not in lieu of the prescribed statements.

In a frequently seen form the “single step” statement appears in the following style:

Statement of Income

For the Year Ended December 31, 194-

| | |
|---|---|
| Revenues: | |
| Sales less discounts, allowances, etc. | $xxx,xxx |
| Other Revenues | xxx |
| Total | $xxx,xxx |
| Costs and Expenses: | |
| Employment costs: | |
| Wages and salaries | $ x,xxx |
| Social Security taxes | xxx |
| Pensions and Group Insurance | xxx |
| Total | $ xx,xxx |
| Materials and services purchased | xxx,xxx |
| Provision for depreciation | x,xxx |
| Losses on assets retired | x,xxx |
| Interest and expense on long term debt | xxx |
| Other charges | xx |
| State, local and miscellaneous taxes | xx |
| Provision for Federal income taxes | x,xxx |
| Total | $xxx,xxx |
| Income for the Year | $ xx,xxx |
| Cash Dividends | xx,xxx |
| Income Retained in the Business | $ xx,xxx |

A variation of the above as presented by an articulate exponent of the present trend takes the following form:

Results of Operations and Summary of Profit
Employed in the Business – Calendar Year 19—

| | | | |
|---|---|---|---|
| Sales | | | $xxx,xxx |
| Costs: | | | |
| Inventories brought forward from previous year | | $ xx,xxx | |
| Add: Costs incurred during year: | | | |
| Materials, supplies, services Purchased, etc. | $ xx,xxx | | |
| Wages, salaries, company contributions for group insurance, retirement plan, unemployment insurance and old-age benefits | xx,xxx | | |
| Portion of cost of buildings, machinery and equipment allocated to operations (depreciation) | x,xxx | | |
| Interest (net) | (xxx) | | |
| Federal income tax after deducting $--- computed under “carry-back” provisions of Internal Revenue Code | x,xxx | xx,xxx | |
| Total | | $xxx,xxx | |
| Deduct: Inventories carried forward to next year | | xx,xxx | |
| Cost allocated to year | | | xxx,xxx |
| Profit for year | | | $ x,xxx |
| Add: Profit employed in the business at beginning of year | | | xx,xxx |
| | | | $ xx,xxx |
| Deduct: Dividends of $-- per share Paid in cash during year | | | x,xxx |
| Profit employed in the business at end of year | | | $ xx,xxx |

The criticism of a New York security analyst published in the Journal of Accountancy for November, 1947, applies to both of these forms. He said:

> "At least the main items of cost, wages, materials, selling, distribution, and administrative expenses, might well be listed separately in corporate annual reports. This enables important operating and expense ratios to be calculated, year-to-year trends noted, and comparisons to be made with similar ratios of other companies in the same line. Such comparisons greatly aid in distinguishing the most efficient from the least efficient and high-cost enterprises. Of late there has been a deplorable tendency on the part of some major corporations to lump together 'cost of goods sold' and 'operating expenses' and to omit entirely the 'gross profit from operations.' One or two steel companies in the past year or two that previously provided a fair amount of detail in this respect, have recently lapsed. The analyst is not enthusiastic about such tendencies."

Having in mind the source of this comment and the fact that in the Commission's administration of the Securities Acts we are required to insist upon financial statements which will be most useful to investors, I think it is clear that the forms presented above are unsatisfactory in several respects. Both statements fail to differentiate between recurring and nonrecurring income (assuming the latter was present) and between investment and operating income. In the second example interest expense is netted against interest income and the balance listed as an offset to "costs incurred." In the first example there is no indication of how the increase or decrease in inventories has been handled and both are obscure as to the items which constitute the cost of inventories and cost of goods sold. There is a possible inference, particularly in the second example, that all items listed as costs incurred may enter into the cost of inventories. This is not a too farfetched assumption for examples have come to our attention in which selling, general and administrative expenses have been included in inventories and cost of goods sold. The practice seems to be a carryover from war contract accounting practice wherein all recoverable costs under the contract were charged thereagainst. With the reconversion to peacetime operations we think this practice is no longer appropriate and the principle of excluding from inventories selling, general and administrative expenses not applicable to production as laid down in the Accounting Research Bulletin No. 29 on "Inventory Pricing" should be applied.

Some of these new style income statements have substituted every-day language (apparently considered to be more understandable to lay readers), for technical accounting terms. The use of "received from customers" and "paid for" elements of cost connotes a cash basis of accounting which surely is not intended. The general idea of simplification expressed in these statements had been used for a number of years prior to the war in special reports prepared for employees or as a basis for "pie" charts or other pictorial forms of presentation in the president's letter. I think this use is appropriate as a supplement, not as a substitute; but before even subscribing to such limited use it should be made certain that the interpretative value of the conventional style of profit and loss statement is not in the process of being subordinated to the anticipated propaganda value of the new style. Nor am I ready to concede that informed stockholders and financial analysts should be confined to a form of reporting designed to meet the needs of those unfamiliar with the terms and principles of corporation finance and accounting. Instead I think we should encourage more investors to learn these principles.

In concluding this consideration of the profit and loss statement it may be mentioned that under the Securities Act our registration forms for mining companies in the developmental and exploratory stage and industrial companies in the promotional stage require the submission of statements of cash receipts and disbursements instead of profit and loss statements as in most such cases the latter would be much less informative than the former. We also have under consideration the extension of this idea to annual reports for such companies.

Experimentation with new forms of statements of financial condition as substitutes for the balance sheet is not new, for companies in the developmental stage. The forms just referred to provide for separate statements of assets and capitalized expenses, liabilities, and capital shares. The reshuffling of the balance sheet for large and well established corporations, however, seems to be a more recent development. The question as to the acceptability of these new forms, generally referred to as narrative statements, as compliance with the balance sheet requirements of Regulation S-X, has arisen since the close of the recent hostilities. As I have indicated above, in some cases we have not objected to the filing of the new form as additional information but at the same time we have required a statement in the customary balanced form. In others we have felt that the new style form was inappropriate and could not be accepted because of its misleading characteristics.

Generally speaking we have the feeling that the narrative form violates the principle that specific liabilities, or classes of liabilities, as a rule are not claims against specific assets or classes of assets. The problem is not particularly serious in a company which is not only financially sound but in which all liabilities are current and are exceeded substantially by the current assets. We have more difficulty as the margin grows narrow and question entirely the propriety of the narrative style when long term debt is present. Occasionally a form of debt crops up that is difficult to classify even on a balanced form of statement. In such cases the narrative form may give a definitely misleading result.

The narrative style generally takes the following form:

Statement of Financial Position
December 31, 19--

| | |
|---|---|
| Current assets (itemized) | $xxx,xxx |
| Deduct: Current liabilities (itemized) | xxx,xxx |
| Net current assets (working capital) | $xxx,xxx |
| Prepaid expenses (cost allocable to future operations) | x,xxx |
| Property, plant and equipment, less reserves | xxx,xxx |
| Intangible assets | x,xxx |
| | $xxx,xxx |
| Less: Long term debt | xxx,xxx |
| Net assets | $xxx,xxx |
| Derived from: | |
| Capital stock, common-stated capital | $xxx,xxx |
| Profit employed in the business | xxx,xxx |
| | $xxx,xxx |

Appropriate supporting schedules provide additional detail, a usual one being a statement analyzing the change in net current assets or working capital.

A variation of this form that has come to my attention concludes the first section with the caption "Invested Capital (net assets less current liabilities)." This is supported by the following analysis:

Sources of Invested Capital

| | |
|---|---|
| Long-term debt | $xxx,xxx |
| Reserves | xx,xxx |
| Capital stock: | |
| Preferred | xxx,xxx |
| Common | xxx,xxx |
| Capital paid-in in excess of par value of capital stock | xxx,xxx |
| Income retained in the business (earned surplus) | xxx,xxx |
| Total Invested Capital | $xxx,xxx |

Observe that this version includes long-term debt in the sources of invested capital and thereby avoids the questionable practice of deducting this liability at any point in the narrative of assets. Another interesting feature of this example is the inclusion of reserves in the sources of invested capital. The supporting reserves schedule shows four items: "Current operating," "Insurance," "contingencies," and "other." The inclusion of all of these items under the sources of invested capital seems to demonstrate that all are considered to be surplus reserves. This is a step that might well be taken in dealing with such reserves in the conventional balance sheet form. The publication of a statement of changes in working capital is also a very desirable feature that should not be restricted to use with the narrative form of statement. In fact the changes in working capital seem to me to demonstrate the weakness of the new form as they necessarily set forth that in addition to net income as reported the sources of working capital are reflected in all areas of the balance sheet – conversion of plant assets through depreciation or sale, disposal of investments, long term loans and issues of bonds and stocks. Conversely reductions of working capital may come from losses in operations, expenditures for plant or investments, repayment of loans, retirement of bonds and capital stock and the payment of dividends. This flow of funds within the business I believe can be visualized more clearly and with less danger of misinterpretation by means of the balance sheet form than can be done in the narrative statement. It seems to me, therefore, that the narrative form is inappropriate except in the simplest situations.

Form and order as I have indicated do need continuous study in order to make the best possible presentation of financial data. A more serious problem, I think, is presented when we consider the confusion that seems to prevail in the lay mind when faced with our accounting terminology. Important suggestions have been made for the replacement of our most misconstrued terms by language believed to be generally understandable to those not versed in the jargon of financial and accounting circles. Scintillating, sarcastic, semiserious surveys of the problem may help to awaken an interest in the matter but it seems unlikely that the public relations men who write the reports are themselves as misinformed as they sometimes appear to be.

Nevertheless, any one of you can make a quick test by asking almost any non-accountant what is understood by the term "surplus" and discover that the profession should get busy and find an acceptable substitute. The examples of statements of financial condition I have given contain two suggestions – "Profit employed in the business" and "Income retained in the business." Other variations are "Net earnings retained for use in the business," "Accumulated earnings – in use in business," "Reinvestment of profits," and "Earnings employed in the business." We have been asked whether these expressions are acceptable substitutes for "earned surplus." Subject to possible complications in individual cases, these phrases are not only acceptable but a desirable step in improving investor understanding of the statements in which they are used.

Complications for which a solution must be sought in individual cases arise when earnings have been capitalized by the payment of stock dividends or by an increase in the stated value of various classes of outstanding capital shares. Consideration must also be given to the proper presentation of appropriations from surplus for reserves or to indicate restrictions on surplus from a variety of causes. An unqualified use of the terms "Accumulated earnings – in use in business" or "Income retained in the business" would appear to be technically incorrect and misleading when earnings have been capitalized or appropriated and shown otherwise than as a part of the recaptioned earned surplus.

Assuming that no earnings have been capitalized by a restatement of capital, a recent report of one of our largest corporations offers a solution to the display of appropriations from earnings as follows:

| | |
|---|---|
| Earnings employed in the business: | |
| Appropriated for: | |
| Inventory price decline | $ xxx |
| Contingencies | xxx |
| Workmen's compensation insurance | xxx |
| Payment of interest and sinking fund on debentures | xxx |
| Cost of retirement of preferred Stock | xxx |
| Unappropriated | xx,xxx |

A variation of this presentation could be made to handle the stock dividend complication, perhaps in this manner:

| | | |
|---|---|---|
| Accumulated earnings – in use In the business | $xxx,xxx | |
| Less: Added to capital stock Through stock dividends | xx,xxx | |
| Balance not capitalized | $xxx,xxx | |
| Appropriated for: | | |
| Inventory price decline | | $ xx,xxx |
| Replacement of plant at higher prices | | xx,xxx |
| Contingencies | | xx,xxx |
| Self insurance | | xx,xxx |
| Unappropriated | | xxx,xxx |

This form of reporting properly classifies that incomprehensible group of reserves commonly shown between "liabilities" and "capital and surplus" concerning which it is left to the reader to decide the treatment to be given in analyzing the financial position of the reporting company.

Considerable criticism has been directed to the all too common practice of heading the right hand side of the balance sheet with the one word, "liabilities." This is a valid criticism. The Regulation S-X solution is to require the caption "Liabilities, Capital Shares, and Surplus." This is more descriptive than the single word but, since it includes the sometimes misconstrued word "Surplus," could be revised to advantage. The term "net worth" which still appears in some of the texts – even recently revised ones – and rarely in published reports, is open to criticism because of the possibly misleading inference that the balance sheet reveals the present value of the business in the figures as stated. Such an inference generally would be denied by accountants but laymen are hard to convince.

It seems unnecessary to catalog other technical terms in common use in our profession and attempt to offer laymen's synonyms for all of them at this time. Certainly this is a field that should receive prompt and careful consideration, for I believe it, rather than the mechanical forms or order of presentation, is the principal root of our trouble.

I referred previously to Accounting Research Bulletin No. 32 issued by the A.I.A. Committee on Accounting Procedure in December 1947. In an article entitled "The Increasing Significance of the Income Statement," appearing I the January 1948 Journal of Accountancy, the Institute's president, Mr. George D. Bailey, stated that this bulletin "definitely rejects the all-inclusive [income] statement, wherein all items that have passed through the books during the year have to be treated in arriving at net income for the year, and accepts instead the principle that the net income shown must be as significant as possible of the operations of the business for the year." If this bulletin is accepted generally by the accounting profession it will indeed be a definite change in trend for it has been our impression, based upon studies we have made,[1] that during the past several years the practice of making direct charges and credits to surplus, other than to reflect the transfer of net income and the distribution of dividends, has been on the wane; in other words, prior to the issuance of Bulletin 32 there had been a definite trend toward the "all-inclusive" income statement. As stated in my letter of December 11, 1947 to the Institute's Director of Research which was previously referred to, this feature of the bulletin was one of the principal reasons for our objection to it.

[1] See "An Analysis of Charges and Credits to Earned Surplus, 1939-1944," The New York Certified Public Accountant, September 1946.

I think it appropriate to state that, so far as we have been able to determine from our reading of such published reports for 1947 as we have been able to obtain, we have noticed little, if any, change in practice with respect to the treatment of "extraordinary" items such as those referred to in Bulletin 32.

In conclusion I should like to make it clear that we are heartily in accord with any changes in principle or practice which will improve the quality of financial statements to the end that there can be no reasonable doubt as to their purport. However, the determination to adopt any material changes in the form and content of published reports, particularly if such changes involve basic accounting principles, should be arrived at only after exhaustive consideration which will leave no argumentative point unsettled.