

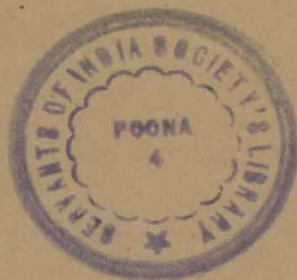
Michigan Business Studies

VOLUME VI

NUMBER 1

CORPORATION FINANCIAL STATEMENTS

BY
MORTIMER B. DANIELS



Gokhale Institute of Politics
and Economics, Poona 4.

UNIVERSITY OF MICHIGAN
SCHOOL OF BUSINESS ADMINISTRATION
BUREAU OF BUSINESS RESEARCH
ANN ARBOR
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BY

MORTIMER B. DANIELS

ASSISTANT PROFESSOR OF ACCOUNTING



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AUTHOR'S NOTE

The primary aim of this study is to present a brief critical survey of financial statement practice. Extended discussion of accounting principles has therefore been included only upon those points in which statement practice seems weakest or in which little discussion is given in the standard accounting texts. Examples of the former are (1) valuation of plant and (2) treatment of various "reserves." Examples of the latter are (1) valuation of investments in foreign subsidiaries and (2) treatment of the minority interest in consolidated statements.

The work is based upon a detailed examination of the published annual reports of two hundred ninety-four corporations. Most of these are industrial companies, although thirty-seven electric utilities are included. Banks and other financial corporations and railroads were excluded inasmuch as their financial statements are of a specialized nature and are also normally presented in a standard, often a prescribed form. The statements examined were taken from the file of published annual reports in the Library of the School of Business Administration of the University of Michigan. Their representativeness is attested by the catalogue of companies included in Appendix B.

No complete list of author's acknowledgments can be attempted. To many former teachers and associates is owed an imponderable debt. Thanks are especially due to Professor W. A. Paton of the University of Michigan, who has given continuous aid and advice and has been a constant source of encouragement.

M. B. Daniels

Ann Arbor, Michigan
January, 1934.

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CORPORATION FINANCIAL STATEMENTS

SUMMARY AND CONCLUSIONS

In the typical large corporation published reports constitute the only means available to investors to judge for themselves the success of the enterprise in which they have made investments. Immediate and often ultimate control lies with the management, but nevertheless the primary function of accounting in respect to business has not changed. Briefly, accounting is a technique designed to record investments of capital and to determine income thereon periodically. A corollary of this premise is that the "income" determined must be defined in the light of existing economic and legal institutions and in consonance with authoritative judicial interpretations. Accounting practices reflecting definitions of income at variance therewith may make interesting comparisons. They may be important as an aid to management. But they must not be substituted for accounting based on sound principles developed in reference to existing institutions. Accepting these premises, the following observations are made in reference to published financial statements of corporations.

1. During the past twenty-five years financial statements have in general tended toward fuller disclosure, particularly as regards current income and its disposition.

2. Financial statements carrying the certificates of public accountants are apt to be superior to uncertified statements. On the other hand, reports of different corporations audited by the same firm of accountants often reveal an attempt to fit all reports to one standard form. Indeed, it sometimes becomes impossible to determine the nature of a business from its financial statements. A second regrettable feature of such standardization is that the set-ups employed may have objectionable features.

3. Financial statements should be clear, adequate, and accurate. The descriptive form of statement favored by certain corporations and the general comments included in many annual

reports are both aids to clarity. Most reports are "adequate" in the sense of extent of information given. The chief fault of financial statements is inaccuracy, interpreting inaccuracy as including the reflection of unsound accounting principles.

4. Too great emphasis has been placed upon the importance of the balance sheet as compared with the income sheet. The two are interdependent. The balance sheet reveals the status of the capital investment; the income sheet shows the current income or loss derived therefrom.

5. The balance sheet of a going concern does not present an inventory of the values of individual assets (with the exception of quick assets) or of the value of the business as a whole. Failure to recognize this fact is responsible for much confusion and much unwarranted revaluation of assets.

6. Accounting valuation of plant is to a large extent an adjunct of income determination. Business income is the excess of revenue over expense, and business loss is the excess of expense over revenue. Therefore, the valuation basis for assets which represent future expenses of operation must be cost to the particular enterprise. It follows that book values of plant assets ordinarily have no direct relation to market values.

7. Write-ups of plant assets and write-downs (which corporation managements have recently been giving effect to) both result in inaccurate financial statements. When plant assets are carried in the accounts above or below cost less depreciation, expression is given to the misconception that balance sheets should reflect values. The more important effect of resulting distortion of future income is often overlooked.

8. There seems to be an impression in some quarters that costs of operation can be adjusted at will by the simple device of basing depreciation charges on values higher or lower than cost. But in the long run success of operations must be measured in terms of the difference between revenues and costs, which, in the nature of the case, are determined by actual outlay.

9. Recent write-downs smack of manipulation. As they are being accounted for, not only will future income be overstated, but to the extent that reductions of capital are a concomitant of the write-down, dividends based on future income

will be, in effect, capital distributions. The stockholder has a right to be apprised of the nature of such dividends.

10. The surplus analysis as a separate financial statement could well be abolished. Specifically, there would be few if any surplus adjustments, and hence a need for only a surplus reconciliation, if all items affecting income in the sense of distributable funds were revealed in the income sheet as adjustments of net income. The possibility of showing a more favorable "income" by making direct charges to surplus can easily lead to pure misrepresentation.

11. Financial statements are inadequate as regards information given explaining the disposition of surplus reserves. Complete disclosure of changes in surplus reserves should be made a part of every report.

12. The popular practice of showing a separate section for "reserves" on the balance sheet is apt to be misleading and should be discouraged. There are few if any "reserves" which cannot be immediately shown for what they are—asset, liability, or surplus.

13. Treasury stock and treasury bonds are often incorrectly listed as assets on the balance sheet. They are not assets, but reductions of proprietorship and liabilities, respectively.

14. Bond discount is invariably treated as an asset on the ground that it represents prepaid interest. However, there can be no prepaid interest. Correct balance-sheet treatment for bond discount is dependent upon its segregation at the start from bond "expense," which is an asset. They are improperly combined.

15. Many published income sheets give no information concerning operating revenues and expenses. Since the figures for sales and total cost of sales (including both cost of product and operating expense) are highly important in statement analysis, income sheets omitting operating details are inadequate from the investors' standpoint.

16. The common practice of excluding depreciation from operating expenses in the income sheet is misleading. There can be no profit "before depreciation."

17. The importance of the legal financial statements of holding companies has been lost sight of in the United States.

Reports to stockholders should contain not only the usual consolidated financial statements but the legal statements of the parent company as well.

18. The fact that consolidated financial statements are synthetic statements is often overlooked. They are the financial statements of no legal corporation. The advisability of subjecting consolidated statements to the process of ratio analysis is questionable, except for comparisons of the same consolidated group between one date or period and another.

19. Consolidated financial statements could be improved by: (1) indication by notes of the financial status of investments in all affiliated companies not "consolidated," (2) classification of consolidated surplus as surplus of the parent company and of subsidiaries, (3) indication of operating deficits absorbed in consolidated surplus and consolidated income, and (4) showing as earned surplus of the parent company only free surplus. Item (2) would be unnecessary and item (4), though desirable in general, would be less essential, if the majority stockholder were furnished with the parent company financial statements.

CHAPTER I
UNDERLYING STRUCTURE OF FINANCIAL
STATEMENTS

Assets. A corporation owns and controls a fund of capital advanced or entrusted to it by various individuals or their representatives. This fund of capital is invested in various forms, tangible and intangible. The total capital fund from this standpoint is the accounting concept of "assets." The generic term "assets" is universally employed in practice to designate the figure on the corporation's balance sheet.¹

Equities. The total capital fund thought of from the standpoint of the legal claims therein, or of the sources from which obtained, is the accounting concept of equities, or liabilities plus proprietorship (capital stock and surplus). The generic term "liabilities" is usually employed in practice to designate total equities in the balance sheet.²

The balance sheet. Since total assets and total equities are but two aspects of the same thing, they are necessarily equal. The balance sheet lists all assets and all equities side by side or one above the other. Thus the physical structure of the balance sheet is ordinarily that of two main divisions—assets and equities—with totals equated, double lines being drawn under the respective totals to indicate their equality.

Liabilities and proprietorship. The second main division of the balance sheet, the equities, which gives the sources of the capital fund of the corporation, is composed of the interests of two separate groups—the creditors and the owners. Herein lies one of the weaknesses of published balance sheets—the two are not always subtotaled. Indeed it is seldom that a total is drawn

¹ Of the 294 balance sheets examined, all used the term "assets." Some banks and some other financial institutions still use the alternative term "resources."

² Among 293 balance sheets, 273 used "Liabilities"; 14 used "Liabilities and Capital"; 2 used "Capital and Liabilities"; 2 used "Liabilities, Capital, and Surplus"; 1 used "Liabilities Side and Capital"; and 1 used "Cr."

for all liabilities.¹ The proprietary interest, on the other hand, is usually designated separately, even if no total for the entire group is set out.²

The most common practice is to set off the proprietorship division of equities by a caption of equal rank with the sub-classifications of assets. The following terms are in current use in about the order given: capital; capital stock and surplus; capital stock, surplus, and reserves; net worth.

The income sheet. The title of the income sheet is not well settled as is that of the balance sheet.³ "Income sheet" is used here for two reasons. First, the word "income" is as apropos descriptively as any other brief designation. Second, the word "sheet," though seldom found in practice, is preferred to "statement" or "report" simply because its use implies close relationship to the balance "sheet." The word "account" is not good, because the statement is seldom an account even when in "account form," save in the sense of "report," and thus the use of "account" confuses technical and general meanings. The principal objection to "profit and loss statement" is that the phrase "profit and loss" is often used for "surplus" and also to designate non-operating and extraordinary adjustments of income.

¹ Of the 294 reports examined, only 23 gave a separate total for liabilities and in 16 of these cases all liabilities were current.

² This statement is subject to the qualification that often appropriated surplus is not included. See the discussion of "reserves," Chapter 12.

³ "Balance sheet" was used with only two exceptions by the 294 companies whose reports were examined. Among 282 statements (12 of the entire number of 294 annual reports reviewed presented no income sheet), no one title was found more than 62 times. The following list gives the appearances of all titles found 10 times or more. Most of the others were variations and combinations of those listed. The words "condensed" and "consolidated" were ignored in this tabulation, as was "earned" modifying "surplus."

Income Account	62
Income Statement or Statement of Income.....	29
Profit and Loss Account	27
Income and Surplus Account	22
Profit and Loss Statement or Statement of Profit and Loss.....	21
Earnings Statement or Statement of Earnings	13
Income and Surplus Statement or Statement of Income and Surplus.....	10
Profit and Loss and Surplus Statement or Statement of Profit and Loss and Surplus	10
Income Summary or Summary of Income	10

Nevertheless, aside from published reports, "profit and loss statement" is probably the most common title for the income sheet.

The balance sheet is a statement of financial condition. The income sheet, on the other hand, is a statement of financial progress. All profit-seeking enterprises are alike in certain respects. Revenue is received from the sale of a commodity or service, and expenses are incurred in its purchase or production and in its distribution. The excess of the revenue over the expense is the principal income, or loss, if the excess is the other way round. Income from any other sources increases the income on sales, and the total is distributed or retained in the business. From this point of view, revenues must first be applied to operating expenses. Further deductions from the remaining balance (positive or negative) must be made for interest and income taxes ("income charges" in the terminology of accounting). The remainder is net (proprietary) income, which in the corporation is distributed to stockholders in the form of cash dividends or is retained in the business. The usual income sheet, then, follows a form giving in one statement the data regarding income both as to its sources and its distribution, the latter at least as far as the balance belonging to stockholders.¹

Under double-entry bookkeeping the accounts for revenues and income have credit balances, while expenses, income charges, and distributions of income have debit balances. Accordingly, the "account form" is a natural type of structure for the income sheet, and no doubt the statement took this form originally as simply an itemized transcript of the "profit and loss" account used in closing the books, or of the various closing accounts used.

The common form today (at least in the United States) is that variously termed the "running," "reducing-balance," or "report" form. The running form is less technical, more logical, and more flexible than the older account form.²

¹ United States Steel Corporation presents its income sheet in two separate statements, "profit and loss account" and "income account," corresponding substantially to sources-of-income and income-distribution divisions.

² In the annual reports of 294 corporations, only 2 income sheets in account form were noted (12 gave no income sheet). Of these same corporations the reports of 95 were also available ten years ago, those of 30 eighteen years ago,

Surplus analysis. Fundamentally, the surplus analysis is simply a reconciliation of the surplus items shown on two successive balance sheets. It completes the tie-up between the income sheet and the balance sheet. It can be, and often is, either appended to the income sheet or included in the balance sheet. It can also be shown as a separate financial statement. The custom of making various adjustments direct to surplus is a feature of recent corporation accounting, and, as a result of the extended nature of such direct surplus adjustments, the practice of presenting the surplus analysis as a separate statement has grown in favor until it now ranks "in practice" as a third financial statement.¹

The "surplus account," shown as a separate financial statement, is doubtless in most cases only a tabulation by kind, of entries made in the surplus account in the ledger. However, the fact that an item has been charged to surplus account on the

and those of 12 twenty-five years ago. Only one of the 95 uses the account form of income sheet today, as was also the case ten years ago, 2 (of 30) changed to the running form between ten and eighteen years ago, while 1 (of 12) adopted the running form between eighteen and twenty-five years ago. Thus, of the income sheets of 25 identical corporations available over the entire twenty-five year period, 1 is now, and was ten years ago, issued in account form, 3 were so issued eighteen years ago, and 4 were in account form twenty-five years ago.

¹One hundred fifty-five of the 294 reports examined included the surplus analysis as a separate statement. Among this number were 9 reports which included what operating data were given—sometimes a complete income sheet—within the surplus analysis. Sixty-four of the 294 included the surplus analysis as a final section of the income sheet; 45 gave it in the balance sheet; while 28 (of which 13 were reports of utilities out of a total of 37 utilities) gave no surplus reconciliation. Two reports included it in both the income sheet and balance sheet.

The history of the surplus analysis statement in published reports is interesting. Of these same companies the reports of 95 were available ten years ago, 30 eighteen years ago, and 12 twenty-five years ago. Of the 12, twenty-five years ago, 2 presented a separate surplus analysis, 4 included it in the income sheet, 1 gave it in the balance sheet, and 5 gave none. Seven years later in the case of 30 companies, 8 reported a separate surplus analysis, 13 included it in the income sheet, 5 presented it in the balance sheet, and 4 gave none. Ten years ago, of 95 reports, 29 presented a separate surplus analysis, 6 more gave a separate surplus analysis which included income-sheet data, 34 included the surplus analysis in the income sheet, 16 put it in the balance sheet, and 10 gave none. The practice of the same 95 companies is now as follows: separate surplus statement, 44; surplus statement including all income-sheet data, 4; surplus analysis in income sheet, 31; surplus analysis in balance sheet, 10; no surplus reconciliation, 6 (of which 3 gave dividend declarations in the income sheet).

books does not mean that it cannot properly be shown in the corporation's income sheet. Yet auditors in effect subscribe to some such notion when they hesitate or refuse to show in the income sheet items which the Board of Directors has duly "resolved" should be charged (or credited) to surplus. This describes an existing condition which probably contributes to the tendency toward separate surplus statements evident in published reports certified to by independent auditors. It unfortunately precludes any proper analysis of "surplus" items.

CHAPTER 2

CLARITY IN FINANCIAL STATEMENTS

The non-technical statement. It is undoubtedly in the interest of clarity that the descriptive and narrative types of financial statement have been developed. Their development has taken two different lines. One has been toward adaptation of the conventional form of statement by the addition of running comments following and describing each item. The other line of development has been toward an entire obliteration of the conventional form.

International Harvester Company, Canada Dry Ginger Ale, Incorporated, American Telephone and Telegraph Company, and Consolidated Gas Electric Light and Power Company of Baltimore are among those corporations regularly publishing the descriptive type of financial statement in their annual reports. Some corporations which issue yearbooks in addition to annual reports use the conventional form of statement in the annual report, and the descriptive form in the yearbook.¹ The following income sheet of American Telephone and Telegraph Company for 1931 is illustrative of the descriptive type of financial statement (reproduced without amounts):

EARNINGS

Dividends	_____
Dividends on stocks owned. As a whole these dividends were earned with a margin of about \$3,400,000.	
Interest	_____
Interest on notes and advances, on bonds owned, on temporary investments and bank deposits, and on other accounts.	
Telephone Operating Revenues	_____
Revenues from operation of the long-distance lines and payments from the Associated Companies for services furnished them under the license contracts.	
Miscellaneous Revenues	_____
Total	_____

¹ Commonwealth Edison Company, for example, follows this practice.

EXPENSES	_____
Expenses incurred in conducting the business, including depreciation and taxes.	
NET EARNINGS	_____
Deduct Interest	_____
Interest on bonds, debentures and other indebtedness.	
NET INCOME	_____
Deduct Dividends	_____
Dividends at the rate of \$9.00 per share per annum on capital stock.	
Balance for Surplus	_____

The descriptive form of financial statement has everything to recommend it. It is admirably suited to the needs of an annual report to stockholders, especially since stock holding on the part of the general public has increased so materially.

Perhaps the best illustration of the complete abandonment of technical form is found in the balance sheet published by Corn Exchange Bank (New York).¹ Omitting amounts, this statement reads as follows:

THE BANK OWES TO DEPOSITORS _____

A conservative banker always has this indebtedness in mind and he arranges his assets so as to be able to meet any request for payment.

For this purpose we have:

CASH _____
 (Gold, bank notes and specie) and with legal deposits,
 returnable on demand.

CHECKS ON OTHER BANKS _____
 Payable in one day.

U. S. GOVERNMENT SECURITIES _____

LOANS TO INDIVIDUALS AND CORPORATIONS _____
 Payable when we ask for them, secured by collateral of
 greater value than the loans.

¹ The name of this institution has recently been changed to Corn Exchange Bank Trust Company.

BONDS	_____
	Of railroads and other corporations, of first quality and easily salable.
LOANS	_____
	Payable in less than three months on the average, largely secured by collateral.
BONDS AND MORTGAGES	_____
BANKING HOUSES	_____
	All located in New York City.
TOTAL TO MEET INDEBTEDNESS	_____
THIS LEAVES A CAPITAL AND SURPLUS OF	_____
	Which is a guarantee fund upon which we solicit new deposits and retain those which have been lodged with us for many years.

Such a statement is probably incomplete. It is doubtful whether all liabilities are included in the item "the bank owes to depositors." Even if it were complete it would never meet the requirements of adequacy. Among all those figures which would be needed for a careful analysis of the statement, the only one derivable is the total of current assets. Financial statements of this nature are desirable only when a complete and adequate statement is available elsewhere.

A regular feature of some corporation annual reports, which can be taken as a well-considered development of the same general idea of a narrative financial statement, is an item-by-item discussion of the various figures contained in the formal statements.¹

Balance-sheet arrangement. The two fundamental divisions of the balance sheet—assets and equities—may be listed side by side or one above the other. The former arrangement is the more popular, but the method followed is entirely optional and may be determined primarily by spatial considerations. Reports bound in pamphlet or book form offer a convenient opportunity of using the horizontal arrangement, since successive

¹ The annual reports of Pacific Gas and Electric Company provide a good example of this practice.

pages on opposite folios can be used respectively for assets and equities. This side-by-side arrangement is popularly referred to as the "account" form. The vertical arrangement, with one division directly above the other, is popularly called the "report" form.

English and American form. It is equally feasible to present assets first or equities first. The prevailing custom in Great Britain is to present the balance sheet in horizontal arrangement with assets on the right and equities on the left. The custom in America and on the Continent is the reverse.¹

Sequence of balance-sheet items. Among assets the order of arrangement may be current to fixed or fixed to current. The former is called the order of liquidity; the latter, inverse order of liquidity.²

Sometimes a similar arrangement of equities is attempted; that is, one in which they also are listed in order of relative permanence or according to the order in which they normally will be liquidated. In the inverse order as applied to equities, paid-in capital theoretically comes first with fixed liabilities next, while earned surplus is last. The difficulty with this method is that the matching of specific equities or groups of equities with certain assets or groups of assets has, with a few exceptions, such as the case of special funds and accompanying reserves, very definite limitations. Furthermore, it is highly important in listing equities to preserve the distinction between liabilities and proprietorship, keeping all items in either category together. Thus, it would be preferable when assets are listed in inverse order of liquidity to put proprietary equities first and liabilities last, arranged from fixed to current.³ This complication of the parallel

¹ None of the 294 balance sheets examined was presented in English form. One, however, that of Eastman Kodak Company, was changed from the English form only within the last ten years.

² The terms "current first" and "fixed first" are suggested by W. T. Sunley and P. W. Pinkerton, *Corporation Accounting* (New York, 1931), p. 273.

³ This method is found in practice (4 of 85 cases), but it is more common to find the proprietary equities split by the insertion of all liabilities between capital stock and surplus (56 of 85 cases). The arrangement of equities accompanying assets listed in inverse order of liquidity is often irregular (25 of 85 cases). Of these irregular orders, 6 gave liabilities first—fixed to current—with capital stock and surplus following. The rest were scattered.

arrangement of assets and equities in inverse order of liquidity may have been one factor in the growing preference for the order of liquidity. The accompanying order of arrangement of equities is: liabilities—current to fixed, followed by proprietary items, with capital stock heading the list and with surplus last. There seems never to have been any suggestion that surplus should be placed first, prior to current liabilities, though this order is as logical as that of capital stock, fixed liabilities, current liabilities, and surplus, which usually is followed when assets are listed in the inverse order of liquidity.¹

The public utilities alone remain devoted to the inverse order of liquidity for arrangement of assets.²

Income-sheet arrangement. As already stated, the “running” or “reducing-balance” form of arrangement as regards basic spatial structure of the income sheet is a logical one and is well-nigh universally employed in practice. In general the arrangement of various items in the income sheet also follows logically from the nature of the information involved.

Income from the principal activity is the first logical consideration of the income sheet. The opening section of the statement, accordingly, summarizes gross revenues as a first step. Usually ancillary revenue is excluded, as it is desirable to compare directly revenues and costs of the principal activity of the business. The matter of ancillary revenues is mentioned later.

Expenses incurred in obtaining the principal revenue are next considered, the total being deducted from net sales, leaving operating income or net operating revenue. If the business sells a physical commodity, there are two parts of this second section

¹The recent history of order of arrangement of balance-sheet items is worthy of passing mention. Of the 294 balance sheets examined 209 listed assets in order of liquidity. Ten years ago 62 of 95 companies presented balance sheets with assets listed in inverse order of liquidity. And of these 62, 24 have since changed to the order of liquidity. Of 30 of these same companies eighteen years ago, 25 published balance sheets with assets arranged in inverse order of liquidity. The published annual reports of 12 of the same companies twenty-five years ago presented balance sheets that without exception gave assets in inverse order of liquidity.

²Of the balance sheets of 37 utilities examined, only 2 presented assets with current preceding fixed. Although the complete inverse order of liquidity was not followed by the remaining 35, plant assets, at least, preceded all others.

of the income sheet which easily can be, and usually are, separated, but which are somewhat less frequently deducted separately.¹ These are: first, the cost of purchasing or producing—"cost" items—and second, the distributing costs or those concerned with selling and delivering the product or service, usually including also the entire expense of general administration—"expense" items. Probably the most common terms for the two groups are "cost of sales" or "cost of merchandise sold," and "operating expense," respectively. The former deducted from sales gives so-called "gross profit"—a poor designation incidentally, since there is no profit as yet; there may actually be a loss. A better name is "margin on sales" or simply "margin."

The next logical step, the third section of the income sheet, is the addition to operating income of ancillary income derived from minor operating activities and also other incidental but regular income. A good illustration from practice is found in the income sheet for 1931 of Magma Copper Company, from which the following excerpt is taken:

[Principal operating income. Item not designated in the original].....				\$159,254.82
Interest and other income.....				97,406.16
				<hr/>
				\$256,660.98
Railroad operating income [revenue]	\$108,413.48			
Railroad operating expense	\$111,602.43			
Depreciation—roadway and equipment	43,558.82	155,161.25	46,747.77	
	<hr/>	<hr/>	<hr/>	
				\$209,913.21

If the costs of ancillary revenue are not available, such revenue should be included in the first section of the income sheet. Interest on bank balances and receivables, net rentals, royalties, and income on securities make up the principal part of the second type of further income. The sum of operating income and all

¹ Of 102 income sheets in which both the margin (or "gross profit") and operating income balances could have been displayed, only 28 showed the margin balance. The remaining number gave all operating expense either as one item (13 as "cost of sales") or in one total.

incidental income gives the amount of total net income of the business currently received or accrued. This figure is not always displayed in the income sheet, but it is one of considerable importance in analysis, inasmuch as it represents income on the entire capital employed.¹

From this point on, income-sheet arrangement is rather unsettled. The bone of contention is where extraordinary and non-recurring charges and credits, so-called "profit and loss" items, are to be recognized. Leaving this matter aside for the moment,² the next logical step in the consideration of income-sheet information concerns the "income charges" or "income deductions." From the viewpoint of the corporation as owner of all the capital, these items are distributions of income. However, corporation accounting procedure is so saturated with the proprietary viewpoint, that "net income" is usually set out in the income sheet as net income for stockholders (that is, the income balance after deduction of interest charges and the provision for income taxes), and the income sheet is often concluded with this figure.³ United States Steel Corporation provides a rather unique exception to the rule inasmuch as its "Profit and Loss Account" designates as "net income in the year" the amount of total current net income before interest on bonds of the parent company and provision for income taxes. The income sheets of some corporations emphasize the common stockholders' viewpoint by concluding the income sheet with the figure for net income after dividends on preferred stock.⁴ Fundamentally, the income sheet is not complete until disposition of total income has been entirely accounted for. Thus, beginning with total net income, there should

¹ Out of 282 statements (12 of the entire number of 294 annual reports reviewed gave no income-sheet data) a figure for total net income was shown in 100 cases, although in 30 of these it was not labeled.

² See Chapter 11.

³ Exactly one-half (141 of 282) of the income sheets examined concluded with the balance of net (proprietary) income either before or after extraordinary charges and credits. The others went on to give either part or all of the further disposition of net income, including 64 which incorporated the entire surplus analysis and reconciliation.

⁴ This practice is followed in the income sheets of E. I. du Pont de Nemours & Company (1931), U. S. Industrial Alcohol Company (1928), and Underwood Elliott Fisher Company (1930).

be deducted successively in the fourth section of the income sheet: interest on current liabilities, interest on long-term liabilities, provision for income taxes, preferred dividends, common dividends, and appropriations, leaving finally the addition to or deduction from free surplus.

One concept of the income sheet is that it should represent a connecting link between the surplus items of two successive balance sheets. Accordingly, it is logical for the income sheet to conclude with the addition of a surplus analysis, which thus constitutes a fifth section of the statement.

Terminology. In 1909 Hatfield wrote: "Unfortunately, despite the advancement made in accounting practice, there is a most embarrassing confusion in terminology, so that one can never be sure of just what is meant by a given account. Amperes and ohms, miners inches and foot pounds, have definite meanings free from misunderstanding. But the current terms of accounting . . . are loosely and divergently used."¹ The statement is as true today, a quarter of a century later. Accounting terminology is largely made up of words which are part of anyone's everyday vocabulary. Added to the confusion resulting from the everyday meanings of accounting terms, there is further confusion in technical usage. Accountants themselves have come to no definite agreement regarding the application of such terms as *reserve, income, profit, revenue, earnings, operating*, and so on.

Doubtless the most confusion is found in income-sheet terminology, particularly with reference to the words *income, revenue, earnings, and profit*. *Profit* is probably never applied to selling price, but *earnings* and *income* are. "Gross earnings" is a common designation for revenues of public utilities.² "Gross income" is not uncommonly used in the same sense by utilities and is found occasionally among the industrials.³ "Gross

¹ H. R. Hatfield, *Modern Accounting* (New York, 1919), p. vi. Originally published in 1909.

² "Gross earnings" is also the typical designation of bank revenues. It is used in the form prescribed by the Comptroller of the Currency for reports from national banks. An example of its use in the industrial field is provided by the income sheet of The Texas Corporation (1931).

³ See income sheets of Inland Steel Co. (1931), The Foundation Company (1928), Loew's, Incorporated (year ending Aug. 31, 1931), Pittsburgh Coal Company (1931), and Indian Refining Company (1931).

income" also frequently means operating income plus other income.¹ "Total income" is often applied to this same figure,² but means as well margin (gross profit) plus other revenue or income.³

In some statements fine distinctions are drawn between terms which are commonly interchangeable. For instance, the 1930 income sheet of General Motors Corporation shows "total net profit"; which, after deducting the total of provisions for various employee bonus and savings plans, results in "net income before income taxes." Another intricate differentiation is found in the income sheet of International Shoe Company for the year ending November 30, 1931. In this statement the addition of miscellaneous income to "net operating profit" gives "net earnings," which become "net income" after deduction of the provision for income taxes. A distinction of more validity is drawn in the income sheet of The Texas Corporation (1930) between income and profit. Interest is deducted from "income before interest charges," leaving "profit for period." In so far as there is a consensus among accountants, it seems to center in restriction of the term "income" to net income; that is, after deduction of any applicable expense from the amount received or to be received. "Revenue" is the safest term where "sales" is not apropos. "Earnings" is best restricted to net income, as is "profit."⁴

Arising out of the confusion there is a praiseworthy tendency in statement presentation today to substitute descriptive designations or to use qualifying words and phrases.⁵ One of the standard examples of confusing terminology is that of the vari-

¹ For example, American Machine & Foundry Company (1931), American Radiator & Standard Sanitary Corporation (1931), Standard Brands Incorporated (1931), Westinghouse Electric & Manufacturing Company (1930).

² For example in the income sheets of The Mathieson Alkali Works (Inc.) (1931), Kennecott Copper Corporation (1931), International Cement Corporation (1930), Hupp Motor Car Corporation (1930).

³ See, for example, income sheets of Chrysler Corporation (1931), The Willys-Overland Company (1930), Schulte Retail Stores Corporation (1930).

⁴ The American Institute of Accountants has defined earnings as resulting only from "operating sources" whereas profits result from all sources. See *Accounting Terminology* (New York, 1924), pp. 57, 93, 97.

⁵ The income sheets of General Electric Company, United States Steel Corporation, and Endicott Johnson Corporation are a few of those to be commended in this respect.

ous applications of "reserve." For instance it is applied to the estimated uncollectible portion of receivables—reserve for bad debts; to the portion of existing depreciable assets written off—reserve for depreciation; to the estimated amounts of various liabilities uncertain in amount—reserve for income taxes, reserve for outstanding coupons, and reserve for pensions; and, finally, to appropriations of surplus—reserves of various sorts. Better terms are "allowance" for the first two cases and "provision" for the next, leaving "reserve" to be applied only to surplus reserves.¹

¹ As an illustration, the balance sheet of Dictaphone Corporation, December 31, 1932, contained the following designations: allowance for doubtful accounts, allowance for depreciation, provision for income taxes, earned surplus appropriated for retirement of preferred stock.

CHAPTER 3

ADEQUACY IN FINANCIAL STATEMENTS

Adequacy in the balance sheet. There are so many variations among published statements in subdivision and classification of both assets and equities that no tabulation of balance-sheet grouping was made from the statements examined. The principal practice contributing to this situation is that of setting out a single item as of equal rank with a principal group or subdivision. This is usually done for emphasis, which may be desired because of: relative importance of the item, doubtful validity, peculiar treatment or unusual nature of the item itself, and desire to emphasize conservatism. These various factors may not be clearly defined in any one case, and sometimes more than one can be applied. Some general examples of items often found listed alone on balance sheets follow:

1. Bond discount and expense (as an asset)
2. Treasury stock or treasury bonds (as an asset)
3. Customers' or other deposits (liability or asset)
4. Cash surrender value of life insurance policies
5. Goodwill and other intangibles
6. Subscriptions to capital stock and capital stock subscribed
7. Advances to employees and officers
8. Pension or other trustee funds and corresponding reserves
9. Goodwill (at \$1.00).

A few examples of more unusual items found listed separately, in the particular balance sheets indicated, are listed below:

1. General Motors Corporation stock (balance sheets of E. I. du Pont de Nemours & Company)
2. Development expenses for new products and processes (The Mathieson Alkali Works (Inc.), December 31, 1931)
3. Interest included in notes receivable—unearned portion (liability. American Multigraph Company, December 31, 1928)
4. Accounts receivable, under award by Mixed Claims Commission—less reserve (of equal amount. Amalgamated Leather Companies, December 31, 1931)

5. Dividend certificates convertible into Common B stock, March 1, 1923, and not yet presented for redemption (American Tobacco Company, December 31, 1928)
6. Stock dividend payable (Paramount Publix Corporation, December 26, 1931)
7. Rental machines in service and on hand at depreciated values (Remington Rand, Inc., March 31, 1932)
8. Returnable containers, racks, etc. (United Biscuit Company of America, December 31, 1930)
9. Mining royalties (United States Steel Corporation, December 31, 1931)
10. Lasts (at \$1.00, Brown Shoe Company, Inc., October 31, 1931).

Another factor contributing to lack of uniformity in the subdivision of assets and equities is the tendency toward extended grouping. Fundamentally, there are only two principal subdivisions of both assets and liabilities—current and fixed—and only two of proprietorship—stated capital and surplus. However, it is now common to employ three to seven groupings. The most common groups found are indicated in the tabulation below. The actual titles employed vary too greatly to attempt listing.

<i>Asset Classifications</i>	<i>Equity Classifications</i>
Most Common Groups—	Most Common Groups—
Current assets	Current liabilities
Investments	Fixed liabilities
Plant and equipment	Reserves
Sinking and other funds	Net worth
Intangibles	Capital stock
Deferred charges	Surplus
Other Groups—	Other Groups—
Prepaid expenses	Mortgages payable
Permanent investments	Deferred credits
Investments in affiliated companies	Accrued liabilities
Mortgages receivable	Revaluation surplus
Special deposits	
Special receivables	
Suspense items	

A study of financial statements was recently made by the Metropolitan Life Insurance Company. In a report of this study a summary of various practices observed was given, and this summary has been adapted in the following list of requisites for adequacy in the balance sheet:¹

1. That current assets are set forth fully and, if pledged, the fact is indicated.
2. That the accounts receivable show to what extent the company is in the installment business.
3. That receivables are safeguarded by adequate allowances for uncollectible items, the amount of which is given.
4. That inventories are reasonably classified, and the basis of valuation is given.
5. That the basis upon which property (including investments and intangibles) is valued is given.
6. That tangible plant assets are classified to some extent.
7. That the amount of depreciation and similar allowances is stated, and preferably classified.
8. That deferred charges are classified, as well as any group of suspense and miscellaneous items.
9. That current liabilities are set forth fully.
10. That particulars are stated as to funded or long-term obligations, including maturities, interest rates, and security.
11. That "reserves" are given in detail and so designated that their true nature is indicated.
12. That the kinds of capital stock are given in detail, and that treasury stock is shown as a separate item with the amount and the number of shares given.
13. That paid-in, capital, earned, and revaluation surpluses are listed separately and show by their designations how each arose.
14. That a notation is made of all contingent liabilities.
15. That the statement is prepared in comparative form as a matter of convenience to the reader.

Adequacy in the income sheet. The income sheet is not complete unless all operating data are given. However, there is a

¹ *Financial Statements in Annual Reports to Stockholders*, Metropolitan Life Insurance Company (New York, 1930), p. 26.

difference of opinion regarding the requirements of adequacy in this respect as applied to statements issued to stockholders. Many corporations regularly issue income sheets opening with the margin figure or that of operating income.¹ The old fear that some benefit to competitors can result from the disclosure of the figures for sales and operating expenses is apparently at the bottom of an unwillingness to publish complete income sheets. According to one authority the trend in presentation is toward complete income sheets,² though it is also claimed that in very recent years this is not so.³ As revealed in the financial statements examined for this study, the tendency in the last twenty-five years has been decidedly toward showing more operating data.⁴ The best answer to the contention that it is in the interests of the corporation not to disclose all operating details lies in the fact that many of our largest and most successful corporations continue to publish year after year complete income sheets. A few instances will be noted.

The first annual report of General Electric Company, for the year 1893, contained parent company financial statements only. The second report, however, contained consolidated financial statements. The income sheet was complete, opening with the sales figure, and this practice has been followed ever since. Financial statements of United States Steel Corporation have, at least since 1903, been published in substantially the same detail and form as today. The income sheet opens with the item "gross receipts—gross sales and earnings." An interesting case in this

¹ Out of 282 reports (12 of 294 examined published no income-sheet data), 154 gave complete operating data, 43 omitted the merchandise or production cost of sales, 81 omitted all operating expense, and 4 showed only the disposition of net income after deduction of interest. Of those not showing complete operating data, however, 9 gave the sales figure.

² Sunley and Pinkerton, *op cit.*, p. 295.

³ The report to stockholders of Canada Dry Ginger Ale, Incorporated, for the nine months ending June 30, 1932, comments as follows on a change from the complete to the incomplete income sheet: "This change recognizes and accords with the general trend now being followed by many corporations whose stocks are listed on the New York Stock Exchange. It is held by many accountants and financial authorities that, all things considered, it is better practice to omit 'sales' and 'cost of sales and expense' from statements and start with 'profits from operation.'" ⁴

⁴ The following figures are compiled from the annual reports of identical corporations over the past twenty-five years. Ninety-five (of the 294 examined)

connection is that of United States Rubber Company. The first report of this corporation was for the year 1893. In 1896 an income sheet was included, giving only part of the operating details. The report for 1903 adopted the complete income sheet. For 1919 and 1920 the income sheet was omitted. The 1921 report contained a brief surplus reconciliation in the letter to stockholders. A surplus analysis, introducing "net income from operations," was included as a formal statement in the 1922 report. For the 1929 report this combined statement was made into two, income sheet and surplus analysis, the income sheet opening with the figure for operating income. The income sheet is again complete for 1931 and for 1932.

Figures for gross revenue and operating expense are essential in calculating the operating ratio and the capital turnover, both matters of the first importance in judging success of operations. It would seem that this is information the investor is entitled to have.

were available ten years ago; 30, eighteen years ago; and 12, twenty-five years ago.

	<i>Ten Years Ago</i>	<i>Eighteen Years Ago</i>	<i>Twenty-five Years Ago</i>
No income sheet	18	4	4
Complete income sheet	44	17	6
Opens with margin figure	8	3	—
Opens with operating income	14	1	—
Opens with income after interest	6	2	—
Opens with net income	5	3	1
Income sheet on cash basis	—	—	1
Total	95	30	12

Comparing the same 95 reports as between ten years ago and today (mostly 1931) the results are as follows:

	<i>Today</i>	<i>Ten Years Ago</i>
No income sheet	2	18
Complete income sheet	52	44
Opens with margin figure	12	8
Opens with operating income	27	14
Opens with income after interest	2	6
Opens with net income	—	5
Total	95	95

There were changes in all directions. Only one company, however, abandoned the practice of publishing an income sheet. The final results show that there was a proportionally greater increase in the showing of partially complete operating data than in the use of complete income sheets.

Another requirement of adequacy in income sheets is that there be sufficient detail to enable the reader to distinguish easily between ordinary income and unusual items.

The study of the Metropolitan Life Insurance Company already referred to has been adapted for the following list of conditions requisite to adequacy in income-sheet presentation:¹

1. All revenues are reported with provision for separation of operating revenues (preferably classified if diverse) from miscellaneous, extraordinary, and non-recurring revenues or income.

2. All operating expenses (including merchandise cost of sales) are shown deducted from revenues, with provision for separation of all miscellaneous, extraordinary, and non-recurring items.

3. Expenses are classified in some detail, with at least production or merchandise cost (in manufacturing and mercantile fields) shown separately from distribution expenses, and with the amounts of depreciation, depletion, and similar amortization charges indicated.

4. Income deductions, distributions of income, and appropriations are shown in detail.

5. If the income reported depends in any way on previous revaluation of assets upward or downward, the fact is disclosed.

6. The statement is presented in comparative form as a matter of convenience for the reader.

Surplus analysis. Whether the surplus analysis is shown in the income sheet or in a separate statement, it is important that all adjustments of surplus and income be completely accounted for and so designated that their nature is clearly shown. Whereas most corporate financial statements are satisfactory in this respect, a most unfortunate practice exists in some quarters in combining the analyses of earned surplus and capital surplus.² In such statements there is no way of telling whether the various items are treated as adjustments of earned or capital surplus

¹ *Financial Statements in Annual Reports to Stockholders*, op. cit., p. 67.

² Representative examples can be found in the financial statements of American Brake Shoe and Foundry Company (1931), American Locomotive Company (1931), Eureka Vacuum Cleaner Company (1930), and Real Silk Hosiery Mills, Incorporated (1930).

or of both, and only a net change is revealed for each. An analysis of capital surplus should be presented, but it should be separate from that of earned surplus.

Corporation financial statements often fail to meet the demands of adequacy in the analysis of "reserves." Frequently various charges or credits are made directly to surplus reserves carried on the books. If the corresponding credits or debits are to income or surplus, that is, if the adjustments are concerned only with appropriations to and releases from reserves, the reader of financial statements is in a position to know what has been done. When, however, losses and gains, expenditures and receipts are made direct to some "reserve" account, a summary or analysis of that account is called for.¹ If a reserve for contingencies exists, the management in its natural anxiety to present a favorable result for the period, may find it easy to interpret various special losses or unusual expenditures as contingencies, charging them off directly to the reserve. Surely the investor is entitled to know the disposition of reserves, even if all charges against them are proper. During the last few years many corporations have charged write-downs of investments, receivables, and inventories to reserves of one sort or another. And such adjustments become buried in the absence of statements analyzing reserves, though the procedure is often mentioned in the comments or the president's letter accompanying the formal statements.²

¹ See Chapter 11 for alternative method of indicating disposal of reserves by bringing the "releases" therefrom into the income sheet.

² For example, the Eastman Kodak Company annual report for the fiscal year ending December 26, 1931, p. 7, comments as follows: "Of particular interest is the item of contingent reserves amounting to \$3,499,029.49 as against \$11,485,741.96 at December 27, 1930, a decrease of \$7,986,712.47 due principally to the following three items:

Reduction in value of net current assets in foreign countries to prevailing rates of exchange	\$3,772,080.09
Unrealized depreciation in market value of securities less profits on sales	2,819,231.01

Payment to United States Alien Property Custodian of dividends on 28,450 shares of common stock, and interest accrued thereon, in accordance with the final decision of the Circuit Court of Appeals made in 1931, carried in Reserve at beginning of year 1,448,968.15

Although these three items amount to more than the net decrease in reserves above mentioned, other adjustments resulting in a net addition thereto of \$53,566.78 account for the difference."

CHAPTER 4

ACCURACY IN FINANCIAL STATEMENTS— VALUATION PRINCIPLES

Popular conceptions of asset valuation. Accuracy in financial statements means something more than mathematical correctness and absence of manipulation. This additional meaning is implicit in the typical expression of auditors' certificates—"correctly sets forth the financial condition." Specifically, how should the financial condition of a corporation be set forth to be correct? Another term current in accounting terminology, which is closely akin to "financial condition," is "net worth." "Worth" is an expression of value. But what values should the balance sheet show, or should it show values at all? Of the two terms, "net worth" definitely indicates value, whereas "financial condition" does not necessarily do so, though it is doubtless popularly understood in that light.¹ In short, the lay reader of financial statements usually believes that the amount shown on the balance sheet for total assets is indicative, and is intended to be so, of the value of the company.²

During the Great War, American business entered an era of writing up assets—it was apparently felt that sound values were higher than recent costs. This era came to a close in 1929. A new era of writing down assets has about ended—it is felt that sound values are lower than recent costs. The in-

¹ It is interesting that the situation is the same in England. "There is, however, quite a widespread impression—among persons who have not reasoned matters out—that all assets appear, or should appear, in a properly drawn up balance sheet at their realisable worth at the date which such balance sheet bears." Lord Plender, "Some Observations on Company Balance Sheets," *The Accountant*, London, February 13, 1932, p. 206.

² As a true statement of financial worth, the balance sheet has greater limitations. Only assets capable of being expressed in money terms can be listed and even these are provisional—their validity is subject to the success of future operations. Many things, assets in a broad sense, such as integrity of the management, loyalty of personnel, and others equally important but imponderable from the standpoint of expression in dollars and cents, cannot, with our present tools for measurement, be shown in the balance sheet at all. Yet, they may play a more important part than the inventory of wealth placed at the disposal of a business.

evitable conclusion is that corporation officials and many accountants are convinced that the balance sheet should display "financial condition" in reference to some kind of *value*. A few quotations from recent corporation reports will make this clear and indicate as well that the subject of valuation is inextricably tied up with the theory of depreciation.

The Liquid Carbonic Corporation (Report for the year ending September 30, 1932):

With regard to the restatement of capital assets, it should be mentioned that the effect thereof is, first, to eliminate the appreciation charged to property accounts prior to the recapitalization in June, 1926, and second, to reduce the charge for expenditures on property accounts since that time in keeping with the lowered construction costs now prevailing. In consequence of these adjustments, the annual depreciation charges will be reduced by approximately \$100,000.00. In the opinion of the officers and the company's accountants, the *depreciation calculated on the reduced values should be sufficient to provide for eventual replacement at current price levels.* [Italics not in original]

Consolidated Oil Corporation (Report for the thirteen months ending January 31, 1932):

It will be noted that the balance sheet valuations of the Consolidated properties have been written down to a very conservative level. While these reductions in asset values may appear severe, it can not be too strongly emphasized that no element of the value that exists in possession and use is in the least degree affected. The Corporation owns the same physical assets in the form of real estate, oil wells, pipe lines, steam ships, refineries, marketing facilities, etc. The only difference is that the stated values formerly assigned to these assets have been reduced to a figure more nearly conforming to present-day economic conditions.

The Studebaker Corporation (Report for 1931):

If a write-down of plant facilities is made, substantial savings would result to the corporation in depreciation and other charges, thereby benefiting the profits of future years.

Motor Wheel Corporation (Report for 1931):

These write-offs as well as other special charges in 1931 effect a saving of approximately \$200,000.00 per year in future operating expenses.

United Fruit Company:¹

The restatement of book values has been made with care and, in so far as it is possible in these times of constantly changing costs, is believed to be just and fair. In making this restatement it should be recognized that the company's assets are not altered thereby. Nothing is added to or taken from the properties by changing their book values to correspond more faithfully to what is believed to be a conservative and fair figure at the present time. To the extent, however, that properties subject to depreciation are reduced in book value by this restatement, the charges for depreciation affecting income in 1932 and subsequent years will be reduced and the annual burden thereby substantially lessened.

The quotations above are illustrative of numerous similar statements to be found in the latest pronouncements of corporation officials regarding their financial ledgerdemain. Under the cloak of conservatism they have been revising assets downward to conform more closely with current "values" or "conditions." (They had hardly completed writing assets upward with like conservatism.) Some, as the quotations above attest, are more frank and say simply that the purpose of the write-down is to allow for better-looking income sheets in the future. The pinnacle of "conservatism" in asset valuation has been reached by Commercial Solvents Corporation, whose plant is listed on the balance sheet at \$1. The following is taken from this company's balance sheet at December 31, 1931, and from the accompanying letter to stockholders:

Land, buildings, equipment, etc.....	\$7,329,121.56
Less: Reserve for depreciation and reduction of assets.....	7,329,120.56

* * * *

Following last year's procedure these [capital] expenditures were written off by a charge against surplus on December 31, 1931, in order to maintain the Corporation's land, buildings, and equipment at the nominal figure of \$1.00, consequently the earnings bear no charge for depreciation during the year 1931.

¹ From letter to stockholders, as quoted in the *Commercial and Financial Chronicle*, Vol. 135 (October 22, 1932), p. 2844.

Certain commentators go still further and indicate a tacit assumption that the very purpose of accounting is to present nice-looking statements. For example:

Sound financial statements cannot be expected while overhead charges and gross earnings ability are out of balance.—*A banker*.¹

Writing down the assets to figures indicating their values as productive factors under present conditions is the only method of obtaining a foundation for forecasting proper fixed charges and earnings rates.—*Professors of finance*.²

Reductions in book value of fixed assets and corresponding reductions in depreciation charges have reacted to advantage of stockholders. Resulting increase in net earnings has tended to stimulate investment demand for securities of corporations following the devaluation policy. . . . Values in security markets the last two years have been determined almost entirely by earnings, and the factor of book value has been neglected.—*A business magazine*.³

It would appear that the last quotation discloses the real motive behind many plant write-downs. The corporation management has its eye on the stock market.

Asset valuation for accounting purposes. Cost is the logical starting point in asset valuation. What determines cost is the value of what has been exchanged for the assets acquired. When cash is the consideration, there is obviously no difficulty, but when securities are issued in payment for property acquired, the initial cost is not so easily determined. It is an unwarranted assumption to value assets at the par or stated value of securities issued in exchange. As Hatfield has observed, this principle of valuation "would require that where stock is sold at a discount, the cash received should be treated as equal to the full face value of the stock, though it is in fact only a fraction of that sum."⁴ Assuming, however, that initial cost has been

¹ J. R. Kraus, as quoted in "Excess Plants 'Water' Stock," *Detroit Free Press*, November 20, 1932.

² G. T. Cartinhour and L. E. Dewey, "Capitalization Changes as a Result of Depression," *Corporate Practice Review*, New York, April, 1932, p. 29.

³ "Business Begins to Write Down Book Values of Fixed Assets," *The Business Week*, New York, May 4, 1932, p. 24.

⁴ H. R. Hatfield, *Accounting* (New York, 1929), p. 72. Basing property values on the face value of stock issued therefor is one variation of stock water-

fairly determined, there is the problem of subsequent valuation. There is first the possibility of revaluing assets on the basis of their market values, that is, liquidation value. Second, there is the possibility of using replacement value. Finally, there is the possibility of retaining cost, as modified by systematic reductions for depreciation, depletion, and amortization. The first two bases require periodic adjustment, since they express current values. The last basis is not concerned with "value" but with a correct historic record of investment. As a *general* basis for asset valuation, liquidation value can be ruled out immediately, on the ground that it has no significance to the going concern. The assumption of the going concern is an important postulate in general accounting. As applied to asset valuation, it means that the proper value of assets to the company holding them is not what those assets would be worth to others or what they would bring if sold. Replacement value and cost remain as possible general rules for valuation. Either may express going-concern value.¹ Going-concern value and liquidation or cash value, however, become practically synonymous in regard to "quick" assets.

As regards valuation, then, assets may be divided into two groups—one for which going-concern value is the logical basis and the other for which present cash value is the logical basis. The first group includes all fixed assets, inventories, and prepayments. In the second group are cash, receivables, and investments of a temporary nature. Roughly, the line between

ing and was a typical abuse until recently. Since the Interstate Commerce Commission took an interest in the matter, there has been a noticeable improvement (see Hatfield, *supra*, p. 73). For a recent example of the practice, however, see the first annual report (for 1929) of Niagara Hudson Power Corporation. A footnote to the plant item on the balance sheet states that the asset values of three subsidiaries have, "in the absence of a complete appraisal . . . been based upon the par value of the capital stock . . . and warrants issued in exchange for securities of these subsidiary companies." Since this corporation issued a part of its capital stock for cash, and there were market values of the securities of subsidiaries acquired, it would appear that a more reasonable indication of cost could have been found.

¹ The distinction between "going-concern value" in accounting and in rate-regulation cases is obvious. The accountant simply uses the term as opposed to liquidation value. It does not include goodwill or the hypothetical cost of building up the business.

the two categories is that dividing items which may or will affect the income of future accounting periods and items which represent repositories of liquid funds, ordinarily existing as a result of past operations. The concept of a continuous flow of capital funds through assets, always tending toward cash, is helpful to an appreciation of the distinction. In the normal operation of a business, cash is the beginning and the end of all business transactions.

Looking at the two groups in another way, the line dividing them is that between assets the valuation of which is of continued interest only to the business, or its owners, and assets the valuation of which is of interest to creditors and other outsiders. Inventories and prepayments are included in the first group because both represent deferred charges to future operations, unrecovered costs. Their interest to outsiders therefore, always assuming the going concern, is in their asset value in the next stage, that is, after sale, as cash or receivable.

The valuation of different classes of assets is discussed in the following chapters. Since only "quick" assets are ordinarily displayed on balance sheets at their cash or "market" value, it follows that the balance sheet is not an inventory of the values of assets in that sense. Neither does the balance sheet show the value of the entire enterprise. These points are behind a recent tendency to relegate the balance sheet to a position of secondary importance in reports to stockholders. The income sheet is now to be emphasized. It has even been suggested that the balance sheet of the future may be reduced to "a half-dozen lines on each side."¹

¹ J. M. B. Hoxsey, *Writing Down Assets and Writing Off Losses*, an address before the Massachusetts Society of Certified Public Accountants, Boston, 1933, p. 8. See also Henry Morgan, "Auditors and Profit and Loss Accounts," *The Accountant*, London, March 5, 1932, p. 303.

CHAPTER 5

VALUATION OF PLANT

Determining asset "values." No proof would seem to be required for the statement that once dollars have been turned into other tangible and intangible assets, the money value invested therein, the cost, ceases to have any direct bearing on their value. Value thenceforth is determined by their ability to produce income. This is a fundamental economic principle, and there are many everyday examples of it. Assuming that the purpose of the balance sheet were to show the value of assets, it is obvious that continual revision would be required. Value is a variable, often a rapidly changing one.

It would obviously be impracticable to revise plant values, say, annually. It happens, consequently, that appraisal values of plant are given expression in the accounts only at infrequent intervals and, usually, only when they reveal substantial disparity from existing book values. Although the cost basis is most widely employed by large corporations, other bases are found with sufficient frequency to warrant discussion here.¹ The present chapter is limited, however, to consideration of the relative merits of cost and of replacement cost.

Depreciation and asset value. Turning first to the matter of depreciation as related to asset valuation, the case for replacement values as opposed to actual investment is well stated in a sentence already quoted² from an annual report of The Liquid Carbonic Corporation: "The depreciation calculated on the reduced values should be sufficient to provide for eventual replacement at current price levels."

¹ Among the balance sheets examined, most made no specific mention of the basis for valuation of plant. In the absence of specific information to the contrary it is probable that the cost basis was used in the majority of these instances. Of 85 mentioning the valuation base, 39 gave cost, 31 appraised values, and 15 "book values" or "ledger values" (which tells nothing except that the auditors probably intended a qualification).

² See p. 28.

The function of depreciation, as recognized by most accountants, is to spread systematically the cost of comparatively long-lived assets. Thus, if a building will be of use during twenty years of operation, its cost should be recognized as operating expense, not of the first year, nor the last, but of all twenty years. Various methods may be proper in so allocating cost.¹ The method used, however, is unimportant in this connection. The important matter is that at the time of abandonment the entire cost of the asset shall, as nearly as possible, have been recognized as expense of the various accounting periods throughout its useful life.² Charging depreciation incidentally accomplishes maintenance of the original investment. If a building originally cost \$50,000, and during its life the \$50,000 is collected from customers through sales at prices covering all charges to expense (including depreciation), then capital funds to the original amount of \$50,000 still remain in the business, though they will now be invested in some other asset or assets.

It is this incidental effect or corollary of depreciation accounting that provides the bone of contention in replacement cost versus original cost for valuation purposes. So long as the general price level was falling or only gently rising, there was little controversy regarding the matter. But with the sharp rise in prices occasioned by the Great War there came a desire on the part of many business men to value their assets at replacement cost. In 1921 the Chamber of Commerce of the United States issued a bulletin³ advocating the retention of the original-cost basis. This stand has since been reiterated in a second bulletin,⁴ from which the following is quoted:

¹ Depreciation may be charged to expense on the basis of proportionate elapsed time (straight line basis), on the basis of intensity of use (output method), or any of several others; for example, sinking-fund method, annuity method, reducing-balance method, sum-of-the-life-digits method, and so on.

² Although depreciation expense is in essence an estimate, the use of normal life-expectancy tables results in reasonably close approximations.

³ *Depreciation*, Fabricated Productions Department (now the Department of Manufacture) of the Chamber of Commerce of the United States (Washington, October, 1921).

⁴ *Depreciation, Treatment in Production Costs*, Department of Manufacture, Chamber of Commerce of the United States, No. 512 (Washington, May, 1929).

When the cost of an asset, less any salvage value, has been recovered, the process of depreciation stops,—the customer has paid for that particular item of service. There are those who maintain that the obligation of the consumer is one rather of replacement cost rather than actual cost. The replacement theory substitutes for something certain and definite, the actual cost, a cost of reproduction which is highly speculative and conjectural and requiring frequent revision. It, moreover, seeks to establish for one expense a basis of computation fundamentally different from that used for the other expenses of doing business. Insurance is charged on a basis of actual premiums paid, not on the basis of probable premiums three years hence; rent on the amount actually paid, not on the problematical rate of the next lease; salaries, light, heat, power, supplies are all charged at actual, not upon a future contingent cost. As one writer has expressed it, "The fact that the plant cannot be replaced at the same cost, but only at much more, has nothing to do with the cost of its product, but only with the cost of future product turned out by the subsequent plant." As the product goes through your factory it should be burdened with expired, not anticipated costs.

One might wonder why objection to cost as a basis for expenses other than depreciation has not also been voiced. The explanation appears in the fact that the expirations of service value of raw materials, labor, insurance, advertising, and so on are relatively close to the time of acquisition. Ordinarily insufficient time intervenes between successive replacements for significant deviations due to changing price levels to occur. For example, take the case of rent mentioned in the quotation above. Rent is charged "on the amount actually paid, not on the problematical rate of the next lease." True, rent is recognized as an expense on the basis of actual cost. But suppose all rental contracts were long-term leases covering from five or ten to fifty years and paid for in one lump sum in advance. Under these conditions rent as an operating expense would correspond to depreciation of plant and equipment, and the same question of cost versus replacement valuation would doubtless arise.

The purpose of accounting is to record as nearly as possible actual costs for the individual enterprise. The depreciation charge, therefore, should reflect actual costs. As aptly stated by Justice Brandeis of the Supreme Court of the United States:¹

¹ Dissenting Opinion, *United Railways and Electric Company v. West*, 280 U.S. 234, 1930.

To use a depreciation charge as the measure of the year's consumption of plant, and at the same time reject original cost as the basis of the charge, is inadmissible. It is a perversion of this business device.

Depreciation exists whether the property being used is to be replaced or not. In no sense does the depreciation allowance or "reserve" account represent an accumulation of funds for the purpose of acquiring future assets. If plant is to be replaced, and if it is expected that replacement will be at a cost higher or lower than original cost, it may be desirable to retain a portion of earnings in the business to provide additional capital for the expected increase in investment or to release a portion of capital to correspond to the probable decrease. This is emphatically not a function of depreciation accounting, however. Rather, it has to do with the administration of income and capital and is thus a matter to be taken up with such questions as the declaration of dividends and the creation or release of surplus reserves.

Results of recent write-downs. The net effect of writing depreciable assets down to replacement values and subsequently basing depreciation charges thereon, is to transfer piecemeal to surplus as net income the amount of the write-down. The nature of the account to which the write-down was originally charged will thus determine the nature of this portion of "earned surplus" and the true character of cash dividends based thereon.¹

If original capital investment in dollars is liquidated, the stockholders should be apprised of the fact. A danger of the write-down movement lies here.²

¹ See Chapter 10.

² That the movement has received more approbation generally among accountants than did the matter of appreciation is particularly noteworthy in this connection. Accountants have always been zealous to guard against any process (such as omission of depreciation or depletion charges) which facilitates impairment of capital. Two reasons can be discerned why accountants have overlooked or neglected the effect on profits, surplus, and dividends of the future in connection with devaluation of assets. The first is that the matter is confused by the presence of write-downs of different sorts: (1) write-downs of abandoned and obsolete plant, (2) write-downs of inflated values resulting directly from appreciation, or indirectly through mergers, consolidations, or reorganization. In the second place accountants are notoriously conservative, which means that they mentally applaud understatement of asset values and frown at overstatement. It is to be suspected that the immediate effect of writing down assets to replace-

The case for cost—summary. One might pose a conundrum, "When is a cost not a cost?" The solution, of course, would be, "When it is a replacement cost."¹ However much one may be in sympathy with the general aim of maintaining physical capital rather than dollars invested, he can never approve the accounting methods of the asset-revaluers unless he can accept the thesis that cost is not actual cost, but is replacement value. Non-acceptance of this premise makes all adjustments of used and useful plant to replacement value smack of manipulation.

The greatest justification for cost valuation of assets is that the very purpose of accounting is to show costs of operation. This seems never to be questioned for those items of cost which can in their entirety be classed as expense of the product for the period immediately under review. Why costs which must be classed as expense of many future accounting periods in addition are fundamentally any different is hard to see. Naturally, the actual costs of operation for individual companies, utilizing plants made up of parts purchased at different times and at varying prices, will differ. But is it not the very function of accounting to show such variations? The costs of most all assets other than cash, receivables, and outside investments represent unrecovered capital outlay; that is, deferred charges to future operations. These commitments were made in dollars, and so long as asset values reflect bona fide original costs,² it may be said that this is just what they should do. The capital invested

ment value appeals to their innate conservatism. The ultimate effect is often overlooked.

¹ It is interesting that in reference to cost of product on the income sheet, the Committee on Terminology of the American Institute of Accountants has noted that "the word 'cost' as used in these captions is a misnomer when inventories have been priced at market or at any price other than cost." *Accounting Terminology* (New York, 1931), p. 90.

² It is a fundamental principle that costs are proper initial values for accounting purposes only if they represent prices arrived at through a process of arm's-length bargaining; that is, legitimate market value in the first place. Needless to say, book values do not always reflect such costs. Acquisitions of assets through the devices of stock issues and exchanges as involved in mergers and consolidations provide the most important means by which valid costs have been beclouded in recent years. And this situation gives some basis to the appraisers' contention that appraised values are more reliable than original costs as recorded on the books.

therein is recovered, or not (in the case of unsuccessful operation), as it is deemed that a portion of the unrecovered cost applies to the current accounting period. This portion is accordingly charged off as depreciation expense. The function of depreciation in this connection has been outlined above. There is no reason why the net book value (cost less accrued depreciation) of assets subject to amortization, depreciation, or depletion should provide, or should be expected to provide, any direct information as to the market value of those assets. If values of any particular assets or of the business as a whole are wanted, they can and should be obtained in other ways.¹ Yet it is no doubt true that most people who read financial statements have a different impression.²

It cannot be denied that the depreciation allowance or "reserve" is often misused in practice. A common abuse, which is defended on the grounds of conservatism, is overdepreciating. This results in understatement of income and the creation of a secret reserve in the depreciation allowance.³ It may reflect a conservative business policy, but it is not good accounting to charge excessive depreciation. The policy could be as easily carried out, without distorting income and earned surplus, by charging depreciation at recognized rates and appropriating surplus to special reserves in whatever amount deemed necessary to provide for exigencies.

There are several other important reasons why cost should continue to be the general basis of valuation for assets which in fact represent unrecovered costs of future revenues.

The first reason is that cost, if properly stated in the first instance, records fact rather than conjecture. It is ordinarily

¹ It is not intended to imply that the net book values of assets may not afford some indication of value. But it cannot be too strongly emphasized that net book values do not express market values.

² The very fact that accountants recognize many valid bases for accruing depreciation, which may give radically different results in respect to net book values, would seem to disprove the conception that net book value is equivalent to market value.

³ Cases in which the aggregate allowance for depreciation is over 50 per cent of gross value of plant and equipment—prima facie evidence of overdepreciation—include: Diamond Match Company (December 31, 1929), General Electric Company (December 31, 1931), American Cyanamid Company (December 31, 1931), The B. F. Goodrich Company (December 31, 1931).

easier and much less expensive to maintain plant records based on cost than on other valuation bases.¹ Universal adoption of the cost basis would afford a greater degree of comparability than now exists in published statements, a comparability which could not be approached by other methods so far devised. Moreover, cost is generally understood, and, if accountants educate the public to appreciate the fact that book values represent cost and depreciated cost, not market or replacement values, there can be little possibility of misinterpreting financial statements and also less opportunity of misrepresentation short of actual falsification.

The final argument here for cost is that one of the primary aims of replacement-cost valuation—namely, providing that through depreciation charges a portion of revenues shall be set aside sufficient in amount to replace assets—can perhaps be achieved as effectively through using actual cost as the basis for depreciation charges as using replacement values. In the first place, while the replacement values employed must necessarily be current costs of replacement, the actual replacement will involve future replacement costs. If replacement is not imminent, there is as good a chance that original cost will approximate the actual replacement cost, as that replacement cost at any intermediate date will. In the second place, plant is composed of diverse items of real and personal property. Many individual price levels are involved, and while the prices of some items will be rising others may be falling. Further there is the effect of progress in the arts upon replacement cost. Consequently, higher replacement costs for some units of property will be partially offset by lower replacement costs for other units. Depreciation charges based upon original costs may thus, in the end, provide for replacement in the aggregate as closely as would such charges based on replacement values. The larger the business enterprise and the more diverse its interests, the more this is apt to be true. Indeed, there is reason to believe that this has been the experience in the past. The following

¹ The fact that actual cost was unascertainable, which contributed so largely, at least in early cases, to the courts' preference for reproduction cost, is now rarely applicable. For many years complete records have been kept by our larger industrial concerns.

statement by Justice Stone of the Supreme Court, though made in reference to a street railway property and in a rate case, has a wide application:¹

Experience, which embraces the past fifteen years of high price levels, and the studies of experts . . . have demonstrated that depreciation reserve, calculated on the basis of cost, has proven to be a most trustworthy guide in determining the amount required to replace, at the end of their useful life, the constantly shifting elements of a property such as the present.

Write-off of idle and obsolete plant. Accounts with debit balances can represent loss as well as asset value. Thus, book values of plant may not always reflect asset value. If assets are idle, obsolete, and virtually abandoned, and there is little or no possibility of their ever being used in the business again, they should be written off. A loss has been suffered and, although it has not been ultimately realized (the income-tax standpoint), good accounting should none the less recognize it. This can be done either by writing the book value of such plant down to salvage value² or by creating a reserve of sufficient proportion to absorb the same loss. The write-off should be made to earned surplus. If earned surplus is insufficient, a deficit should be carried forward.

Temporarily idle plant, or plant used only to a small portion of normal capacity, involves a different problem. There is no justification for writing down temporarily idle or partially utilized plant. Expense has not become less merely because output is far below normal. Rather has cost, in terms of aggregate product, increased. While there is some excuse from a cost-accounting standpoint for allocating something less than the entire normal depreciation expense to production cost, this does not justify recognizing no depreciation,³ or recognizing depreci-

¹ Justice Stone, Dissenting Opinion, *United Railways and Electric Co. v. West*, 280 U.S. 234, 1930.

² For example, see the balance sheets of Certain-teed Products Company (December 31, 1930) and Vadsco Sales Corporation (December 31, 1931).

³ The annual report of American Radiator & Standard Sanitary Corporation for 1931, for example, contained the following comment: "Depreciation has been charged at the customary rates against the profits of all companies showing a net profit. Such charges, however, have not been made with respect to com-

ation only at some fraction of previous rates.¹ It is more reasonable (and there is a tendency in this direction) to compute the depreciation charge to production on a carefully calculated percentage of normal output and to recognize the remainder as a deduction to be shown in the income sheet after the operating income balance.² That the existence of idle plant is no new situation and that this is no new solution of the problem is shown by the following two illustrations. The income sheet of United States Steel Corporation for 1904 opened as follows:

Gross Receipts—Gross sales and earnings	-----
Less: Manufacturing and producing cost and operating expenses	-----
Balance	-----
Sundry net manufacturing and operating gains and losses, including idle plant expenses	-----

Similarly, the income sheet for the year 1922 of Wheeling Steel Corporation included the item "idle plant expense" among non-operating charges.

There are, of course, some companies following the old doctrine that depreciation and similar expenses need be recognized only if earned.³ It would be just as legitimate to defer recognition of any other fixed expense, such as rent or taxes, so long as over a long period the aggregate expense was charged. It can be insisted that if the income sheet is to show a true picture

panies showing a deficit for the year." Again, the income sheet of Cuban Cane Products Co., Inc. for the year ending September 30, 1931, concluded with the item "net loss for the year before charging interest and depreciation." Interest was deducted in the surplus analysis, but there was no reference to depreciation.

¹ For instance, the 1931 income sheet of Belding Heminway Company carried the following footnote: "Depreciation charge computed at half the rates used in previous years."

² Recent income sheets presented on such a basis include those of Spicer Manufacturing Corporation (1931), "depreciation and expense of idle plant"; American Hide and Leather Company (year ending June 28, 1930), "idle plant expense"; United States Steel Corporation (1931), "sundry net manufacturing and operating gains and losses, including idle plant expenses"—an adjustment of operating income.

³ Among large corporations upholding the case for equalizing income through varying depreciation charges is The Detroit Edison Company. See its 1926 annual report for a statement of the policy. The trouble with such theories is that they make maintenance of capital, which is an incidental effect of depreciation accounting, its prime excuse for being.

the full quota of maintenance and depreciation on used and useful plant must appear somewhere therein.¹

Valuation of land and wasting assets. The foregoing discussion has referred primarily to tangible and depreciable plant, though the intention is that it should apply in general to other assets representing future costs of operation, and as such subject to amortization or to depletion. In other words it applies to intangibles like patents and copyrights; to leaseholds; and to wasting assets. Land and wasting assets, however, have special characteristics which call for brief further treatment.

Land is a permanent asset, ordinarily not subject to declining asset value through use, and as such it deserves separate designation on the balance sheet.² For one thing it is obviously incorrect to include land with depreciable assets and then deduct the allowance for depreciation from the total figure. Further, the value of land is subject to fortuitous circumstances which do not affect other fixed assets. Its value, in other words, is not determined by its use in the business.

There is consequently more to be said for stating land on the balance sheet at appraised market value than for so showing depreciable assets. In the first place, the objections regarding distortion of actual future operating expense do not apply. Second, if the increase or decrease in value of land is considerable, the matter should doubtless be disclosed to interested parties. The case of an increased value is particularly important. For one thing it is often possible to market some of the holdings without disturbing the plant, and, further, if the land increases sufficiently in value, its present utilization may become uneconomical to such an extent as to call for a change of location.

If it is deemed desirable to state the appraised value of land in the balance sheet, this can be accomplished by footnote or by parenthetical statement following the land item as listed. If the appraised value is brought onto the books, the resulting credit or debit represents an unrealized addition to or subtrac-

¹ W. A. Paton, "Accounting Problems of the Depression," *The Accounting Review*, Chicago, December, 1932, p. 266.

² Of 131 cases in which all plant was not displayed as a single item on the balance sheet, land or wasting assets or both were the only exceptions in 41 cases. In 90 balance sheets further classification of tangible plant assets was given.

tion from capital. It should not be merged, however, with earned or capital surplus, and it should be shown under proprietorship on the balance sheet as a separate item.

In a sense wasting assets can be classed as inventory, and in practice at least one company follows this interpretation.¹ However, only that portion which is to be used in, say, the succeeding accounting period is legitimately a current asset, and it would be as proper to include as current assets a similar portion of the cost of depreciable and amortizable plant: The only distinction between wasting assets and other unrecovered costs evidenced by lump-sum purchase is that the wasting assets become in substance the product or become physically part of the product. Buildings and machinery, equipment, and patents can as well be conceived as becoming embodied in the product though in an intangible fashion.

The cost of certain types of wasting assets, such as deposits of precious mineral and pools of oil, is not only difficult of ascertainment—for example, how much of prospecting and exploration cost should be assigned to a given mine or well—but often bears no indication of, nor relation to, the value of the product. For this reason, and owing to the fact that for income-tax purposes depletion can be deducted on “discovery value,” some companies do not value assets subject to depletion at cost.² Other companies retain cost in the financial statements.³ Some refer to the fact that the “discovery value” provisions in the

¹ The balance sheet of Diamond Match Company lists “standing timber (at cost, less depletion)” under the caption “inventory and current assets” (December 31, 1931).

² The balance sheets (December 31, 1931) of both Socony-Vacuum Corporation and Indian Refining Company state that appraised value is the basis used. The balance sheet of Miami Copper Company (December 31, 1931) lists mines and mining claims at discovery value—“at value agreed upon with Treasury Department for depletion purposes.”

³ Continental Oil Company, Humble Oil & Refining Company, and Phillips Petroleum Company (December 31, 1931) state that cost is used. Also Inspiration Consolidated Copper Company (December 31, 1930). The annual report of Phillips Petroleum Company for 1928 contained the following comment: “Early in the Company’s history appreciation by independent appraisal was set up on the records in the amount of \$17,458,261.22. Subsequent appreciation has not been added, with the result that the item has become misleading and has, therefore, been charged off, thus presenting the balance sheet on a cash basis.”

income-tax regulations are being availed of, usually in footnotes somewhat as follows:

Note—Entries recording depletion are made upon the books of the Company, but being made for income tax purposes only, the result of those entries is omitted from the current statements.¹

Cost doubtless remains the preferable basis for balance-sheet valuation of wasting assets. The fact that cost and correct depletion bases may be more difficult to ascertain than for depreciable assets cannot be considered as arguments for the use of market values. The strongest argument for values other than cost is that the use of only "March 1, 1913, value" or of "discovery value" may save considerable duplication in record-keeping.

¹ Income sheet of Greene Cananea Copper Company for 1930. See also annual report for 1930 of Calumet and Arizona Mining Company. Similarly, the December 31, 1931, balance sheet of Kennecott Copper Corporation contains the following comment introduced parenthetically after "earned surplus": (without deduction of any depletion based on March 1, 1913, values).

CHAPTER 6

VALUATION OF GOODWILL

Goodwill in published financial statements. It is common to find "goodwill" in published balance sheets. Sometimes it is shown at a nominal figure, usually \$1. In many cases, however, the goodwill item is a substantial part of total assets.¹ A few annual reports indicate that, though goodwill is carried on the books, it is omitted from the balance sheet. One company, for example, deducts goodwill from the common-stock item, and gives the following explanation under the asset-caption "intangible capital assets":²

This balance sheet does not take into account the capital asset of Goodwill on the books, amounting to \$57,798,000, nor the Patents or Trade-marks carried on the books at \$1.00, but shows the condition of the Company on the basis of tangible capital assets.

Goodwill is usually included together with other intangibles in one blanket item.³ The following titles are typical:

- Patents, processes, trade-marks, goodwill, etc.
- Goodwill, trade-marks, and copyrights.
- Goodwill, patents, etc.
- Goodwill, trade names, and trade-marks.

Occasionally goodwill is merged with the tangible plant or with organization expenses. In some cases the asset value listed has been constant for a number of years.⁴ In other cases it is being amortized.⁵

¹ Among 294 balance sheets, goodwill appears on 113. In 50 cases it is shown at \$1. In 60 cases the figure ranges from 5 to over 50 per cent of total assets. In 3 it is listed, but no value is given.

² The B. F. Goodrich Company (December 31, 1931).

³ Eighty of 113 cases.

⁴ For example, Allied Chemical & Dye Corporation (same at December 31, 1931, as in 1921), The Hartman Corporation (same at December 31, 1930, as in 1917), R. H. Macy & Co., Inc. (same at January 31, 1931, as in 1914—the balance sheet carries a footnote: "At the rate paid for one-half interest in 1914").

⁵ The balance sheet of American Encaustic Tiling Co., Ltd. (December 31, 1930) lists the item as follows: "Goodwill purchased, less amount written off."

Goodwill in published balance sheets is doubtless often simply "consolidated goodwill." For example, the annual report of General Motors Corporation for the year 1931 contains the following comment in regard to the balance-sheet item "goodwill and patents":

This account, as reported in the balance sheet, shows practically no change during the period. Goodwill represents the difference between the purchase price and book value of properties acquired. The patent account represents the cost of acquisition to the Corporation less subsequent amortization.

In this case, if the "purchase price of properties acquired" includes cost of subsidiaries' stock, the goodwill item is consolidated goodwill, at least in part. Consolidated goodwill is clearly stated as such in the balance sheet of United Biscuit Company of America (December 31, 1930), which contains an asset labeled "cost of capital stocks of subsidiary companies in excess of net tangible assets acquired." The same item had been designated previous to 1929 as "goodwill." Although consolidated goodwill may represent real goodwill, the chances are equally great that it does not, and practice would be improved if consolidated goodwill were always set forth separately on the balance sheet, as in the United Biscuit Company of America statement.¹

In other cases the goodwill item appearing in balance sheets may represent an arbitrary expression of value. That is, it may simply have been written on the books, perhaps as a means of concealing excess earnings.

The nature of goodwill. It is not possible here to go into an extended discussion of the various kinds of goodwill which can be distinguished² nor of the various factors which contribute to building up goodwill. For accounting purposes it represents the conjuncture, fortuitous or otherwise, contributing to a

Goodwill is listed on the balance sheet (November 28, 1931) of Hart Schaffner & Marx as follows:

Good will, trade names, and trade marks	\$15,000,000
Less—amount written off in 1920.....	5,000,000

¹ See Chapter 15.

² J. M. Yang, *Goodwill and Other Intangibles* (New York, 1927), distinguishes three types of goodwill—consumer's, industrial, and financial.

superior earning capacity. Goodwill is "the value of capitalized excess income."¹

It is an orthodox rule of accounting that goodwill should be recognized only when purchased. That is, regardless of the existence of goodwill, it is a legitimate asset for balance-sheet purposes only when it represents a cost, a commitment of capital. Whether it should be amortized, and how, must depend upon the nature of what has been purchased as an asset.

In the operation of a business all the various elements which contribute to a superior earning power become inextricably fused, and when goodwill is purchased its price represents this conglomerate.² It would simplify matters were it possible to precipitate the mixture. For example, purchased goodwill arising from terminable monopoly privileges could then be assigned to the remaining lives of patents, copyrights, or franchises; that arising from a superior location could be amortized according to estimated trade-section movements; and that due to managerial ability would be allocated to the time it was planned to retain the existing management.³ However, there is no way to impute goodwill to the various contributory factors, and it must be considered in its entirety for accounting purposes.

Owing to the fact that duration of the goodwill of a particular concern cannot be assumed to be permanent, its value should be, and no doubt usually is, computed upon some more or less systematic basis as representing the discounted value for a definite period of future years of the company's present excess earning capacity. The excess consists of that portion of a company's earning power over and above what can be attributed to utilization of tangible assets on a reasonably appraised basis. Various methods of calculation are possible, which, however, cannot be reviewed here.⁴

¹ *Ibid.*, p. 159.

² In this respect the typical blanket designations for goodwill and other intangibles, which appear on published balance sheets, are legitimate, providing the items represent a cost.

³ Presumably goodwill of the last type would become the object of purchase only if the management were to remain, and then only to the extent that the goodwill was not being appropriated in the form of salaries and bonuses.

⁴ See *Accountants' Handbook*, Second Edition (New York, 1932), pp. 818-824.

Assuming that the goodwill has been properly calculated, it should be set up on the purchaser's books in a separate account and should be separately designated on the balance sheet.¹ It represents a legitimate asset—a commitment of capital to be recovered over a definite series of future accounting periods. Goodwill should be amortized ratably against net income over the period of time which was considered in computing it.² If the excess earnings continue, the capital investment is being recovered. If they do not continue, the loss is similar to any other loss arising from an unwise investment of capital.

Charging goodwill off either immediately or as accumulated earnings become sufficient may be "conservative," but neither method is systematic.³ Leaving the cost of goodwill permanently on the books can be considered as equivalent to any other means of overstating assets. It can be argued that failure to write it off permits impairment of capital unless dividend declarations are permitted to absorb accumulated earnings only over and above an amount equivalent to the cost of goodwill.

¹ This much apparently is usually done in practice. Only 8 of 294 balance sheets indicated that goodwill or other intangibles were included in the tangible plant item or items. Intangible asset values may not be indicated, however; they can easily be buried under other asset titles.

² The only case of display in the financial statements of amortization of goodwill, among those examined (294), is that of American Encaustic Tiling Co., Ltd. This company's income sheet for 1930 shows "amortization of goodwill purchased" as a deduction from operating income along with interest.

³ There may sometimes be an expedient reason for charging goodwill off rapidly in order to save taxes. Some states have a corporation privilege fee, popularly termed a franchise or capital stock tax, which is based upon the book value of the corporation's capital stock.

CHAPTER 7

VALUATION OF INVESTMENTS

Types of investments. Under "investments" in a corporation's balance sheet are listed those commitments of capital outside the business proper. They include stocks, bonds, mortgages, leaseholds, annuities, life insurance, contracts, special funds, and so on. Of these, leaseholds has already been referred to, since ordinarily this item is included in plant. If leaseholds and real estate owned in fee are not used in the business, it is proper that they be classed as investments, though this does not alter the conclusion that cost is the proper basis of valuation for balance-sheet purposes. Life insurance will be mentioned later (Chapter 13.) Notes and mortgages offer no particular problems. If they are good, face value or purchase price, whichever represents the original investment of capital therein, is the proper basis of valuation. This chapter will thus have particular reference only to stocks and bonds. Industrial and utility companies, to which the study is confined, generally have two different classes of stock and bond investments—first, temporary investments of excess cash funds, and, second, long-term holdings of securities in associated or other companies. Furthermore, securities often make up the major part of sinking funds of one type or another. For all investments cost is regularly the starting point.¹

Short-term investments. Short-term investments should be in a highly liquid form. That is, they should be easily marketable, and hence the popular balance-sheet title "marketable securities" is suitable in that it is descriptive.² It is hardly exclusive enough, however, since long-term investments in companies whose securities are actively traded in are also marketable. As far as published statements are concerned, it is possible

¹ *Accountants' Handbook*, Second Edition, p. 318 and p. 327.

² Numerous instances of the employment of the designation "marketable securities" include the balance sheets of General Motors Corporation, General Foods Corporation, Union Carbide and Carbon Corporation, Standard Oil Company of California.

to tell whether use of the term "marketable securities" is restricted to temporary holdings, only when the item is listed under current assets.¹ It is probable that, in spite of its denotation, usage sanctions the term "marketable securities" only as applying to temporary investments.

Balance-sheet valuation of temporary investments at market, or in other words, at present realizable values, is logical inasmuch as the item is of considerable interest to current creditors. On the other hand, cost is the only basis of valuation recognized by the Bureau of Internal Revenue.² It can be insisted that, in any event, market value be indicated in the balance sheet. This can be accomplished by carrying the asset on the books at market value (revalued at closing dates only, of course). Or, when cost is retained in the accounts, indication of market value in the balance sheet can be accomplished by footnote or parenthetical statement.

If market value of temporary investments is to be recognized in the accounts, two methods are available. The first calls for actual write-down; the second for creation of a "reserve," a contra account, to express the difference between cost and present value.³ While the latter method is to be preferred, since it does not obliterate the cost figure, the "reserve" must be interpreted as a contra to the asset account rather than as a contingent reserve to be shown among the equities on the balance sheet.⁴

¹ In 155 cases in which marketable securities appeared on the balance sheet, the item was listed under current assets in 134 cases, and separately or under investments in 21 cases.

² Exceptions are securities held by recognized dealers and those which can be proved worthless.

³ If present value is the correct basis of valuation for marketable securities, there is no logical reason why increases in value should not be recorded as well as decreases. The practice is frowned upon, however, owing to established accounting custom, which in general approves recognition of unrealized losses, but disallows recognition of unrealized gains.

⁴ When cost is to be retained as a basis of balance-sheet valuation, it would be good accounting to establish a reserve for any prospective loss on securities, which would, in the nature of the case, be some flat amount rather than the exact amount of the decline to market value and would be classed as a contingent surplus reserve. (See the "reserve for fluctuation of value of marketable securities" listed among equities on the balance sheet of General Foods Corporation, December 31, 1929.)

Among published balance sheets, there is no uniform basis of valuation for marketable securities. Cost is used most frequently, but market value is often indicated in any event.¹

Short-term investments in bonds usually have accrued interest thereon at balance-sheet dates. Though this accrued interest should not be set up in the investment account, it is often included in the marketable securities item on the balance sheet.² Another and possibly preferable method is to include the accrued interest in a separate item, such as "interest and dividends receivable."³

Permanent investments. Except for investments in associated or affiliated companies, cost is the basis of valuation for long-term investments most often seen in published balance sheets.⁴ Investments in associated and affiliated companies are shown on balance sheets in various ways. Equity represented on the associated company's books and cost are the most common bases for balance-sheet valuation.⁵

¹ In the published statements examined the valuation of temporary investments was as follows: No basis indicated, 54; cost, 50; market, 28; "cost or market," 10; miscellaneous, 13; a total of 155. Among the miscellaneous bases were: *book value*; *lower than cost*; subject to a "reserve"; *lower of par or market*; listed securities "at market," unlisted at "cost"; *par*; *below market*; bonds "at par," stocks "at market." Out of a total of 155 cases, market value was used or indicated in 52.

² See balance sheets of International Cement Corporation (December 31, 1930) and General Foods Corporation (December 31, 1929), containing the item "marketable securities and accrued interest."

³ See balance sheets of Commonwealth Edison Company (December 31, 1932) and Consolidated Gas Electric Light and Power Company of Baltimore (December 31, 1929). The form of balance sheet prescribed by the Interstate Commerce Commission for steam railroads provides for the same treatment.

⁴ The basis of valuation is frequently not mentioned. In 28 instances, cost was indicated in 20; "book value" in 4; market in 2; and "less reserve" in 2. "Book value" may have meant simply the amount carried on the investor's books, or it may have referred to book value on the issuing company's books. "Book value" is a poor term for use in reference to valuation of assets. It is either confusing, as in this situation, or it means nothing except that the auditors probably intended a qualification of some sort.

⁵ Among 58 cases, the bases used were: cost, 23; equity, or cost plus share of earnings, 21; "book value," 4; various bases less a "reserve," 6; par, 1; market, 1; appraised, 1; "as valued by Board of Directors," 1.

Most companies differentiate investments in affiliated and in non-affiliated companies.¹ It is customary to show "investments in and advances to affiliated companies" as one item,² but advances are often listed separately.³ Frequently the name of the company invested in is given, as is also the percentage of ownership.⁴

With respect to whether "investments" are to show the book value of the equity represented and if so, when, the following quotations from various annual reports are interesting. The balance sheet of Paramount Publix Corporation (December 26, 1931) carries the following footnote to the asset item "investments in subsidiary and affiliated companies not consolidated (including \$17,915,992.64 investments in companies in which the voting stock is owned less than 65%)":

Investments include \$85,655.25, the Corporation's share of undistributed earnings of non-consolidated subsidiaries owned between 65% and 85%. . . .

Fox Film Corporation (Report for the year ending December 27, 1930):

In the audit as of September 27, 1930, used in the offering circular of April 10, 1931, the assets and liabilities of all companies that were at least 85 per cent owned were included in the consolidated balance sheet of your company. In the case of companies in which your company's interests were more than 50 per cent, the proportional parts of net profits were included in the consolidated statement of profit and loss, but the assets and liabilities of these companies were not included in the consolidated balance sheet. In the case of companies 50 per cent

¹ The balance sheets of Eastman Kodak Company (December 31, 1931) and Standard Oil Company of California (December 31, 1931) provide good examples of this practice. What constitutes "affiliation" is not stated.

² For instance in the balance sheets of American Car and Foundry Company (December 31, 1931) and Bethlehem Steel Corporation (December 31, 1930).

³ See balance sheets of International Silver Company (December 31, 1931) and General Foods Corporation (December 31, 1930).

⁴ The following item, for example, is given under the caption "other investments" in the balance sheet of Fairbanks, Morse & Company (December 31, 1931): Fairbanks-Morse Water Supply Company (85 per cent owned) less reserve.

or less owned, only net profits were included that had actually been received by your company as dividends.

Instead of using this method it has been the custom of your company not to include in its consolidated balance sheet the assets and liabilities of companies unless they were 100 per cent owned, but to carry its interest in them simply as investments. . . . With respect to income it has been the custom of your company to include in the profit and loss statement all American companies that were effectively controlled, irrespective of the percentage of ownership, deducting of course, the proportionate part of the net profit accruing to stocks not owned.¹

General Motors Corporation (Report for 1931):

It has been the practice of the Corporation to carry at cost its investments in subsidiary and affiliated companies not consolidated. This practice was changed at the close of 1931, and hereafter the amount at which the Corporation's investment in these subsidiaries is carried will be adjusted currently to reflect the Corporation's proportion of the undivided profits or losses accruing during the period.

Probably the best-known investment in an associated company which is not consolidated is that of E. I. du Pont de Nemours & Company in General Motors Corporation. This investment and all transactions relating to it are treated separately in the du Pont company's financial statements. The investment account is valued on the basis of the equity represented, adjustments are handled through surplus, and income actually received is separately listed in the income sheet. The following explanation is given of the adjustment for 1931:²

A debit of \$8,484,037 reduces the value at which your company carries its holdings of 9,981,220 shares of General Motors Corporation common stock to \$178,663,838, or from \$18.75 a share to \$17.90 a share. This is consistent with your company's policy of adjusting each year the value of this investment to a figure closely corresponding to its net asset value as shown by balance sheet of General Motors Corporation at December 31 of the preceding year.

Although the interest in General Motors Corporation is only about 23 per cent (December 31, 1932), the investment as

¹ This method is such that the balance sheet is partially "consolidated," while the income sheet is completely so. See also annual report of National Cash Register Company (1931) in which foreign subsidiaries are similarly handled.

² Annual report for 1931, p. 17.

valued is over one-fourth of the du Pont company's total assets. On the score alone of the importance of the outside investment the shareholders are doubtless often entitled to more information than cost.

In some cases it is a matter of conjecture whether investments in other companies are displayed at the book value, or equity, represented or at cost plus a pro rata share of earnings since acquisition.¹ This particular point is definitely stated in the balance sheet of L. Bamberger & Co. (January 30 1932):

Other investments—at cost, and for controlled companies, including proportion of profits or losses since acquisition.

An alternative method for indicating similar information in the financial statements consists in giving the data in footnotes. As used by E. I. du Pont de Nemours & Company, this treatment is described as follows:²

Investments in companies not wholly owned, other than permanent holdings in General Motors Corporation, are included under the item "Investment in affiliated companies not wholly owned and miscellaneous investments." A footnote on the balance sheet shows the net amount by which your company's equity in surplus of controlled companies not consolidated has increased since acquisition; this amount, which is in addition to the value at which these securities are carried, is not included in surplus stated in the balance sheet.

The income sheet concludes with the item "consolidated earnings applicable to common stock." Immediately thereafter is the following item: "Including E. I. du Pont de Nemours & Company's equity in undivided profits or losses of controlled companies not consolidated, amount earned on common stock is. . . ." ³

¹ The difference in the two methods is simply that, under the latter method, an element which corresponds to "consolidated goodwill" or "negative goodwill" in consolidated statements (see Chapter 15) is retained in the investment account. Under the former method it is merged with surplus.

² Annual report for 1932, p. 8.

³ Among other companies following a similar plan are: Continental Oil Company (1931), The Davison Chemical Company (year ending June 30, 1931), Standard Oil Company of California (1931), Virginia-Carolina Chemical Corporation (year ending June 30, 1931).

In conclusion it may be said that the presence of large holdings of stock in other companies, classified in the balance sheet as investments, calls for some indication as to the "financial condition" of such investments. What determines "largeness" in this sense varies. It may be a definite percentage of stock ownership (Paramount Publix Corporation), effective control (Fox Film Corporation), or relative importance of the investment (E. I. du Pont de Nemours & Company, stock of General Motors Corporation). Market value or appraised value given as a note may satisfy the need. There is an apparent tendency in published financial statements, however, to list such investments at the approximate book value of the stock on the issuing company's books.¹ If this means that the earnings of the company invested in are "taken up" in the accounts of the investing corporation, legal actualities are obscured. In other words, the effect on the balance sheet as regards proprietorship, and on the income sheet if the earnings "taken up" are credited to income,² is exactly the same as if the accounts of the companies invested in were "consolidated."³ These effects are not objectionable in themselves, but it would be a great improvement to segregate the accumulated amount of unrealized gain "taken up" by the investing company from truly realized earned surplus and to display it in the balance sheet as a separate item of proprietorship. An alternative and generally preferable method, however, is simply to make note in the balance sheet of the equity in undistributed earnings, and to make note in the income sheet of the equity in current earnings, of companies not consolidated.

¹ Compare the method of General Electric Company. As stated in its report for 1931, the investments in controlled companies not consolidated are "appraised on a basis similar to that used in the valuation of your Company's assets. Investments in other companies are appraised after consideration of cost, net worth, return on investment, market price, if any, and foreign exchange." The investment is never appraised at a figure higher than "the market price on a recognized exchange."

² Under the method followed by E. I. du Pont de Nemours & Company in respect to its investment in General Motors Corporation, the share of earnings is credited to surplus rather than to income.

³ The effect on total assets and total equities is somewhat different and that on the classifications of assets and liabilities is very different, however, as is also the effect on gross revenues and operating expenses.

Investments in foreign corporations. Some corporations make it a point to "consolidate" only domestic subsidiaries and to show the interests in foreign subsidiaries as "investments" in the balance sheet.¹ There are, of course, other investments in foreign countries, which would not be consolidated even if they were domestic commitments. Cost should doubtless be retained for the latter class, though if there has been any considerable change therefrom, the present value also should be indicated. The case of foreign subsidiaries is more important and is worthy of further consideration. The same principles are involved whether the foreign subsidiary's accounts are to be consolidated or not, though only in the latter case is it possible to avoid dealing with the problem of valuation. Consequently, the principles will be discussed in the following paragraphs in the light of a "consolidation."

Transfer of actual funds to and from foreign subsidiaries presents no particular difficulties. The procedure usually results in a realized gain or loss on exchange. In consolidating the accounts of a foreign subsidiary, however, the money values must be translated into terms of dollars. Four bases are possible: par of exchange, rate of exchange at time of transaction, current rate of exchange, and average rate during the period involved. The conversion is made at the closing date from the balance sheet and income sheet of the subsidiary as prepared in terms of the foreign monetary unit. The recognized rules of balance-sheet valuation—cost for fixed items and present value for current items—yield the following:

1. Current assets and current liabilities at rate of exchange on date of balance sheet.
2. Fixed liabilities at rate of exchange when incurred.
3. Fixed assets at rate of exchange when acquired.
4. Income sheet at current or average rate of exchange.

Conversion of the income sheet as listed above is primarily a matter of convenience. It would be impossible to state revenue and expense items in terms of the different exchange rates existing at the time of the numerous transactions involved. Since the

¹ Among companies following this practice are Coty, Inc. (1931), National Cash Register Company (1931), and International Business Machines Corporation (1930).

net result of operations is reflected in current assets and current liabilities, and since these are converted at the current rate of exchange, this same rate is to be preferred to an average in converting the income-sheet items. The principal application of an average rate would be for fixed assets constructed over a period of time. The use of par of exchange can have support only on grounds of expediency in providing a uniform basis. Its applicability would be restricted to fixed assets and then could be sanctioned only if the actual rate had been relatively close to par for some time.

The net result of converting the foreign subsidiary's balance sheet into dollars is almost bound to throw it out of balance. The difference may be carried as a "reserve for foreign exchange fluctuations," to which the adjustments from year to year are credited and debited. Such an account is in the nature of unrealized gain or loss, and normally the periodic adjustments to it would tend to counterbalance.¹ An alternative method, of course, would be to absorb the balancing item in income or surplus each period.

Recent years have been generally ones of depreciating foreign currencies, and corporations have given more attention in their reports to the valuation of assets in foreign countries. A lengthy comment on the matter appeared in a recent report of Parke, Davis & Company, from which the following is quoted:²

The financial statement shows that our earnings, except for the foreign exchange situation, would have been \$7,415,676.25. Due to conditions quite beyond our control funds brought from abroad during the year netted an amount equalling \$302,491.15 less than normal, which has been deducted from our profits earned.

There has been set aside Item "A" as a reserve for adjustment of 1931 profits represented by current assets still held abroad, amounting to \$153,634.89.

¹ If it happened to contain a debit balance, there would be nothing illogical in showing such an account as a contra to proprietorship on the balance sheet. But this would probably be looked upon as "unconservative," and so it happens that in recent years the income sheets or surplus statements of corporations with foreign branches and subsidiaries contain deductions adjusting foreign net current assets to current rates of exchange. And reserves for foreign-exchange fluctuations are generally missing from balance sheets.

² Annual report for 1931, pp. 5, 8, and 9.

We now come to Item "B" in our statement, representing a reduction in values of current assets held in foreign countries (prior to 1931) where we maintain our own laboratories and where we do business on a local-currency basis. This includes cash, accounts receivable, and inventories, less accounts payable. . . .

To definitely assume that the foreign plant assets have depreciated in the same degree as currency would be fallacious, for the reason that we bring back to this country only the actual profits made. . . .

These assets (cash, accounts receivable, and merchandise) represent the tools with which our profits in foreign lands are earned—they are needed just where they are and they probably (in augmented form) will be in operation long after the present world disturbances have been forgotten.¹

For this reason we feel that Item "B" in our statement, covering a reserve of \$666,984.72, must by no means be regarded as a final loss but rather as a safety provision which we deem it advisable to make because of existing world conditions.

The report quoted above makes no reference to fixed assets (and there were no fixed liabilities), but fixed assets must have been converted at the rate of exchange at date of acquisition. The two "reserves" mentioned are shown in the balance sheet under current liabilities, as "reserve for exchange on current assets," and they are deducted in the income sheet as appropriations of net income.

Not many reports make specific reference to valuation of fixed assets of foreign subsidiaries. Some companies use par and some use rate of exchange at acquisition.² One company converted foreign subsidiaries' bonds at the current rate of exchange. The following quotation from this company's balance sheet is a footnote to the "reserve for foreign exchange fluctuations":³

¹ The similarity of this statement to the argument supporting the "base stock" method of inventory valuation is apparent, though in general it has more validity.

² Among 7 reports mentioning the matter, par was used in 3 instances and rate of exchange at acquisition in 4.

³ Balance sheet of Paramount Publix Corporation, December 26, 1931. The balance sheet is presented in a combining form, giving separate columns for "total," "U.S.A. companies," and "foreign companies."

The capital assets of all foreign subsidiaries have been converted at the rates of exchange prevailing at dates of acquisition; all other assets and liabilities have been converted at current rates of exchange. The reduction in funded debt, arising from the conversion on this basis of the long term liabilities of British and Canadian subsidiaries, has been carried to reserve.

There is more mention of valuation of foreign current assets. This is not surprising in view of the fact that market rate of exchange is the accepted basis for conversion, and that for a number of years this basis has resulted in effect in the recognition of losses. Current assets, and presumably current liabilities, of foreign subsidiaries are valued on the basis of the rate of exchange at balance-sheet date in almost every instance.¹ In the treatment of the resulting debit adjustment there was more variation. It is commonly treated as a non-operating charge, a direct surplus adjustment, or a charge to "contingent" reserves.²

With particular reference to investments in foreign companies not consolidated, it can be said that if the proportionate share of income and loss is "taken up" in the investment account, the same principles apply as for consolidated foreign subsidiaries. As usually handled, this calls for an adjustment to bring current assets and current liabilities represented in line with present exchange rates. Thus, National Cash Register Company refers to the balance-sheet item "investments in foreign subsidiaries and branches" as follows: "Property accounts of foreign subsidiary companies and branches were valued at United States dollar costs less depreciation and all other items at rates of exchange as at December 31, 1932."³ In this instance the balance-sheet item is supported by a separate "combined statement of assets and liabilities of foreign subsidiary

¹ This was the basis used, among the reports examined, in 25 of 26 cases. The single exception used par of exchange.

² In 25 cases the item was handled as follows: non-operating item, 9; surplus charge, 5; absorbed in contingent reserves, 5; not indicated, 5; as a deferred charge ("exchange fluctuations on current assets of foreign subsidiaries") with an offsetting surplus reserve ("appropriated for exchange fluctuations on current assets of foreign subsidiaries") in the remaining instance (The Texas Corporation, December 31, 1931).

³ Annual report for 1932, p. 2.

companies and branches.”¹ On the other hand, if cost is retained in the investment account, no adjustment need be made for decline in foreign exchange unless conversion of current assets and liabilities at the existing rate would wipe out the equity in surplus since acquisition (that is, unless the original investment were impaired). However, the matter may be mentioned. For example, the asset item “investments—foreign (at cost)” on the balance sheet of Coty, Inc. (December 31, 1931), refers to the following footnote:

Based on their examination of the books and accounts of the various foreign companies, Price, Waterhouse & Co., Paris, have certified that the increase in the equity from the date of acquisition of control of the stock of foreign subsidiary and associated companies at December 31, 1931, after providing for approximate taxes on proportionate share of undistributed profits since acquisition and after allowing for the shrinkage of approximately \$107,000 in value of investment in Coty (England) Ltd., at December 31, 1930, due to the fall in Sterling exchange during 1931, amounts to \$519,699.90, as compared with similar increase from date of acquisition to December 31, 1930, of \$1,085,456.04.

In the same report, further attention was drawn to the shrinkage in value in a note in the income sheet included parenthetically after the addition of “dividends from foreign subsidiary and associated companies”:

The proportion of profits and losses of foreign subsidiary and associated companies for the year ended December 31, 1931, applicable to holdings of Coty, Inc., in these companies as certified to by Price, Waterhouse & Co., Paris, amounted to a net loss of \$424,424.04, including approximate taxes on proportionate profits.

¹ A similar method is followed by International Silver Company for its investment in International Silver Company of Canada, Ltd. The investment item is described as follows (balance sheet, December 31, 1931): (At book value of net tangible assets after adjusting net current assets to U.S. currency).

CHAPTER 8

VALUATION OF INVENTORIES

Inventories in published financial statements. In the fields covered by the statements examined, inventories comprise merchandise and supplies in the trading concerns; raw materials, supplies, work in process, and finished product in the fabricating companies; supplies, crude product, product in process, and finished product in the various extractive industries; or simply supplies, and sometimes merchandise, as in the utilities. A common designation among the utilities is "materials and supplies." To the extent that construction materials are involved, the amount should be included under plant rather than inventories. The balance sheet of The Detroit Edison Company (December 31, 1931), for instance, lists the following item under current assets: "Construction materials, coal, and other supplies on hand and in transit." It is not uncommon to find the various inventories classified, as for example in the balance sheet of Union Carbide and Carbon Corporation (December 31, 1929):

Inventories:

- Raw materials at cost or market (whichever is lower)
- Work in process at present manufacturing cost
- Finished goods at present manufacturing cost

It is more usual, however, to find all inventories listed in one item and designated in somewhat the following manner: "Inventories of materials, work in process, and finished goods" (balance sheet of Julius Kayser & Co., June 30, 1931). Since supplies do not enter the product in a physical sense as do raw materials, there is more of a tendency to classify them separately. In some cases they are listed as one item with prepaid expenses.¹

Among published balance sheets the basis of "cost or market whichever is lower" for inventory valuation is by far the

¹ As in the balance sheets of Inspiration Consolidated Copper Company (December 31, 1930), Anaconda Copper Mining Company (December 31, 1928), and Williams Oil-O-Matic Heating Corporation (October 31, 1929).

most popular.¹ In some cases more than one basis is used. For example:

1. Cost of finished products ready for sale, and generally the lower of cost or market on other materials and supplies (Canada Dry Ginger Ale, Incorporated, September 30, 1931).
2. Mercantile inventory, at cost; Ore and concentrate inventory, at cost; Metal inventory, at or below market (Cerro de Pasco Copper Corporation, December 31, 1931).
3. Raw materials at cost or market, whichever was lower, and finished goods at cost (Firestone Tire & Rubber Company, October 31, 1931).
4. Finished goods and goods in process inventoried at cost, and yarns, piece goods, trimmings, and other raw materials and supplies at the lower of cost or market (Munsingwear, Inc., December 31, 1931).

Among miscellaneous bases found are the following: "cost, less reserve," "less than cost," "approximate market," "below market," "basic price," "book value," and selling prices. Examples of the use of selling prices follow:

1. Packing house products at market values less allowance for selling expenses (Armour and Company, October 31, 1931).
2. Sugars on hand, subsequently sold at selling prices and unsold, at market value (Cuban Cane Products Co., Inc., September 30, 1931).
3. Refined copper which has been sold is at selling price (Kennecott Copper Corporation, December 31, 1931).
4. All copper, gold and silver included in the inventories are under contract of sale. The inventory valuation is based upon the amount which will be realized upon the consummation of the sale contracts (Magma Copper Company, December 31, 1931).
5. Wheat and other grains are valued at market and finished products at developed cost (based upon market prices of grains), with adjustment to basis of market in respect of

¹ Among 290 balance sheets the bases of inventory valuation were as follows: "cost or market," 157; cost, 37; miscellaneous, 38; not indicated, 58.

open grain and unfilled flour sales contracts (auditors' certificate, Pillsbury Flour Mills, Incorporated, June 30, 1930).

Some of the large smelting companies have used a base-stock or modified base-stock method of inventory valuation.¹

Cost or market, whichever is lower. In the last few years the employment of "cost or market, whichever is lower" has in practically all cases resulted in a series of downward revisions of the closing inventory. The adjustment is made in several ways. The inventory accounts may actually be written down, or a contra account, a "reserve," may be established for the same amount. If the latter method is followed, the "reserve" should be deducted from the asset account on the balance sheet, inasmuch as acceptance of a fall in value as "realized" is a corollary of the use of the "cost or market" basis. This "reserve" is not to be confused with a contingent surplus reserve for possible further decline in inventory value. For example, the following quotation is taken from the 1931 annual report of J. I. Case Company:

Inventories were reduced \$4,223,593.37 during the year, of which \$531,501.28 represents reduction to market values. The latter amount might properly have been charged against the Reserve for Inventories, but on account of the uncertain business conditions, it was deemed advisable to maintain the reserves heretofore set up against current assets.

The effect an inventory write-down to replacement value has on income is also handled in various ways. The most common and natural method is to value the closing inventory in the income sheet at the written-down figure. This method results in the "loss" being absorbed in production or merchandise cost.² A related method is to show the amount of the inventory adjustment as a separate operating expense.³ The

¹ See, for example, the 1931 report of Anaconda Copper Mining Company and the 1930 report of American Smelting and Refining Company.

² It is interesting to note that merchandise turnover ratios will not be correctly stated when this figure and the written-down figure for inventory are used in the calculations.

³ Several oil companies follow this method; for instance, Atlantic Refining Company (1931), Gulf Oil Corporation of Pennsylvania (1931), and Houston Oil Company of Texas (1931).

production department is thus relieved of shouldering the loss in value. A third treatment is to consider the amount as a non-operating item,¹ or even as a surplus charge.²

The main justification for the "cost or market" basis seems to be its claim to conservatism. This is urged on the score of both the balance sheet and the income sheet. (Yet it should be noted that the amount actually realized in current cash funds is the same irrespective of the method of inventory valuation.) As regards the income sheet, the conservative effect of the "cost or market" basis is that, if the inventory at cost is higher than replacement value, the earnings of the current fiscal period will be charged for a loss which will be realized only in the next.³ What is conservative in this respect as regards one fiscal period is equally unconservative as regards the following period.

Aside from objections to the theory of the "cost or market" basis, there is the further point that it is notoriously inconsistent. It results in an inventory "which is almost invariably a mixture of cost and market prices."⁴ Moreover, its use may mean "in effect that the management is swinging from cost to replacement cost and back again from period to period."⁵ Doubtless the strongest objections to the rule are of a practical nature. It is not only difficult of application, but it necessitates considerable duplication of work. Hence it is somewhat surprising that the "cost or market" basis has gained such popularity in practice. One suspects that it is seldom applied in any thoroughgoing manner. It is an extensive task to obtain replacement costs of all items of merchandise in the mercantile fields or of raw materials in fabricating industries, but for product in process

¹ For instance, in the income sheets of American Hide and Leather Company (year ending June 28, 1930), American Radiator & Standard Sanitary Corporation (1931), The B. F. Goodrich Company (1931), National Steel Corporation (1930), Standard Brands Incorporated (1931). This method has been officially approved by the Committee on Terminology of the American Institute of Accountants. *Accounting Terminology* (New York, 1931), p. 96.

² As in the reports of Sloss-Sheffield Steel and Iron Company (1930) and The Yale & Towne Manufacturing Company (1931).

³ If the loss in value is charged to surplus it will never be reflected in "net income," however.

⁴ R. B. Kester, *Accounting Theory and Practice*, Vol. II, Second Edition Revised (New York, 1925), p. 149.

⁵ *Accountants' Handbook*, Second Edition, p. 421.

and finished goods ascertaining replacement value is highly impracticable and is almost sure to give erroneous and dangerous results. Not only have the prices of materials changed, but also no doubt those of labor and many of the items of overhead.¹

In conclusion it may be noted that it is not necessary to employ the "cost or market" basis to assure that damaged, obsolete, and slow-moving items are conservatively valued. Such stock should always be segregated from the regular inventories and be extended at not more than realizable cash value.

¹ Note the following quotation from the report of National Cash Register Company for the year 1932: In valuing inventories at the end of 1932, adjustments were made for the decline in market prices of purchased materials and for reduction in labor rates as well as for a manufacturing overhead substantially below the actual overhead for the year.

CHAPTER 9

VALUATION OF LIABILITIES

“Valuation” as applied to liabilities. It is ordinarily considered that there is no problem of valuation in regard to liabilities, that liabilities should be shown in the balance sheet at the full amount of the obligation when due.¹ There is one valuation problem regarding liabilities, however, which is of notable importance in the balance sheets of corporations.

Obviously, the present value of a contract to pay a fixed sum of money in the future corresponds to that sum of money only when the obligation bears interest and when the interest rate accurately reflects the market in respect to that particular type of security. It follows that when bonds are issued at a premium or a discount, and when non-interest-bearing notes are discounted upon issue, the premium or discount reflects the difference between present and future value. Moreover, consistency would seem to demand that, if it is correct to set up a bond purchased at cost, it should be equally correct to set up a bond issued at value received, since both represent present value as contrasted with future value. Accordingly, premium on bonds sold represents an addition to the nominal amount of value received—par value, and discount on bonds sold represents a reduction of the same figure.

Balance-sheet considerations. Correct initial accounting for a bond issue usually involves three matters worthy of expression in the books—par value, discount or premium, and expense. The par value and the discount or premium are essentially one item, which as a matter of custom is expressed in two accounts in order to show the face value of the obligation. In practice, however, bond discount is probably never shown as an offset to

¹ It is necessary, of course, to estimate the amount of the eventual obligation in some cases. The provision for income taxes is an estimate, especially for balance sheets prepared within the taxable year to which the provision will apply. Other typical examples are: outstanding tickets and coupons, estimated cost of restoring leased premises, pension and compensation “reserves.”

bonds payable on the balance sheet,¹ and bond premium is apt to appear as a special liability, perhaps under the caption "deferred credits."² The bond expense, if reasonable in view of the service received, represents a legitimate asset, a true deferred charge. Practice could be improved by a considered endeavor to separate bond discount and bond expense in the accounts and on the balance sheet.³ To the extent that the customary "bond discount and expense" item represents true discount, assets are overstated and liabilities are correspondingly overstated.

Income-sheet considerations. The treatment of bond discount, or premium, and bond expense in the income sheet deserves emphasis. It has been pointed out that premium and discount represent adjustments of the nominal interest rate. Therefore, discount accumulation is an increase of the current period's contractual interest, while amortization of premium is a decrease.⁴ Amortization of bond expense should be treated as a non-operating charge. In practice, discount and expense are sometimes charged off arbitrarily to income or surplus.⁵ This is manifestly improper. From the proprietary point of view, writing off discount and expense initially is analogous in its effects to writing down plant, since it charges future deductions against past earnings.

¹ In every one of 96 appearances, bond discount was listed as an asset, usually under the title, "bond discount and expense." In 39 of these instances, it was not designated separately, but was merged with prepaid expenses, deferred charges, or intangibles.

² As in the form of balance sheet for steam railroads prescribed by the Interstate Commerce Commission.

³ When bonds sell at a premium the undesirability of considering the interest adjustment (the premium) together with bond expense becomes most apparent. It amounts to cancellation of an asset against a liability.

⁴ Among 40 cases in which amortization of discount was mentioned in the income sheet, in 30 cases it was included as an adjustment of interest charges and in 10 it was shown as a separate deduction. The effect on net (proprietary) income is, of course, the same in both cases.

⁵ Among the companies having bond issues outstanding, there was no sign of amortization of "bond discount and expense" in the income sheet, nor of any unamortized remainder in the balance sheet, in 40 cases. This indicates that in at least a portion of these instances, discount and expense had previously been entirely written off. See surplus analysis of National Tea Co. (1931) for a blanket write-off of "unamortized discount and expense." For a similar write-off to surplus from revaluation, see footnote to income sheet of Northern States Power Company (1929).

CHAPTER 10

VALUATION OF PROPRIETORSHIP

“Valuation” as applied to proprietorship. Proprietorship as given in most balance sheets is literally as well as legally the residual equity. It represents a plug inserted in the records so that the accounting equation can be equated. There are various reasons why proprietorship as displayed in balance sheets is apt to be in effect a balancing item rather than reflecting the financial history of the actual stockholders’ investment. The first is directly related to write-ups and write-downs of fixed assets. Second, it is possible to remove a deficit from the books by absorbing it in surplus from a legal reduction of capital. Third, the original capital stock item may not reflect actual investment. Fourth, the use of no-par-value stocks, at least in most states, enables a corporation to pay dividends out of capital, that is, from paid-in surplus. Fifth, underwriting and other expenses incurred in the flotation of stock issues are almost always initially or subsequently absorbed in paid-in surplus or earned surplus. It is not intended to discuss here the numerous problems which arise in accounting for capital stock and surplus, but only to indicate these in passing as they relate particularly to the display of proprietorship on the balance sheet in reference to each of the above points.

Writing up and writing down assets. It is almost universally held by accountants that appreciation surplus is not “surplus” but capital, and that consequently it is not immediately available for cash dividends. This view is expressed in most corporation laws and is upheld by the courts. The logical objection to charging cash dividends against appreciation surplus is that no additional cash funds are made immediately available simply from increases in the value of assets. Book entries provide no funds. As the appreciation becomes “realized”; that is, as soon as it is replaced by income determined on

a cost basis, it is legal to declare dividends thereon.¹ On the other hand, it is usually considered proper to declare stock dividends from appreciation surplus. When this procedure is followed, the equity of stockholders in terms of dollars invested is no longer revealed in the accounts.

The matter of devaluation or of write-downs is particularly pertinent at the present time. In practice, write-downs of fixed assets are being charged to existing earned surplus and capital surplus, when these are sufficient in amount. If they are not, legal stated capital is reduced, thereby creating a "surplus."

When write-downs of used and useful assets subject to amortization, depletion, or depreciation are charged to earned surplus, the effect is that of charging future costs against past earnings. During a considerable future time periodic net income reported will in fact contain proportionate amounts of a sum which has already been reported as income. The final net effect on proprietorship will be nil.²

The case is different, however, with respect to write-downs charged against capital surplus or surplus from decapitalization.³ Here, the ultimate effect of either procedure is to break down the fundamental distinction between income and capital. Unrecovered costs, properly applicable to the future, are charged against capital, with the effect that during a considerable future time periodic net income reported will in fact contain amounts which at the time of the write-down were classed as capital. Dividends declared from earnings during this time may thus be to some extent liquidating dividends.

¹ The Uniform Business Corporation Act, which has been adopted in several states, provides in Section 24, 4, p. 9, that no cash or property dividends can be paid from "unrealized appreciation."

² For an example of charging plant write-downs to earned surplus see the annual report for 1931 of American Smelting and Refining Company.

³ For examples of write-downs against capital surplus see the annual reports of American Locomotive Company (1931), Celanese Corporation of America (patents and developmental expenses only, 1931), and Continental Baking Corporation (1931). (In this last case the par value of preferred stock received in settlement of litigation and retired was credited to "Patents, Formulae, Goodwill, etc.") For examples of write-downs charged or to be charged to surplus from reduction of capital stock see reports of Certain-teed Products Company (1930, shut-down plant), and The Studebaker Corporation (1931).

Operating deficits. That dividends may be declared from profits without first making up an existing deficit from operations has been termed a "well established common law doctrine."¹ In this country, however, the courts have generally taken an opposite view, which is also the position of the Bureau of Internal Revenue and of most accountants. For instance, the Board of Tax Appeals has held that "there can be no accumulated earnings or profits until an operating deficit is made good."² Consequently, corporations have sometimes found it desirable to go through a reorganization in order to remove an accumulated deficit. Another method which is becoming increasingly popular is that afforded by the legal reduction of capital.³ These methods need be resorted to only if there is no paid-in surplus in the first place, since it is possible to absorb an operating deficit in capital surplus.⁴ From an accounting standpoint the result of any one of these methods is to convert an operating deficit into a capital deficit.

Stock discount. Stock discount arises only in connection with par-value capital stocks. If par-value stock is originally issued at a discount the fact is likely to be concealed by overvaluation of asset accounts. This was one of the evils leading to the development of no-par-value stock. It was believed that under the use of no-par stocks the actual value contributed by stockholders would represent "capital." Development in treating no-par stocks in the accounts led in other directions, however, and the belief is held by some people that one evil was exchanged for many.

Proprietorship is correctly stated only to the extent that initial contributions of stockholders, as measured in cash or equivalent values, are set up in the capital accounts. Thus, discount on capital stock should be originally stated on the books

¹ *Cook on Corporations*, Eighth Edition (New York, 1923), II, 1905, footnote 3.

² *Louise Glassell Shorb*, 22 B.T.A. 644.

³ See, for example, annual reports of The Foundation Company (1930), Certain-teed Products Company (1930), Vadsco Sales Corporation (1931).

⁴ See, for example, surplus analysis for 1932 of Motor Wheel Corporation.

and should be displayed in the balance sheet as a deduction from the nominal or par value of capital stock.¹

Dividends from paid-in surplus. Justification for paying dividends from contributed surplus is to be found if at all in financial policy. First, in order to maintain the corporation's credit, it is often considered necessary to pay dividends from the start on preferred issues. Second, when economic causes have resulted in wiping out earned surplus, it is said to be proper to dip into paid-in surplus for dividend appropriations. Regardless of the legitimacy of such reasons, and both of them are doubtful, the effect from an accounting standpoint is that of a liquidating dividend.² Consequently, dividends from paid-in surplus should be accumulated in a separate contra account to be displayed on the balance sheet as a deduction from capital.

Organization costs. Theoretically, bona fide costs of organizing an enterprise, such as stock-issue expense and promoters' fees, represent assets of a high degree of permanency. They attach to the business as a whole as an intangible value, which

¹ Among the statements examined only one, that of The Granby Consolidated Mining, Smelting and Power Company, Limited, sets forth clearly the item of stock discount as a deduction from capital. Several of the utilities, however, indicate existence of stock discount, but it is listed among assets and is usually merged with organization costs and stock premium. For example: "Discount, premium, and expense on original sales and on resales of preferred and common stocks" (Electric Bond and Share Company, December 31, 1930; Northern States Power Company, December 31, 1929); "Stock discount and premium (net)" (Southern California Edison Company, Ltd., December 31, 1930); "Discount on preferred stocks" (The Toledo Edison Company, December 31, 1930); "Discount and expense on capital stocks" with a deduction of "premium on common capital stock" (Pacific Gas and Electric Light Company, December 31, 1930).

An interesting illustration is found in the annual report of Real Silk Hosiery Mills, Incorporated, for 1930. The surplus analysis shows the deduction of "amortization of preferred stock discount." The unamortized portion, however, if any, is not revealed unless it is contained in the balance-sheet item "goodwill, bond discount, and organization expense."

² One must generally turn to the mining companies to find traces in published financial statements of capital distributions. Some indicate that liquidating dividends have been paid, as for example, in the following designation: "Capital Surplus—stockholders' equity in owned properties—after effecting capital distributions" (balance sheet, December 31, 1931, of Cerro de Pasco Copper Corporation). A case of showing the amount of such distributions in the statement itself is found in the balance sheet of The Granby Consolidated Mining, Smelting and Power Company, Limited, reproduced at the end of this chapter.

disappears only with liquidation.¹ This view is taken by the Bureau of Internal Revenue. It has even been held recently by the courts that organization costs of a corporation operating under a limited-life charter cannot be deducted pro rata during its term of existence.² It has also been held that stock-issue expense cannot be deducted according as the stock to which it applies is retired.³ This last decision is particularly unfortunate from an accounting standpoint.

In practice, organization costs are usually written off as soon as possible. When they are to be handled as a deferred charge, the amount is set up as unamortized organization expense, underwriting expense, or stock-issue expense.⁴ Methods of amortization vary. Income may be charged,⁵ or earned surplus.⁶ But, most often, organization "expense" never appears in the balance sheet. The use of no-par-value stocks and low stated values has made it possible to deduct all organization costs of whatever nature from the amount originally reflected in capital stock and paid-in surplus.⁷ If this is done, not only may the amount of organization costs be lost as a matter of permanent record in the financial statements, but the amount of such costs may never be revealed to shareholders.⁸ An example of engaging frankness in this respect is the following, taken from the report of Furniss Withy and Co., Ltd.:⁹

¹ See W. A. Paton, "Economic Theory in Relation to Accounting Valuations," *The Accounting Review*, June, 1931, p. 90.

² *Surety Finance Co. of Tacoma v. Commissioner*, 27 B.T.A. . . . 1933.

³ *Simmons Co. v. Commissioner*, 8 B.T.A. 631, 33 Fed. (2d) 75, certiorari denied, 280 U.S. 588.

⁴ See the balance sheets of National Fireproofing Corporation (December 31, 1930), Munsingwear, Inc. (December 31, 1931), The Foundation Company (December 31, 1928), Midland Steel Products Company ("recapitalization expense," December 31, 1930), Brown Fence & Wire Company (with prepaid insurance, June 30, 1931), United Biscuit Company of America (with bond discount, December 31, 1930).

⁵ See 1930 income sheets of United Biscuit Company of America and Midland Steel Products Company.

⁶ See annual report of The Foundation Company for 1928.

⁷ Along the same line is the practice of charging to paid-in surplus the expense of carrying on a separate stock-sales organization. See the auditors' certificate in the annual report of Cities Service Company (1932).

⁸ The recent Federal Securities Act provides for publication of the amount of underwriters' fees and commissions on issues of securities.

⁹ In the *Board of Trade Journal*, London, July 21, 1932, p. i.

Finally, there is the new issue expenses account, which the directors have considered it prudent to deal with entirely in these accounts. The total expenses amounted to £125,822 15s., of which £100,000 represented commission of 1s. per share paid to Messrs. N. M. Rothschild and Son inclusive of underwriting, sub-underwriting and other expenses, and of the balance of £25,822, stamp duty absorbed £20,000. In order to eliminate this item entirely from the balance sheet the share premium account has been absorbed, and the balance of £25,822 15s. has been written out of profits.¹ I have no doubt shareholders will approve of this matter having been handled in this way in accordance with our usual practice of keeping our balance sheet as clean as possible.

Conclusion. The advantages of the actual-investment basis of accounting for proprietorship would be many.² For one thing, the earnings figures reported by corporations would mean something instead of being a mixture of fact and fancy. The stockholder could look at the income sheet and say with some truth that his investment had earned so many dollars.³ Making his own adjustment on account of changed purchasing power would be the same everyday matter he is already accustomed to. His interest in the "value" represented by his individual equity must in any event be stated in terms of stock market quotations or other market values. And stock market quotations would mean more, since it is generally held that prices of stocks depend primarily upon earnings. It would be the duty of the independent auditors to see that earnings were properly reported. As it is, we get into a vicious circle by assuming that earnings determine value, when the earnings reported are often themselves to a considerable extent based on value (i.e., appraised values).

¹ For a similar example of charging underwriters' fees partly to capital surplus and partly to earned surplus, see Commercial Credit Company, Stock Listing Application A-8837, New York Stock Exchange.

² The following quotation from the 1931 annual report of Munsingwear, Inc. is interesting in this connection: "The valuation of physical properties has likewise been materially reduced by the elimination of appraised sound values as established at the date of acquisition of the subsidiary companies and substitution of original cost less depreciation to date."

³ There is much to be said for considering the pro rata share of earnings of the corporation as income of the stockholder, disregarding the corporate fiction. See dissenting opinion of Justice Brandeis in *Eisner v. Macomber*, 252 U.S. 189.

An illustration from practice displaying several of the historical financial facts of proprietorship, which are more often buried or improperly treated, is found in the following excerpt from the December 31, 1930, balance sheet of The Granby Consolidated Mining, Smelting and Power Company, Limited:

Capital Stock Issued:

450,000.65 shares of \$100 each	_____
Deduct capital distributed to shareholders	_____
Deduct discount on capital stock	_____
Deficit as at December 31	_____

It is too early to say how the writing down of assets, often with accompanying reductions of capital, will be reflected in the proprietary sections of published balance sheets. The least that should be expected is footnotes to both the balance sheet and the income sheet, showing, respectively, the amount and date of the write-down, and what the income would be if depreciation were being based on cost rather than on appraised values.¹ With respect to legal reductions of capital, it has been suggested that the surplus items be stated as dating from the time of the decapitalization. This method is occasionally found in practice.² Legal reduction of capital, as a means of providing surplus against which write-downs can be charged, may possibly be approved on the theory that corporations could easily achieve the same result by going through a re-organization. But at least the stockholder should know what is going on, not only at the time of write-down, but in subsequent years when it has its effect on income and surplus.

¹ The financial statements of The May Department Stores Company in its annual report for 1932 are commendable in this connection.

² See balance sheets of Wilson & Co., Inc. (November 1, 1930), and Simons Company (December 31, 1929).

CHAPTER 11

INCOME AND THE INCOME SHEET

Business income. Corporate income may be defined from various viewpoints, which can be roughly illustrated by the following outline:

Operating income	Managerial view
Add other income (net)	
Total income	Corporation view
Interest on current liabilities	
Balance	Investors' view
Interest on long-term liabilities	
Net income	Stockholders' view
Dividends on preferred stock	
Balance	Common stockholders' view

In practice the published income sheets of corporations set forth in a general way these various views. There is little uniformity, however, regarding how and where specific items are to be displayed. At bottom, these differences result from, first, distinctions between capital gain, or loss, and income; second, distinctions between extraordinary and normal items; third, distinctions between current items and those which can be construed as attaching to prior periods; and, fourth, distinctions between "operating" and "non-operating" income.

Capital gains and losses. Identification of part of the entire capital fund of a corporation as fixed capital is carried out frequently in England, where the prescribed form of balance sheet for public service companies is divided into two sections, "capital account" and "balance sheet." In this country, when the balance sheet is prepared in the form listing assets in inverse order of liquidity, the arrangement of equities—capital stock, fixed liabilities, current liabilities, and surplus—gives expression to the same idea.¹

¹ In some balance sheets capital stock and bonds are totaled together and designated as "capital liabilities" (Commonwealth Edison Company, December 31, 1931) or as "funded debt and capital stock" (American Smelting and Refining Company, December 31, 1931).

After donations,¹ the clearest case of capital gain or loss is that resulting from the sale of land (except, of course, for dealers). Then come transactions in other plant assets and permanent investments, and, finally, in those concerning capital stock and bonds of the company itself. The courts now make no effort to distinguish between realized gains from appreciation of capital assets and any other income. In regard to depreciable assets the apparent profit may in reality be a restoration in part of overdepreciation in the past. In respect to permanent investments, it is specious at best to draw the distinction.² As regards a corporation's own bonds, the matter has been substantially resolved owing to a recent decision of the Supreme Court, holding that the gains or losses on such transactions represent taxable income or loss.³ As regards so-called gains and losses resulting from dealings in treasury stock, accountants and the courts generally hold that they constitute adjustments of capital surplus.

In published financial statements, practice varies. There seems to be no attempt to segregate capital gains and losses from earned income except for those arising from transactions in treasury stock, and even then they are not usually so differentiated. Gains and losses from disposals of fixed assets and from retirement of bonds are about equally divided between adjustments of income and adjustments of surplus.⁴

¹ There is, of course, a certain objection to considering donations, except those of stockholders (which are in the nature of capital contribution), as capital. They are taxable gains to the corporation under the income-tax regulations. However, they are not made as a source of dividend distributions, and they can be considered as an investment of capital made for the stockholders. See E. L. Kohler, "The Concept of Earned Surplus," *The Accounting Review*, Chicago, September, 1931, p. 208.

² The following situation appears to be an application of the concept of capital gains and losses in this connection. The corporation purchased its own preferred capital stock below par value, crediting the difference to a "reserve as applicable to the cost of certain of the Company's investments which at this time, because of the prevailing security markets, show a depreciation in value." (Report for the year ending October 31, 1931, Firestone Tire & Rubber Company.) A similar offset is found in the income sheet of Gimbel Bros., Inc. (report for the year ending January 31, 1931).

³ *Kirby Lumber Co. v. U.S.*, 284 U.S. 1 (1931).

⁴ Among statements in which the items discussed above were set forth sepa-

Extraordinary income or loss. Certain items of profit or loss, while definitely representing income or loss of the current period and affecting the surplus available for dividends, can still be considered as "extraordinary" or "non-recurring." Such items are deemed abnormal and so are sometimes charged direct to surplus or to some account which is not closed to income. This practice may be misleading, however, since introducing a previous surplus balance before listing extraordinary gains and losses conceals the effect they have on funds from current income.

The treatment accorded extraordinary and non-recurring items in published statements varies. Such items are often lumped with other adjustments of income or surplus and thus they cannot be identified. Further, there is an apparent tendency to class as "extraordinary" certain items which can hardly be so considered.¹

rately, the gain or loss was displayed as follows:

	<i>Sale of Fixed Assets</i>	<i>Abandon- ment of Fixed Assets</i>	<i>Own Bonds</i>	<i>Own Stocks</i>
Before net income	10	2	7	3
Before surplus.....	3	---	1	---
After surplus.....	14	3	5	27
Capital surplus.....	---	1	---	10
Total.....	27	6	13	40

One statement included profit on sale of real estate in income, but listed "loss on disposal of capital assets and investments" as a deduction from surplus. Two statements differentiated between the gain or loss on transactions in the company's own bonds and in its stocks. The differentiation, however, was as between income and surplus in the one case and between surplus and capital surplus in the other.

¹ Four tabulations were made of cases observed in the statements examined:

	<i>Before Net Income</i>	<i>Before Surplus</i>	<i>Surplus</i>	<i>Capital Surplus</i>
Research, experiment, prospecting, legal, and taxes....	8	1	3	---
Moving, recapitalization, litigation settlement, bonus....	2	2	5	3
Life insurance proceeds.....	1	---	1	---
Additions to provisions for loss on current assets.....	6	4	15	---
Total.....	17	7	24	3

Adjustments of prior years' earnings. Adjustments arising from transactions of prior periods, and thus regarded as not altering current income, are of two classes—those which affect current funds and those which do not. In the first class are additional assessments or refunds of income taxes. In the latter class are simple correcting entries. It may, for example, be discovered that the opening inventory figure was wrong or that depreciation rates have been excessive or too low. The objection noted above to charging surplus for extraordinary items which affect distributable funds currently made available, applies with equal force to the first class of prior years' items. The second class should doubtless be shown in financial statements as a correction of the opening surplus balance.

In published statements it is usually not possible to draw this distinction, since it is usual to show a single figure for all surplus adjustments or to show a separate item designated only as adjustments "applicable to prior years." The common method is to show "prior years'" items only after the opening surplus balance has been introduced.¹

Employment of contingent reserves. A method not infrequently followed in practice is to handle some or all of the various items which have been discussed in the preceding pages as adjustments of contingent reserves. Creation from past earnings of reserves to cover losses and expenditures of an abnormal nature, which may or may not be foreseen, is laudable. From an accounting standpoint, however, the subsequent use of contingent reserves is not entirely exemplary. In the first place, the disposal of such reserves may never be disclosed in the financial statements. Second, and partly because of this fact, the use of contingent reserves is subject to

¹ The tabulations which it was possible to make from the statements examined are as follows:

	<i>After</i>	<i>Surplus</i>
	<i>Net Income</i>	
"Prior years".....	3	16
Corrections of depreciation.....	—	5
Additional taxes or refunds.....	—	5
Total.....	3	26

abuse. Charging a loss or expenditure to surplus relieves current income of the burden of an expense or loss which arises during the period.

It can be urged that the disposal of contingent reserves be disclosed in the regular financial statements issued by the corporation. One method of doing this is by the presentation of a separate analysis of surplus reserves.¹ A second method, on the whole preferable, is to show the item in the income statement, deducting therefrom the amount released from the reserve, which may, of course, have been created for the purpose. Two examples of this procedure follow. In the respective income sheets both excerpts are located among income deductions:

(a) ²	
Loss on sale of marketable securities.....	\$ 69,343.75
Less appropriated from reserve.....	69,343.75
	\$ 0.00
(b) ³	
Loss on sale of securities.....	\$443,156.39
Less amount previously provided for by charges to surplus to December 31, 1930.....	376,406.70

This method shows clearly that the expense or loss arose in the current period, it gives the amount of the item, and it indicates to what extent the current income has been relieved.

Operating and non-operating income. The distinction between operating and non-operating income is somewhat related to that between normal and extraordinary items. The application of the distinction is different, however. Both operating and non-operating income are normal, considering the business as a whole, but the non-operating items arise as a by-product, so to speak, of carrying on the regular business. Perhaps the

¹ See, for example, annual report of International Harvester Company (1931), and annual report of Fox Film Corporation (year ending December 27, 1930). Existence of a large secret reserve deducted from inventories shown net on the balance sheet of International Harvester Company has been made public only recently.

² Income sheet of General Railway Signal Company (1931).

³ Income sheet of American Safety Razor Corporation (1931). See also income sheet of American Bank Note Company (1931).

terms "other" and "miscellaneous," which are more often found in published income sheets, are preferable on this score to "non-operating."

There are three different views regarding the character and treatment of cash discounts. One is that they are in the nature of interest and hence should be considered as non-operating items.¹ The second is that they are essentially reductions of the invoice prices and are thus adjustments of revenues, of cost of merchandise, or of cost of manufacturing, as the case may be.² The third view is that, under efficient management, the net price is always the effective price and should be so recorded. Accordingly, any discounts not taken are in the nature of a penalty and should be regarded as non-operating income (sales discounts) or non-operating expense (purchases discounts).³

There are in general two variations in improper treatment of taxes. Sometimes all taxes, including income taxes, are considered as an operating item; sometimes they are all deemed to be a non-operating charge. Most authorities agree, however, that all property and miscellaneous taxes (capital stock tax, check tax, and so on) are best classified as operating expense, whereas income taxes are a non-operating deduction—a distribution of total net income.⁴

Depreciation is often shown in published income sheets as excluded from operating expense.⁵ When this is done, the

¹ See H. A. Finney, *Principles of Accounting* (1923), Vol. I, Chap. 2, pp. 13-14.

² See W. A. Paton, *Accounting* (New York, 1926), pp. 151, 159.

³ See H. C. Greer, *How to Understand Accounting* (New York, 1928), pp. 179, 185.

⁴ Sales taxes present a different problem. See discussion in Chapter 13.

⁵ Among 282 income sheets (12 of 294 annual reports examined gave no income sheet or only the legal income sheet of the holding company), depreciation or "retirement expense" (in the utilities) was shown as follows: operating expense, 130; income charge, 133; appropriation of net (proprietary) income or surplus, 16. Of the remaining 3 cases, one showed no depreciation charge, since the replacement method of accounting is followed (American Car and Foundry Company); one had no depreciation inasmuch as its depreciable assets have been written off (Commercial Solvents Corporation); and one showed depreciation as an operating expense, added it back to operating income, and deducted it finally as an income charge (United States Steel Corporation).

designation of operating income is ordinarily qualified by the phrase "before depreciation." Accountants universally subscribe to the view that depreciation and similar charges are operating expenses. It is possible that auditors and private accountants prepare statements showing depreciation excluded from operating expense with the intention of emphasizing that depreciation is being recognized and of showing aggregate depreciation charges for the fiscal period. Nevertheless, practice could be improved if depreciation were always included in operating expenses. The amount can be disclosed in better ways than in excluding depreciation from its proper classification. Footnotes and parenthetical expressions are simple devices for this purpose.

Conclusion. In Chapter 2 it was pointed out that there is little uniformity in published income sheets (including the surplus analysis) beyond or below the figure for net operating income. The foregoing discussion is concerned with various reasons why this is so.

More uniform treatment could be accomplished by recognizing all items of income, gain, or loss of whatever nature, realized during the current period, as adjustments of current income before the introduction of the opening balance of surplus. With the exceptions of donations to the corporation, gains and losses from dealing in its own capital stocks, and correcting entries of the opening surplus balance, almost all "profit and loss" items, and surplus charges and credits, affect the amount of surplus available for dividends or the amount of income measured in terms of current asset funds. Moreover, if the integrity of the figure for income, or loss, from current operations is not disturbed—a matter which is easily accomplished—there seems little to be gained by drawing fine and often troublesome distinctions between items which affect income and those which affect surplus.

If this procedure were adopted in practice, the income sheet proper would conclude with a figure representing the addition to or subtraction from the opening balance of surplus,

perhaps as corrected. A simple reconciliation of surplus would then complete the statement.¹

An example from a published income sheet follows, which carries out in a general way the conclusions reached here and which exhibits significant distinctions between treatment of ordinary and special dividends and cash and stock dividends. This income sheet is published in a five-year comparative form (amounts are excluded below):²

INCOME AND SURPLUS OF CURRENT YEAR:

Consolidated earnings from operations, before depreciation.....	_____
Depreciation	_____
Consolidated net earnings from operations.....	_____
Interest and dividends received.....	_____
Net income, before Federal and foreign income taxes.....	_____
Federal and foreign income taxes.....	_____
Net income for the year, before adjustment to market of securities and foreign net current assets.....	_____
Adjustments of prior years—net.....	_____
Gross surplus for the year.....	_____
Adjustment to market of securities and foreign net current assets (credit).....	_____
Surplus reserves (decrease).....	_____
Balance of surplus for the year, before dividends.....	_____
Ordinary dividends: Preferred stock.....	_____
Common stock.....	_____
Net surplus for the year.....	_____

¹ Companies following this method in their income sheets are not numerous. They include: American Bank Note Company (1930), American Zinc, Lead and Smelting Company (1931), Fisk Rubber Company (1929), Jewel Tea Co., Inc. (Year ending Jan. 2, 1932), White Sewing Machine Corporation (1931), Wilson & Co., Inc. (Year ending Nov. 1, 1930), Northern States Power Company (1929).

² Income sheet of The Quaker Oats Corporation (1932). For a somewhat similar arrangement, see income sheet of Standard Brands Incorporated (1931). See also the form in *Verification of Financial Statements*, Federal Reserve Board (Washington, 1929), p. 23.

SUMMARY OF SURPLUS:

Balance at beginning of the year.....
Special dividend on common stock.....
Stock dividend on common stock—surplus transferred . to capital stock.....
Remainder, undistributed.....
Net surplus for the year.....
Balance at the end of the year.....

CHAPTER 12
TREASURY STOCK, TREASURY BONDS,
AND RESERVES

Reasons for acquiring treasury stock. The following quotations from annual reports are typical of the reasons assigned for acquisitions of treasury stock.

Munsingwear, Inc. (1931)

The established policy of your Board of Directors in regard to reducing the capital structure to conform more nearly to present-day capital requirements has been continued and a portion of surplus cash has been used in the purchase and retirement of shares of capital stock. . . .

International Shoe Company (year ending November 30, 1931)

Because of the decline in merchandise values since 1929, less capital has been required in the Company's operations and this has resulted in large increases in its cash balances, the profitable investment of which has become more and more difficult. With this problem before us, the Company has used \$12,039,365.65 of its cash in the acquisition of 250,000 shares of its common stock, which are being held as treasury stock—thereby reducing dividend requirements \$750,000 per annum at the present dividend rate.

Cudahy Packing Company (year ending October 31, 1931)

During the past two years the price of our common stock in common with most securities, dropped considerably below its real value. In supporting the stock, the Company purchased on the open market from time to time 27,940 shares at an average price of \$43.52 per share. The book value of the stock is approximately sixty per cent higher than this price and I am confident that the investment will prove a profitable one to the Company.

Standard Oil Company (New Jersey) (1931)

Favorable opportunities were availed of to purchase Company stock in the open market as a means of providing shares for corporate use without increasing the amount outstanding.

Fundamentally, all reasons expressing a legitimate desire on the part of management to acquire treasury stock fall into two classes. One is concerned with temporary or permanent reduction in capitalization; the second has to do with obtaining stock needed to fulfill certain plans or contracts. Reasons are often indirectly or superficially stated, and there are certain variations. The first quotation above expresses in straightforward fashion the aim of permanently reducing the capital investment. The second quotation indicates the purpose of accomplishing a temporary reduction of capital, with the variation expressed of lessening the burden of the established dividend rates. Another variation can be discerned in the third quotation; namely, the possible benefit to be derived by the remaining stockholders from the withdrawal of others who take less in cash than their book equity. The purpose specifically expressed of supporting the market price must be classed among the non-legitimate reasons for acquiring treasury stock. The fourth quotation states a purpose or purposes falling in the second class of reasons for acquisition of treasury stock.

It is not pertinent here to consider the legitimacy of allowing or prohibiting a corporation to acquire its own capital stock. It would seem that the advantages of permitting a corporation to acquire treasury stock under certain conditions outweigh the disadvantages. In any event it can be urged that full disclosure be made to stockholders regarding the cost and number of treasury shares held and the conditions of subsequent disposal.

Treasury stock as an asset. When a corporation acquires its own stock it has liquidated a portion of its capital. Whether it is intended to retire the shares or to reissue them the situation is the same. Despite the seemingly unanswerable logic of this view, the idea that treasury stock is an asset is not uncommon, and it is classed as such on the balance sheets of many corporations.¹ It is considered that an investment has

¹ Among 159 balance sheets displaying treasury stock, it was shown as an asset in 94 cases, as a deduction from proprietorship in 61 cases, and partly as an asset and partly as a deduction in 4 cases.

been made and that the company's own stock has been purchased in preference to some other available security of similar marketability. In some cases this fiction is carried so far that treasury stock is considered as an earning asset. Thus, one corporation's annual report comments as follows:¹

The Company has an investment in shares of its own stock at a figure which is less than market price at December 31, 1931. This investment, somewhat larger than at the close of the preceding year, produces a very attractive yield as compared to what could be obtained from any equivalent high-grade security in which surplus cash funds could be placed.

If treasury stock is an earning asset, dividends thereon must constitute part of the corporation's income. Thus, in reference to the instance cited above: "It has been our policy to credit to earnings the dividends on this stock, as it is carried as an investment."² Sometimes when treasury stock is considered as an asset it is carried on the books at market value.³ It may even be classified as a current asset.⁴ Not all these different conditions are apt to be found in any one set of financial statements. Treasury stock is, for example, more often shown under "investments," or as an entirely separate asset, than among current assets, and the use of market value is relatively infrequent.⁵ Moreover, in perhaps the majority of cases in which treasury stock is classed as an asset, the corporation does not go through the formality of paying itself dividends.

¹ R. J. Reynolds Tobacco Company (1931).

² Excerpt from correspondence with the treasurer of R. J. Reynolds Tobacco Company. For examples in which this practice is revealed in the statements, see income sheets of Ingersoll-Rand Company (1931) and Bucyrus-Erie Company (1931).

³ See, for example, balance sheets of American Safety Razor Corporation (December 31, 1931), The Lambert Company (December 31, 1931), Swift & Company (October 31, 1931), R. H. Macy & Co., Inc. (January 31, 1931).

⁴ See balance sheets of Allis-Chalmers Manufacturing Company (December 31, 1930), Standard Oil Company (New Jersey) (December 31, 1931), Union Carbide and Carbon Corporation (December 31, 1930).

⁵ Among 98 cases in which treasury stock was listed as an asset it was valued as follows: not indicated, 27; cost, 49; par, 7; market, 8; miscellaneous, 7. Among the miscellaneous methods: "cost, less dividends on such stock and proceeds of shares sold," "less than market," "below cost," and "less reserve."

The effect on the balance sheet of listing treasury stock as an asset is to overstate both assets and equities.¹ If dividends are paid on the stock and included as income, the effect on the income sheet is to overstate income.

Treasury stock in the balance sheet. The legal capital of a corporation is the par or stated value of its issued capital stock. According to the trust fund doctrine the legal capital constitutes a trust fund to which creditors may look for payment of their debts. Any decreases of this amount can legally be made only by formal reduction of capital, which includes, of course, the retirement of certain shares of stock. Purchase of treasury stock, therefore, is illegal in a sense. However, it is probable that if there exists a corresponding amount of legal surplus—the sum of paid-in, or other capital surplus, and earned surplus—the corporation has not infringed the trust fund doctrine. Accordingly, some accountants have interpreted the acquisition of treasury stock as calling under the law for an appropriation of surplus equal to the par or stated value of treasury stock. The following excerpt provides an illustration of this view:²

SURPLUS

Appropriated through purchase of Treasury Stock	\$1,800,000.00
Less: Profit and loss deficit	181,706.73

Surplus appropriated in this way is released only upon formal retirement of the treasury stock or its reissue.

Treasury bonds. Treasury bonds are a corporation's own bonds reacquired subsequent to issue, and as yet uncanceled. Although they are similar in nature to treasury stock, a corporation may acquire treasury bonds without legal complications, and they can be retired without the formalities incident to a reduction of capital stock. Treasury bonds are often listed

¹ The argument that treasury stock is a "potential asset" is faulty. Unissued stock has the same characteristics and few if any balance sheets list unissued stock as an asset.

² From balance sheet of The New York Air Brake Company (December 31, 1931). See also balance sheets of Chrysler Corporation (December 31, 1930), L. Bamberger & Co. (February 1, 1930), Gotham Silk Hosiery Co., Inc. (December 31, 1931), Victor Talking Machine Company (December 31, 1928). In the last case the appropriated surplus is added to the capital stock item.

as an asset in published financial statements.¹ Though it is analogous to the contention that treasury stock is an asset, the view that treasury bonds are an asset gains special credence owing to the fact that interest payments on bonds are usually handled through a fiscal agent and to the further fact that treasury bonds may be in the hands of the sinking fund trustee. These matters will be taken up in turn.

Interest on treasury bonds. It is undoubtedly sound financial policy to purchase the company's own bonds when earnings have fallen, so as to lessen the burden of interest charges. However, it is specious to hold that the employment of cash in this way is no different from investing an equivalent amount in a security of like market rating. From the viewpoint of the corporation as an entity, nothing has been accomplished except the reduction of a portion of the entire capital investment. From the viewpoint of the stockholder, however, a future saving has been made, not a future income assured, and, to the extent that the bonds were purchased below book value, the common stockholders have gained.

When treasury bonds are coupon bonds, the coupons must be duly cancelled. One method is to send the coupons, together with a check for the net amount payable on outstanding bonds, to the paying bank. Another method is to deposit the coupons, issuing the interest check as covering all uncanceled bonds. The result is, or should be, the same under either method. It is easy, however, under the latter method, since cash is actually received for the coupons, to credit interest income rather than interest charges for the amount of the coupons deposited. It is probable that this error in bookkeeping has strengthened the "investment" view of treasury bonds. Considering interest on treasury bonds as income results in overstatement of total net income and overstatement of interest distributions. To be sure, these errors have no effect on the correct showing of proprietary net income in the income

¹ Among 60 balance sheets revealing the possession of treasury bonds, the bonds were shown as an asset in 22, while in 38 they were listed as a deduction from the liability or the liability was shown net of treasury bonds. When listed as an asset they are usually valued at cost, though "market" and par value are also found.

sheet, nor of proprietary equity in the balance sheet, but from the viewpoint of the corporation they are none the less important.¹

Treasury bonds held in the sinking fund. Even when sinking funds are actually held by a trustee, they are assets of the corporation and are so carried on the balance sheet. It is a fiction, therefore, to include the corporation's own bonds as adding to a sinking fund.² If the procedure of keeping bonds "alive" in the sinking fund is decided upon as a convenient means of making additional payments to the fund, it is still possible to keep the accounts in such a way that the true situation is revealed.

Treasury bonds in the balance sheet. When treasury bonds are acquired it is best to have the original entries reflect the analytical effect on the accounts. If the cost is below book value, the purchase has resulted in a "gain"; if it is higher than book value, the result is a loss. In other words, an obligation has been satisfied at less or more than present book value.³

The balance sheet should show treasury bonds as follows:⁴

Bonds	xxx
Less: Held in sinking fund.....	xxx
Held in treasury.....	xxx xxx

When bonds are cancelled, they are no longer treasury bonds and need not be shown in the balance sheet. However, it is desirable as a matter of financial history to show the original amount of the bond issue, with formally retired or cancelled bonds as a deduction.⁵

¹ The method leads to such an absurdity as showing accrued interest receivable on the company's own bonds as a current asset. See balance sheet of National Fireproofing Corporation (December 31, 1930).

² The balance sheet of Puget Sound Power & Light Company (December 31, 1931) contains the following comment in respect to a sinking fund: "The account also includes \$937,000 face value of Company bonds which have been acquired by the trustee and are held uncanceled for the benefit of the bondholders."

³ If treasury bonds are sold rather than retired, it is best to regard the sale as creating an entirely new liability. Any discount or premium will be accordingly measured from par, as upon original issue.

⁴ As in the balance sheet of Chrysler Corporation (December 31, 1931).

⁵ As in the balance sheet of Pathé Exchange, Inc. (December 27, 1930).

"Reserves" as a subdivision of equities. There are fundamentally only two divisions of equities—liabilities and proprietorship. In published balance sheets, however, there appear to be three.¹ Partly, this situation is due to disagreement among accountants regarding the nature of certain reserves; partly, it must be assigned to apathy on the part of private and public accountants or to a compromise between auditors and the management. These various points will be considered briefly.

Reserves resembling both liability and surplus. Space does not permit the discussion of every possible "reserve" which may be classed by different authorities as surplus or liability. Two of the more common ones will be mentioned as examples; namely, self-insurance reserves and reserves for pensions.

The most common self-insurance reserves are for fire or other similar losses and for compensation and damages. If self-insurance reserves are accumulated on an actuarial basis, it is good accounting in one sense to charge expense for an amount corresponding to standard insurance rates, at the same time crediting the reserve. According to this view the self-insurance reserve is a liability, different from most liabilities only because the maturity date of the obligation is uncertain.² The reserve is charged with the amounts of the actual losses or payments. On the other hand, self-insurance reserves can be viewed as segregations of surplus, to provide for possible contingencies which may never arise. This view has been upheld by the Board of Tax Appeals in the following words:³

The taxpayer also urges that it is improper to discriminate between one who pays premiums to an insurer and one who bears his own risk.

¹ Among 150 balance sheets showing reserves, other than contra to assets and estimated current liabilities, 133 displayed them as a separate item, or group of items, independent of both liabilities and proprietorship. In 17 cases reserves were listed under proprietorship.

² See *Accountants' Handbook*, Second Edition, p. 984. A majority of published balance sheets exclude self-insurance reserves from proprietorship, but since they are not specifically designated as liabilities, either, it is impossible to discover the attitude of the accountants who prepared the statements.

³ *Pan-American Hide Co.*, 1 B.T.A. 1249.

The difference is one of fact; in the one case the expense of premiums is paid or incurred and in the other it is not. The discrimination if such it be is self-imposed. Since the statute does not permit a taxpayer to deduct as an expense an amount which he fears he may some day be called upon to spend, there can be no sanction for such a deduction.

Income-tax considerations are not, of course, necessarily identical with accounting principles, but this view is also supported by many accounting authorities and is followed in various balance sheets.¹ When this interpretation is followed the reserve for insurance should be accumulated by appropriations of income, while the actual losses or payments will measure the expense.

There are two types of pension reserves and other reserves for employees' benefits. They may be formal in nature, with or without involving accumulation of a special fund, and hence amount to a definite bargain to pay specified amounts at some time in the future. In such a case, there is little doubt that they represent true liabilities rather than surplus reserves, and the accumulation of the reserve should accordingly be charged to expense.² On the other hand, if the pension or other reserves are quite informal and so more in the nature of reflecting a generous intention on the part of the corporation, they are possibly best classed as surplus. When pension and other such funds are definitely trust funds, held either by the corporation or some outside party as trustee, there is some question whether it is proper to include the fund and the corresponding reserve in the balance sheet at all.³

Misplaced "reserves." The results of listing allowances for depreciation, depletion, and amortization as "reserves" among equities are to overstate fixed assets and overstate

¹ For examples among published financial statements, see balance sheets of Crucible Steel Company of America (December 31, 1930), Socony-Vacuum Corporation (December 31, 1931), United States Steel Corporation (December 31, 1931).

² Whether such amounts can be deducted for tax purposes as expense seems to depend on the existence of both a fund and a trust relationship. See *Hibbard, Spencer, Bartlett & Co.*, 5 B.T.A. 464.

³ Compare in this respect balance sheets of Commonwealth Edison Company (December 31, 1931) for inclusion and Sears, Roebuck and Co. (December 31, 1930) for exclusion.

equities. When allowances for bad accounts and outstanding discounts are similarly handled, current assets and equities are overstated. Finally, when estimated liabilities like the provision for income tax are listed in a separate "reserves" group, current liabilities are understated.

Reserves for depreciation demand some further consideration. The accrued depreciation allowance is the most frequently misplaced of all contra-asset accounts, though in the great majority of cases it is now correctly shown as a deduction from plant.¹ Depreciation periodically charged off is only by courtesy credited to a separate account rather than directly to the main asset account, since statistically it is often advantageous to know both the original cost and the accrued depreciation. The depreciation allowance, or reserve, cannot be a liability or surplus, but is essentially a part of the asset to which it applies. Cole has said:²

... the asset account may be said to measure the diameter of a doughnut, and the allowance account to measure the diameter of the hole; so that the substance of the doughnut is indicated by the difference between the two. An allowance account measures a hole in an asset when for statistical reasons we desire to show both the original whole and the present hole.

It cannot be denied that overdepreciation provides a simple means of creating a secret reserve.³ Consequently the depreciation allowance may in some cases represent surplus to some extent; that is, non-reported and undisclosed profits. But this is no reason for considering the entire allowance as an equity.

"Reserves" unclassified as to nature. It is common to find a "reserve for contingencies" listed between the liability and proprietary items. Often it is the only "reserve" shown. The title gives no clue to what its nature really is, and, since

¹ Among 288 balance sheets, the depreciation or depletion allowance was handled as follows: deducted, 197; plant shown net of the allowance, 24; among equities, 59; not indicated, 8. The "retirement reserve" or "depreciation reserve" on balance sheets of utilities was invariably listed as an equity (36 cases), and was totaled with surplus in 3 cases.

² W. M. Cole, *The Fundamentals of Accounting* (Boston, 1921), p. 107

³ See, for example, report of Diamond Match Company, for 1929, pp. 37-39, where such a policy is specifically stated.

the location on the balance sheet is likewise noncommittal, the reader is left in the dark. Reserves for contingencies may represent surplus appropriated for possible losses, such as for inventory shrinkage and extraordinary obsolescence. They may also represent provisions for contingent liabilities such as a possible assessment for damages under pending litigation. Here again, the reserve is an appropriation of surplus unless the liability is no longer contingent, in which case "reserve for contingencies" is a misnomer, and the item should definitely be shown as a liability, even though the exact amount of the obligation is unknown at the moment. It is proper for a management to express conservatism by setting up reserves for possible but unexpected losses and obligations. The purpose is presumably to prevent distribution to stockholders of a portion of earnings. But this does not change the nature of the reserve as surplus.

On the other hand, there is reason to believe that in many cases the "reserve for contingencies" represents, to a considerable extent, deductions from assets. For example, if the existing allowance for uncollectibles is patently inadequate, or, in other words, if there are many bad accounts being carried as good receivables, the outside auditors are often satisfied if the management agrees to appropriate additional surplus to a "reserve for contingencies."

Finally, there are frequent cases of unwarranted combination or condensation of "reserves." A few illustrations taken from published balance sheets are given below:

Reserves for crude oil, property abandonments, insurance, annuities, etc.
 Reserve for self insurance, advertising, store front replacement, etc.
 Other taxes, advertising, royalties, contingencies, etc.
 Reserves for insurance, bad debts, and contingencies, and obligation to trustee under pension plan.
 Reserves for depreciation, etc.
 Miscellaneous reserves.
 Reserves.

Reserves and surplus. Some balance sheets differentiate between "reserves" and appropriated surplus. For example,

the following is taken from the balance sheet of United States Steel Corporation:¹

RESERVES AND SURPLUS

Contingent, miscellaneous operating and other reserves	_____
Insurance reserve	_____
Premiums on common stock	_____
Earned Surplus	
Appropriated for and invested in capital expenditures	_____
Undivided surplus of United States Steel Corporation and subsidiary companies	_____

If "reserves," however, are really surplus, there is no distinction. There is something to be said, however, for a system of reserve accounting which would reveal the disposition of funds represented by earned surplus. The average reader probably has the impression that unappropriated surplus in the balance sheet represents surplus actually available for dividend purposes, not simply legally available. The theory that the surplus balance should be restricted to free surplus is a tenable one. It has been expressed by Diamond Match Company as follows:²

This figured surplus may or may not be surplus in fact, or usable surplus . . . Cash and its equivalent in quantity (beyond working capital needs) . . . are essential to the existence of a real and potent working surplus.

If this theory of surplus were carried into practice, the balance in surplus account would represent an existent excess of working capital over normal requirements, and not as yet destined for any particular purpose. It seems as though somewhat this idea was the intention of those who framed the Interstate Commerce Commission form of balance sheet, from which the following is taken:³

¹ December 31, 1931. See, also, balance sheet of Standard Oil Company (New Jersey) (December 31, 1931).

² Annual report for 1929, p. 47.

³ *Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads* (Washington, 1914), p. 60.

CORPORATE SURPLUS:

Additions to property through income and surplus.....	_____
Funded debt retired through income and surplus.....	_____
Sinking fund reserves.....	_____
Miscellaneous fund reserves.....	_____
Appropriated surplus not specifically invested.....	_____
Total appropriated surplus.....	_____
Profit and loss—Balance.....	_____
Total corporate surplus.....	_____

CHAPTER 13

TREATMENT OF MISCELLANEOUS ITEMS

Subscriptions to capital stock. There are in general three methods of accounting for subscriptions to capital stock. One is to set up the full amount of the subscription as a receivable and as part of capital.¹ Only upon full payment and issue of the stock is the account for subscribed capital stock transferred to the regular capital stock account. Another procedure, which might be called the installment method, is to show only the amounts paid in on subscriptions as proprietorship.² Still another possibility is to carry the amounts paid in on subscriptions as a liability. This last method is often used for employees' subscriptions.³ It is most applicable when the payments really rank as deposits, bearing interest, and being perhaps returnable if the subscription is not completed. Employees' subscriptions are handled in still other ways, depending upon the terms of the subscription contract. An item occasionally found among assets is "treasury stock held for employees, less payments thereon" or something similar. Presumably in such cases, the item is really a receivable, secured by the stock, and thus is improperly described as treasury stock. However, it may be a mixture of receivable and treasury stock, as in the following case:⁴

Common stock acquired for resale to employees,
partly subscribed, less payments thereon.....

¹ See, for example, balance sheets of Commonwealth Edison Company (December 31, 1929) and Cities Service Company (December 31, 1932). In the latter case the proprietorship item for stock subscribed is not separately shown.

² See the balance sheet of American Telephone and Telegraph Company (December 31, 1930); also, for employees' stock, balance sheet of Julius Kayser & Co. (June 30, 1931).

³ See balance sheets of General Foods Corporation (December 31, 1930), Ingersoll-Rand Company (December 31, 1931), and The Kroger Grocery & Baking Company (January 2, 1932).

⁴ Balance sheet of American Bank Note Company (December 31, 1930).

Compare the separation of a similar item as follows:¹

Employees' Common Stock Purchase Plan:

Due from employees.....
 Unsold stock in hands of trustee (4,732 shares at cost)

Life insurance. Insurance on the lives of officers is uniformly shown on balance sheets at "cash surrender value." There is some variation in classification, though it is usually displayed among current assets.² Since the insurance is doubtless intended as a quasi-permanent investment, there is no good reason for considering it as a current asset. It is highly liquid to be sure, but in a large number of cases so are the stocks of affiliated corporations held as permanent investments.

Prepayments and deferred charges. There is a legitimate distinction between prepayments and deferred charges; namely, that prepayments rank as a special type of receivable. Short-term prepayments are legitimately considered as current assets. They are not often so treated in published balance sheets, however, owing probably to the following reasons: (1) bankers object to the practice, (2) accountants often make no endeavor to separate prepayments, or service receivables, from other varieties of deferred charges.³ The first reason is probably partly dependent on the second, for bankers seem to have no objection to the inclusion of supplies and work in process as current assets, both of which may have a liquidation value as negligible as do prepayments. Indeed, the "deferred" subdivision of assets constitutes one of the weak spots in balance-sheet presentation.

All plant assets of a wasting nature are deferred charges in a broad sense. The caption "deferred" is usually restricted in practice, however, to items of an intangible nature.⁴ There are few legitimate deferred charges of this character, and the classi-

¹ Balance sheet of Loose-Wiles Biscuit Company (December 31, 1931). See also balance sheet of J. C. Penney Company (December 31, 1931).

² In 32 cases in which the item was separately revealed it was listed as current in 19, as an investment in 7, and as an entirely separate item in 6 cases.

³ In 138 cases prepayments were treated as follows: as a current asset, 32; as a separate asset, 48; under "other assets," 3; under "deferred" assets or charges, 13; combined with "deferred charges," 42.

⁴ But see the balance sheet of United Cigar Stores Company of America (December 31, 1921), in which "furniture, fixtures, and equipment" is listed as

fication must be sparingly applied. Specifically, deferred charges represent past expenditures for which the service has been received, but the benefits of which can be said to attach to future revenues. Developmental activities may give rise to legitimate deferred expenses. Examples are stripping overburden, building roads, and providing drainage facilities in certain extractive industries.¹ If commissions on sales are paid in advance of the recognition of revenue, for example in the cases of long-term service contracts and of rentals of equipment or real estate, the prepaid commission is a valid deferred charge. Bond expense is also a deferred charge, and, in a special sense, so is purchased goodwill. Of doubtful validity as deferred charges are moving expenses, expenditures of a special advertising campaign, and so on.² Finally, the deferred group of assets sometimes contains items which are nothing more than losses.³

In conclusion, it can be said that no expenditure should be classed as a deferred charge, unless: (1) it is clear that the cost attaches to future periods, (2) resulting benefits will materialize almost as a matter of course, and (3) there exists a reasonable basis for allocating the amount to future revenues. The "deferred charges" section of balance sheets should contain only separate items, specifically designated. Combination should generally be avoided, and use of the terms "miscellaneous" and "etc." should be narrowly restricted.

Bond sinking funds. Cash in bond sinking funds is sometimes deducted from the liability on the balance sheet.⁴ It is better considered as an asset, however, since the bonds still

a "deferred asset." And see the item "alterations and improvements to leased stores" listed as a "deferred charge" in the balance sheet of W. T. Grant Company, application for listing, A-8195, New York Stock Exchange.

¹ Such items may, with equal logic, be listed among plant assets on the balance sheet.

² The following item appears on the balance sheet of Southern California Edison Company, Ltd. (December 31, 1930): "New business development expense, deferred."

³ For example: "abandoned property," balance sheet of Central Maine Power Company (December 31, 1931); "expenses, interest, and taxes paid exceeding earnings," balance sheet of State Bank of Marcellus, *Report of the Commissioner of Banking*, Michigan, 1928, p. 229.

⁴ See, for example, balance sheet of Pathé Exchange, Inc. (December 27, 1930).

remain a liability until actually retired or reacquired, even if the fund is entirely outside the control of the corporation.

Mortgages payable. Occasionally mortgages payable are found deducted from assets.¹ The method does, of course, show clearly the equity of the owning corporation. It is, however, a proprietary view as opposed to that of the corporation. It is also a step in the direction of cancelling liabilities against assets, and all in all is an undesirable practice, particularly for corporate balance sheets.

Notes receivable discounted. Notes receivable discounted can be handled in several ways. They may be deducted from the asset,² offset by a liability of equivalent amount,³ or finally, when the asset is shown net of discounted items, noted as a contingent liability. The second method is least desirable, since there is no direct liability. The third is the most common.

Deficits. Deficits are in no sense assets, but they are occasionally shown as an addition to total assets.⁴ Deficits are properly handled as deductions from proprietorship in several ways. For instance, they may be deducted from the total of all capital stock⁵ or from the common stock item alone.⁶ The latter method is more exact. When a paid-in or other capital surplus exists, the deficit is properly first applied against it.

Maturing portion of long-term debt. There is considerable variation in practice as well as a difference of opinion among authorities regarding the question of whether a bond issue maturing within the subsequent fiscal year should be classed as a current liability. If the obligation is to be refunded, it is quite unnecessary to distort the normal relationship between current assets and current liabilities by treating the amount as a current

¹ See, for example, balance sheets of Gimbel Bros., Inc. (January 31, 1931), Schulte Retail Stores Corporation (December 31, 1930), Sloss-Sheffield Steel and Iron Company (December 31, 1930), and Lehn & Fink Products Company (December 31, 1930—mortgage due within the following fiscal period).

² As in the balance sheet of Seiberling Rubber Company (October 31, 1928).

³ See balance sheet of Indian Refining Company (December 31, 1928).

⁴ For example, in the balance sheets of International Silver Company and Shell Union Oil Corporation (December 31, 1931).

⁵ For example, in the balance sheets of Indian Refining Company (December 31, 1931).

⁶ See balance sheet of United States Rubber Company (December 31, 1931).

liability. Segregation of the item under fixed liabilities, with a brief note regarding the refunding plan, is sufficient notice of the impending maturity. Assuming the liability is to be paid off in cash, however, the correct procedure might seem to depend on the asset classification of the funds to be used for payment. It would certainly be improper to show the maturing obligation as a current liability, while the sinking or other fund was listed as a fixed asset. On the other hand, it should be noted that moving approximately equal amounts from the fixed to the current classifications of both assets and liabilities does not have an equal effect on the current ratio. For this reason a method somewhat like the following is to be preferred: (1) list the item separately among fixed liabilities, indicating date of maturity, and (2) indicate in a footnote that the funds for payment are in readiness, but are excluded from current assets.¹

Fractional shares. Fractional shares, or "scrip," arise in the issue of stock dividends. Scrip is normally not eligible for dividends and usually expires unless presented for exchange into full shares within a limited time after issue.² Scrip of this sort is to be distinguished from a scrip dividend, which is a dividend paid in promissory notes rather than in cash and is thus akin to a bond dividend.

Some corporate balance sheets list outstanding scrip as a separate proprietorship item. The balance sheet of Commercial Solvents Corporation (December 31, 1931), for example, shows the following under capital stock: "Outstanding scrip equivalent to 3,061-34/50 shares." Scrip may also be included in the capital stock item, as is indicated in the following item from the balance sheet of The Commonwealth & Southern Corporation (December 31, 1930): "Common stock, no par value, issued and outstanding 34,011,010-581/1200 shares."

When scrip expires, a special adjustment must be made. The following item, for example, appears in the analysis of capital surplus of The May Department Stores Company:

¹ As in the balance sheet of Memphis Power & Light Company (December 31, 1930).

² For an exception see a balance sheet of American Tobacco Company (December 31, 1928) which includes the following items listed among liabilities: "scrip matured March 1, 1921, and not yet presented for redemption."

Par value of scrip not presented for conversion by

December 31, 1931, the date on which rights expired _____

The adjustment is sometimes made to earned surplus, but this is less desirable because the item is analogous to the "gain" on treasury stock acquired below par or stated value. The following item from the surplus analysis of Safeway Stores, Incorporated (1931) provides an example of this second method:

Scrip issued for stock dividends in prior years now expired _____

Stock purchase warrants and rights. The terms "warrants" and "rights" are used rather loosely. Technically, a "right" refers only to the privilege accorded an existing stockholder to subscribe to his pro rata portion of a new issue of stock. Warrants are the certificates issued by the corporation to evidence these rights. There are also other types of stock purchase warrants. As an additional inducement to investors, for instance, warrants to purchase common stock are sometimes attached to bonds or to preferred stock. When stock purchase warrants are attached to securities sold, part of the sale price should be assigned to the warrants, if they have any value upon issue. The tangible evidence of such value is the market price soon after issue. Writers on accounting are generally silent on these matters, probably because they are deemed in practice to have no significance. It is customary in practice only to reserve the appropriate number of unissued shares of the stock to which the purchase options apply and, upon exercise of the warrants, to record the stock issued in the same manner as any other sale of stock. On the balance sheet the existence of outstanding purchase warrants is indicated in the description of unissued stock, or sometimes as a separate comment. The following illustration is unusual in that the item is listed directly after common stock, but with no value assigned:¹

¹ Balance sheet of Melville Shoe Corporation (December 31, 1929). Only two cases were noted in which any value was assigned to outstanding warrants. The balance sheet of American Light and Traction Company shows an item "common stock warrants," which may represent scrip certificates, however. (See the *Commercial and Financial Chronicle*, New York, Vol. 132, p. 3333.) The item "paid-in surplus, including value placed on stock option warrants, less organization expenses" is listed in the balance sheet of Niagara Hudson Power Corporation (December 31, 1929).

Common stock warrants entitling holders to purchase 22,500 shares at \$100 per share on or before August 1, 1931_____

Reserve for unrealized profit on installment sales. When installment accounts receivable are set up at their face value and the installment method of reporting income has been adopted, there is an auxiliary account usually titled "reserve for unrealized profit on installment sales." This account represents the deferred income which will be recognized in the future as collections are made on the installment accounts. It is ordinarily classed as surplus. According to Montgomery:¹

The unrealized profit is a surplus reserve, provided the costs of collection, etc., are deducted from the asset or allowance is made for them among liabilities.

However, since the installment basis takes as its premise that income is to be recognized only upon a cash basis, it would seem more consistent to show the "reserve for unrealized profit" as a deduction from installment accounts receivable.²

Stock dividends declared. If a balance sheet is prepared between the time a stock dividend is declared and the time it is paid, the problem of recognizing the fact arises. Since the only liability in connection with a stock dividend is to issue the stock itself, it would be incorrect to show a stock dividend payable as a liability on the balance sheet. However, prior to the actual capitalization of surplus, which takes place upon the issue of the stock, some indication should be made that a portion of surplus has, in fact, been appropriated. One method is simply to make a notation of the dividend declared. For instance, the following comment was included in the body of a balance sheet at the end of the proprietorship section, but no adjustment of surplus was made:³

¹ R. H. Montgomery, *Auditing Theory and Practice*, Fourth Revised Edition (New York, 1927), p. 342. See also balance sheet of Best & Company (January 31, 1932).

² H. F. Taggart, "Subdivision Accounts," *Michigan Business Studies*, Vol. II, No. 7, pp. 24-30, recommends that the reserve for unrealized profit on installment sales be divided between net worth and a contra account to installment accounts receivable, sufficient in amount to reduce them to a reasonable current value.

³ R. H. Macy & Co., Inc. (January 31, 1931).

Note: Stock dividend declared of 68,461 shares of common capital stock, payable on February 16, 1931, increased the shares to be then outstanding to 1,437,672.

A more satisfactory method is indicated in the following item which was listed between capital stock and surplus:¹

Surplus appropriated for stock dividend (70,000 shares)
payable January 10, 1929.....

Sales tax. Federal and state sales taxes constitute a relatively new problem in income-sheet display. Doubtless when the taxpayer is legally in the position of a tax collector, as in the case of the Federal and state gasoline tax, the tax collected should be deducted from sales, probably not appearing on the income sheet at all.

Recently, some states have levied taxes upon "sales at retail." In fact, these levies represent a sales tax on the consumer. Legally, however, they are a tax upon the retailer and so differ from the gasoline tax. All sales taxes are levied in one manner or another on sales. If there are no sales, there is no tax. Property taxes, on the other hand, do not vary in proportion to sales. For these reasons, state taxes upon "sales at retail" should probably be displayed in the retailer's income sheet as a deduction from sales, rather than being included as an operating expense.

¹ Balance sheet of Stromberg Carburetor Company of America, Inc. (December 31, 1928).

CHAPTER 14
CONSOLIDATED STATEMENTS—GENERAL
CONSIDERATIONS

Alternative methods for holding company reports. The legal balance sheet alone of a holding company is ordinarily inadequate to serve the needs of shareholders. The reason for this is simply that a true picture of an enterprise cannot be obtained by showing capital investment and income thereon in summary form. The legal financial statements of a holding company do just this in respect to all subsidiaries. It is as if a balance sheet were prepared showing only three figures—net assets (assets minus liabilities), capital stock, and surplus—and as if no operating data were revealed. In so far as subsidiaries and holding companies do make up a single business unit, details regarding assets and liabilities, revenues and expenses, and distribution of income are important considerations in any critical analysis of financial position and progress. Roughly there are three methods of presenting this sort of information.¹

1. The legal financial statements of all subsidiaries may be given.
2. Summaries of the assets and liabilities and of the operating data of subsidiaries may be included.
3. Consolidated financial statements may be prepared.

The first method is seldom followed when subsidiaries are numerous.² When it is used, the intercompany balances should be carefully designated. The disadvantage of the method to the stockholder of the holding company lies in the difficulties of

¹ The tabulation is that given by Gilbert Garnsey, *Holding Companies and Their Published Accounts* (London, 1923), pp. 13-14, except that Garnsey does not mention in "2" the summaries of operating data.

² For examples, however, see the annual reports of American Power & Light Company, Eastern Utilities Associates, Public Service Corporation of New Jersey, and Standard Gas and Electric Company. See also report of Midland Utilities Company, which gives a columnar summary of subsidiaries' balance sheets and income sheets.

interpreting as a whole a number of subsidiary company financial statements together with the holding company statements. Alone, this method would be somewhat similar to offering a trial balance in lieu of a balance sheet and income sheet. As information supplementary to consolidated statements, or to consolidated statements and parent company statements together, there is much to be said for the practice, particularly if there are large minority stock holdings and substantial bond issues among the subsidiaries.¹

Presenting summaries of the assets and liabilities of subsidiaries and of their income statements is also seldom followed in practice. Variations of this method are occasionally found in published annual reports. In one case schedules of the plant assets of the principal subsidiaries are shown.² In another case the asset item "net assets of retail dry goods stores wholly owned (no goodwill or other tangible assets included) brought down from above" is preceded by a tabulation of the combined tangible assets and liabilities of subsidiaries and a list of the holding company investments in subsidiaries by companies.³ It is a custom of some of the utilities to present the consolidated income sheet in two sections, the first of which gives the combined operating data of subsidiaries and ends with the balance of income applicable to the parent corporation.⁴ This method is especially suitable for the consolidated income sheet of a holding company exclusively.

The third method, that of consolidated financial statements, is the custom in the United States. In fact the presentation of consolidated statements alone is the rule. Only among the electric power utilities is there any tendency to give the legal balance sheet of the parent company as well.

Two viewpoints in consolidated statements. There seem to be two ways of looking at consolidated financial statements

¹ The five companies mentioned in note (2) above present the subsidiaries' financial statements in addition to a set of parent company statements and a set of consolidated statements.

² Annual report of Midland Utilities Company (1931).

³ Annual report of Associated Dry Goods Corporation (1928).

⁴ See, for example, income sheets of Electric Power & Light Corporation (1930) and The United Light and Power Company (1930).

in general, which writers do not mention, but which nevertheless affect the attitude that is to be taken toward the questions of when to consolidate, how to handle certain problems, and how to present the statements themselves. For want of better names these views are here termed the "combined" viewpoint and the "holding company" or "majority interest" viewpoint. They are similar to the corporation view and the proprietary (stockholders') view as concerns a single corporation. These two viewpoints will be mentioned from time to time in the following pages as they affect the particular point under discussion.

When to consolidate. Practice varies greatly in respect to what companies are consolidated. Some corporations consolidate only wholly owned subsidiaries.¹ In Chapter 7 examples were cited of companies which apply a set percentage of ownership. The following paragraph from the 1931 annual report of Standard Oil Company (New Jersey) is also interesting in this connection:

The appended balance sheet and income account consolidate all subsidiaries and subsidiaries of subsidiaries where the ownership is 50 per cent or more, except in a few instances where the ownership is so divided as to make consolidation impracticable and where, in any case, the consolidated net value or the consolidated earnings would not be materially affected.

In such cases the factor determining whether a subsidiary is to be consolidated or not is the degree of effective control or of ownership.

Another important consideration is nature of the business. Subsidiaries engaged in lines different from that of the majority of corporations in the group may be omitted from the consolidation, regardless of degree of ownership by the holding company.² It is common to find consolidated statements in which

¹ See, for example, balance sheets of Freeport Texas Company (December 31, 1931), Air Reduction Company, Inc. (December 31, 1931), and American Car and Foundry Company (April 30, 1931), and annual report of Eastman Kodak Company (13 months ending December 26, 1931).

² For example, in the only consolidated statement published by American Telephone and Telegraph Company, that of the "Bell System," the investments in Bell Telephone Laboratories, Inc., Western Electric Company, Bell Telephone Securities Company, and 195 Broadway Corporation are not consolidated, though

real estate subsidiaries or foreign subsidiaries are excluded.¹

Limitations of consolidated statements. Consolidated balance sheets inadequately disclose the position of creditors. Further, the consolidated balance sheet may be unsatisfactory evidence of available surplus for dividend purposes. Earnings of subsidiaries become available for distribution to stockholders of the parent company only as actually received in the form of interest or dividends. Another weakness is that consolidated statements, as now prepared, give no indication as to which subsidiaries are profitable and which ones are operating at a loss. Finally, statistical analysis should be applied to consolidated statements with special care. In the first place the underlying individual figures may not be comparable. Second, it must be recognized that ratios based on consolidated statements are of necessity averages.

In short, it can be said that the device of consolidated financial statements, in its present stage of development, does not constitute a substitute for the legal financial statements of holding companies and their subsidiaries. Creditors and shareholders alike of a parent company cannot obtain all the information they are interested in from a set of consolidated financial statements. Consolidated statements are, however, the best means yet devised of presenting a bird's-eye view of a group of individual corporations operated as a single enterprise.

the last two are 100 per cent owned and the first two over 98 per cent owned (Bell Telephone Laboratories, indirectly).

¹ See, for example, balance sheets of W. T. Grant Company (January 31, 1931), Swift & Company (October 31, 1931), National Cash Register Company (December 31, 1931), and United States Rubber Company (December 31, 1930).

CHAPTER 15

CONSOLIDATED STATEMENTS— SPECIFIC PROBLEMS

Surplus of subsidiary at acquisition. When a corporation acquires assets upon issue of its stock, the cost of such assets to the corporation measures the capital contribution of the new stockholders. The acquisition of a subsidiary's stock is similar, and thus the entire cost thereof should be credited on the holding company's books to capital. If the amount is in excess of the par or stated value of the holding company's stock the difference represents premium or paid-in surplus. This is the view of most accountants. Staub, for example, says:¹

Part of this difference may be represented by the surplus of the subsidiary at acquisition. . . . However, the surplus so resulting is in fact, capital surplus and must be shown separately and not merged with the consolidated surplus.

Conversely, on the grounds that a merger has been effected by the acquisition of a subsidiary, it is sometimes held that any earned surplus of the subsidiary at date of acquisition becomes earned surplus of the consolidated group.² This view overlooks the legal situation too greatly.

A few illustrations follow from published statements in which the surplus of subsidiaries at acquisition is shown either as earned surplus or as paid-in surplus. The latter method is not particularly objectionable, but there seems little to be gained by it.

As Surplus

Subsidiary companies' at dates acquired, less amounts accruing to minority interests (balance sheet of Electric Power & Light Corporation, December 31, 1930).

¹ W. A. Staub, "Some Difficulties Arising in Consolidated Financial Statements," *The Journal of Accountancy*, New York, January, 1932, p. 21.

² For a good exposition of this view, see Sunley and Pinkerton, *op. cit.*, pp. 490-499.

Earned surplus of subsidiary companies at date of acquisition (balance sheet of American Radiator & Standard Sanitary Corporation, December 31, 1930).

As Capital Surplus or Special Surplus

Surplus balance of present subsidiary companies as of dates of control (balance sheet of The Commonwealth & Southern Corporation, December 31, 1930).

Surplus on books of subsidiary companies at dates of acquisition thereof (balance sheet of Northern States Power Company, December 31, 1929).

The amount of the surplus at acquisition is important also in connection with the dividends of subsidiaries. A subsidiary may legally declare dividends from any earned surplus. When, however, dividends reduce its surplus below the amount at acquisition date, the parent company is not receiving income, but a return of investment.

Consolidated goodwill. In the event that the cost of a subsidiary's stock exceeds the book value of that stock on the subsidiary's books, it is customary to consider the excess as goodwill and to carry it on the consolidated balance sheet as such. It will represent true goodwill only if the assets of the subsidiary are shown as of the date of acquisition at replacement values. Among the other possibilities are:

1. Appreciation
2. Accretion
3. Cost to eliminate competition
4. Promoters' profits.

As a balancing item arising out of the preparation of the consolidated balance sheet, "consolidated goodwill" may thus represent one or a combination of things. Consequently, the preferable procedure is to display it separately in the consolidated balance sheet with a distinctive title. "Cost of capital stocks of subsidiaries in excess of net tangible assets acquired" has been observed.¹

¹ Balance sheet of United Biscuit Company of America (December 31, 1930). See also the item "premiums paid for capital stocks of consolidated subsidiary companies," balance sheet of Paramount Publix Corporation (December 26, 1931) and "premium on investments in subsidiaries," balance sheet of Air Reduction Company (December 31, 1922).

It is difficult to judge practice as regards consolidated goodwill from studying published statements, since the item is seldom revealed separately. The following quotations from annual reports indicate that in these instances the amount is included in the goodwill designation:

Several small ice businesses were acquired during the year and their purchase is reflected in the balance sheet, particularly in the increase of \$861,713 in the item of Good Will.¹

Goodwill represents the difference between the purchase price and book value of properties acquired.²

It is known that among the utilities, consolidated goodwill is often included in the plant assets as shown on the balance sheet. The following sentence is taken from an auditors' certificate:³

Subsequent additions have been accounted for at cost, and in the case of major acquisitions of new properties, include cost over appraisal value.

On the other hand, consolidated goodwill is often absorbed in consolidated surplus. This method is followed as a matter of course by those corporations which eliminate all intangibles from their balance sheets. A similar but preferable method is to show the amount as a deduction from consolidated surplus on the face of the balance sheet.⁴

Negative goodwill. When book value of the subsidiary's stock exceeds the cost thereof to the holding company, the balance arising from the consolidation is a credit. Like consolidated goodwill it is a balancing item, which is created by the consolidated statement device, and the same conclusion stated with respect to consolidated goodwill applies; namely, it should not be merged with other items in the consolidated balance sheet. The following method is suggested, assuming that both consolidated goodwill and negative goodwill arise in a single consolidation:

¹ Annual report of American Ice Company (1929).

² Annual report of General Motors Corporation (1931).

³ See annual report of Northern States Power Company (1929).

⁴ See the balance sheet of The Commonwealth & Southern Corporation (December 31, 1930).

Excess of cost over book value of subsidiaries' stocks.....
 Less excess of book value over cost of subsidiaries' stocks.....

Minority interests. According to the "combined" view, the minority interest is a proprietary interest, that is, part of the capital and surplus. According to the majority interest view, it is essentially a liability. A compromise view excludes the minority interest from capital stock and surplus on the consolidated balance sheet and lists it immediately preceding capital stock, but after the liabilities.

Since liabilities are rarely totaled in published balance sheets, it is generally impossible to tell whether the minority interest is considered as a liability or not when excluded from the proprietorship division.¹ The majority interest view is the more common, though among the utilities the minority interest is listed under capital stock and surplus in as many cases as not.² Since the consolidated statement is prepared primarily for the benefit of stockholders of the holding company, it is probably preferable to state capital stock and surplus applicable to their interests separately. Most frequently the entire minority interest is stated in one item, but when it consists in surplus as well as par or stated value of capital stock, it is desirable to list the two separately as in the following instance:³

Minority Interest:

Capital stock of subsidiary outstanding.....
 Surplus applicable thereto.....

A question arises regarding the treatment of the minority interest in the consolidated income sheet. Here again, the two views, the "combined" view and the majority interest view, may be differentiated, and there is an intermediate view. If the minority interest consists entirely of preferred stock, dividends declared thereon constitute the only deduction. If, however, there is minority common stock as well, the minority interest

¹ See, however, balance sheet of The Grand Union Company (January 2, 1932).

² Among 88 consolidated balance sheets indicating a minority interest it was shown as follows: Under capital stock and surplus—industrials, 6; utilities, 12. Excluded from capital stock and surplus—industrials, 60; utilities, 10.

³ Balance sheet of National Steel Corporation (December 31, 1930).

includes dividends on both preferred and common stock and, in addition, the proportionate share of subsidiaries' net income pertaining to the minority common stock.¹

Under the "combined" view, net income is that of the entire consolidated group, and the dividends to stockholders of the subsidiaries are deducted along with dividends to the holding company stockholders. The following is an illustration:²

Surplus before deducting dividends.....	xxx	
Dividends:		
On Pacific Gas and Electric Company capital stocks:		
Preferred.....	xxx	
Common.....	xxx	
On Subsidiary company capital stocks:		
Preferred.....	xxx	
Common.....	xxx	
Total.....	xxx	
Minority interest.....	xxx	
Total.....		xxx

An example of the majority interest viewpoint follows:³

Net revenue, including other income.....	xxx	
Less:		
Interest on funded debt.....	xxx	
Depreciation.....	xxx	
Amortization of discount and expenses.....	xxx	
Reserve for income taxes.....	xxx	
Dividends on preferred and minority common stocks of subsidiaries.....	xxx	
Minority interest in earnings of subsidiaries.....	xxx	xxx
Balance added to surplus.....		xxx

The intermediate view is illustrated in the following excerpt:⁴

¹ The minority interest is an addition, that is, a credit item, in case subsidiaries show a net loss. It is often held that the parent company should absorb in consolidated earnings and surplus all a subsidiary's loss, without adjustment for the minority interest. There is point to such a procedure after the book value of the minority holdings of common stock has been extinguished, but hardly before.

² Income sheet of Pacific Gas and Electric Company (1930).

³ From income sheet of International Paper and Power Company (1931).

⁴ From income sheet of Standard Brands Incorporated (1930).

Net income before deducting amount applicable to minority interest in preferred and common stocks of subsidiary companies.....	xxx
Less amount applicable to minority interest in preferred and common stocks of subsidiary company.....	xxx
Net income applicable to parent company.....	xxx

As in the case of displaying minority interest in the balance sheet, the intermediate view is probably to be preferred.¹ It is also desirable to classify the various deductions. Compare in this respect the first and third of the illustrations above.

When the minority interest includes cumulative preferred stock on which dividends are in arrears, the fact must be revealed in the consolidated balance sheet. Two methods may be followed. A portion of the combined surplus equivalent to such back dividends may be transferred from the consolidated surplus to the minority interest as shown on the consolidated balance sheet.² It is probably sufficient to indicate the fact in a footnote, however, without making the adjustment of consolidated surplus in the balance sheet proper.

A similar question arises when preferred stock of a subsidiary held by the public is redeemable at a premium. An extreme expression of the majority interest view shows the minority interest in such stock on the consolidated balance sheet at redemption value and the consolidated surplus reduced accordingly.³

Acquisition date. The date upon which the holding company gains a controlling interest in the subsidiary is the date of acquisition. The balance sheet of the subsidiary at this date is

¹ Among 64 cases in which a minority interest was shown in the income sheet or the surplus analysis, it was handled as follows: majority interest view, 29; intermediate view, 25; "combined" view, 10.

² For example, see balance sheet of The Davison Chemical Company (June 30, 1931).

³ See annual report of R. H. Macy & Co., Inc. (fiscal year ending January 31, 1931). The consolidated surplus analysis also carries an adjustment for a portion of the minority stock acquired by the parent company at less than redemption value. For a balance sheet showing parent company's preferred stock at redemption value, see balance sheet of Minneapolis-Moline Power Implement Company (December 31, 1930).

used for the determination of the book value of the subsidiary's stock acquired by the holding company.

When the stock is purchased in the open market, there is no question about the acquisition date, but it may not coincide with a balance-sheet date. In such a case it is not customary to carry through a formal closing of the books, but rather to determine the book value of the subsidiary's stock at acquisition date through using the balance sheet at the nearest date and adjusting it by prorating the earnings of the immediately preceding or following period. This is doubtless accurate enough if the subsidiary's books are closed monthly or even quarterly, but it is less satisfactory otherwise.

When the stock is acquired directly from the subsidiary's stockholders, the case is apt to be the reverse. That is, there will be a balance sheet at a stipulated acquisition date, but legal title to the stock may not pass until later. If the time between the actual acquisition and the stipulated date is negligible, the earnings or losses of the subsidiary in the interval may be ignored for practical reasons.¹

Income sheets for a period during which a subsidiary has been acquired may be presented in two ways. They may include the figures of the subsidiary for the entire period and deduct from net income that portion of the subsidiary's earnings prior to acquisition date, or they may include the figures of the subsidiary only since acquisition. The former method is expedient when the subsidiary's books were not closed at the date of acquisition, and it is often used in any event because it gives a better basis for comparisons. The following excerpt illustrates the method:²

Consolidated net income for the year, including income of
 subsidiary prior to date of acquisition _____
 Deduct—Income of subsidiary prior to date of acquisition _____

Treasury stock and treasury bonds. If any portion of a parent company's stock is held by a subsidiary, the situation is the same as regards the consolidated balance sheet as if the

¹ See Staub, *op. cit.*, pp. 22-23. The author implies that two months might be considered "negligible," but that three months or more could not be so viewed.

² From income sheet of Loose-Wiles Biscuit Company (1931).

parent company held some of its own stock. In this case the outstanding stock in terms of the majority interest does not correspond to the outstanding stock of the parent company. As would be expected, such consolidated treasury stock is found in published balance sheets both as an asset and as a deduction from capital stock.¹ Further, it may not be revealed at all in the consolidated balance sheet. In this event, it will be discovered only by a comparison of the parent company and the consolidated balance sheet.² Intercompany holdings of subsidiary stocks are of course eliminated in the consolidated working papers.

Intercompany holdings of bonds, whether of the parent company or of subsidiaries, should be treated as treasury bonds. This problem is no different from that which arises when a particular corporation possesses its own bonds, except that the adjustments are made in the consolidated working papers alone and not on any individual company's books. There is perhaps more to be said for treating intercompany bond holdings as assets than for handling a corporation's own treasury bonds in this fashion.

Intercompany sales. Intercompany sales are revenues to the selling company and costs to the purchasing company. The combined sales and purchases can be given in the consolidated statement, in which case elimination of intercompany sales is automatically taken care of in deducting operating expenses from revenues.³ A second method is to show both sales and cost of sales in the consolidated income sheet net of intercompany sales.⁴ On this point Kester says:⁵

A showing of the combined results without eliminations should be made when it is desired to show the entire volume of sales and to provide a true basis on which to judge earnings in comparison with sales effort and with the values invested by the various companies. . . .

¹ See the consolidated balance sheet of Midland Utilities Company (December 31, 1931) for the asset treatment, and of United States Rubber Company (December 31, 1930) for the contra treatment.

² See the annual report of Associated Gas and Electric Company (1931).

³ See the 1931 income sheet of Standard Oil Company (New Jersey).

⁴ See income sheets of American Radiator & Standard Sanitary Corporation (1930) and The Goodyear Tire & Rubber Company (1930).

⁵ Kester, *op. cit.*, Vol. II, p. 569.

Intercompany profits. Intercompany profits are automatically cancelled in the preparation of the consolidated income sheet to the extent that the profits of the selling company become the expenses of the purchasing company. It is only that portion of intercompany profits which has been capitalized, that is, which is comprised in assets of the combined group, that becomes the object of adjustment to eliminate intercompany profits. The problem arises in the following ways:

1. Intercompany sales of merchandise or service
2. Intercompany sales of plant and investments
3. Intercompany fees.

The first situation gives rise to the problem of intercompany profits in inventories. Intercompany profit to be eliminated is deducted from inventories on the consolidated balance sheet.¹

If fixed assets are transferred from one corporation in a consolidated group to another at higher than their cost or net book value, an element of intercompany profit arises. Theoretically, this necessitates eliminating the amount from the assets shown on the consolidated balance sheet and, if the asset is depreciable, thereafter periodically adjusting the depreciation expense of the purchasing subsidiary. It is doubtful whether in practice such problems often arise, and when they do the problem of unrealized intercompany profit is likely to be ignored. In the utilities, subsidiary companies are often realigned, and what amounts to an unrealized profit or appreciation from the viewpoint of the combined group arises.²

The third item of unrealized profit noted above is not uncommon in public utility holding companies. For the consolidated statements, such items balance out in so far as the income from fees is reported as expense of a subsidiary. They may, however, be at least in part capitalized. Engineering and construction fees are a case in point.

¹ See balance sheet of United States Steel Corporation (December 31, 1930).

² See for example the treatment of such a profit in the consolidated balance sheet of International Paper and Power Company (December 31, 1931). The balance sheet reflects "the addition to reserves to property account of \$11,450,207.28 representing excess of the price at which water power properties were transferred to subsidiaries of International Hydro-Electric System over the former book value thereof."

Such unusual items as described in the last two paragraphs deserve separate recognition in financial statements. Several examples follow:

1. Profit on sale of securities to affiliated companies (consolidated surplus item, Southwestern Gas and Electric Company, 1931).
2. Addition to surplus from intercompany sale of Public Service Coordinated Transport electric power plants and properties (consolidated balance sheet of Public Service Corporation of New Jersey, December 31, 1930).
3. Interest and dividends on outside investments, miscellaneous reserves, and profits of approximately \$1,385,000 on engineering and other construction services rendered to subsidiary companies (consolidated income sheet of The Commonwealth & Southern Corporation, December 31, 1930).

APPENDIX A
OUTLINE FORMS OF BALANCE SHEET
AND INCOME SHEET

It would be difficult to present outline statements illustrating every possible item. The statement forms given below are intended to be only suggestive in this respect. Moreover, in many instances the designations used would be unsatisfactory for an actual statement. Finally, actual statements may employ more or less detail depending upon circumstances. Thus, the forms illustrated are not models in themselves. They are, however, exemplary of sound principles of arrangement and presentation, and it is believed that they can readily be adapted to specific uses. The degree of adaptation necessary is of course greater in respect to the income sheet than the balance sheet. The treatment of most doubtful and moot points is indicated in the forms or the accompanying notes. However, the reader is urged to consider the forms as supplementary to the text rather than as complete in themselves, and consequently to refer to the discussion before passing judgment on the treatment of individual items.

THE BLANK CORPORATION
CONSOLIDATED BALANCE SHEET

December 31, 19—

Current Assets:	<i>Assets</i>		
Cash and Current Funds—			
Cash on hand and in banks.....		XXX	
Temporary investments (market value \$_____)		XXX	XXX
Receivables—			
Notes receivable—trade.....	XXX		
Accounts receivable—trade.....	XXX	XXX	
Less allowance for uncollectible items.....		XXX	XXX
Advances to officers and employees ¹			XXX
Other current receivables ¹			XXX
Inventories—			
Finished goods (at cost) ²		XXX	
Work in process (at cost) ³		XXX	
Raw materials (at cost) ³		XXX	
Supplies (at cost) ³		XXX	
Salvage value of damaged and obsolete inventory.....		XXX	XXX
Prepayments— ⁴			
Prepaid insurance, rent, taxes, wages, licenses, and dues....			XXX
Total current assets.....			XXX
Fixed Assets:			
Long-Term Receivables—			
Mortgages (good).....			XXX
Other loans (good).....			XXX
Installment accounts receivable.....	XXX		
Less unrealized income ⁵	XXX	XXX	XXX
Long-Term Investments—			
Bonds (at adjusted cost, ⁶ market value \$_____)			XXX
Investments in and advances to affiliated companies not consolidated ⁷			XXX
Holdings in other companies (at cost).....			XXX
Cash surrender value of life insurance.....			XXX
Sinking funds.....			XXX
Plant (at cost)—			
		Depl. or	
		Depr.	Net
Land.....			XXX
Natural resources.....	XXX	XXX	XXX
Buildings.....	XXX	XXX	XXX
Machinery and equipment.....	XXX	XXX	XXX
Automobiles and other vehicles.....	XXX	XXX	XXX
Leasehold improvements.....	XXX	XXX	XXX
Tools, dies, and patterns.....			XXX
Liquidation value of abandoned plant and equipment.....			XXX
Intangibles—			
Organization costs.....			XXX
Stock issue costs.....			XXX
Unamortized bond expense.....			XXX
Unamortized cost of			
patents, trade-marks, and copyrights.....			XXX
Unamortized development costs.....			XXX
Goodwill (unamortized cost to holding or subsidiary companies).....			XXX
Excess of book value of subsidiaries' stocks over cost.....	XXX		
Less excess of cost of subsidiaries' stocks over book value.....		XXX	XXX
Total assets.....			XXX

¹ If this item is not shown at realizable value, an appropriate allowance should be deducted.

² Estimated realizable cash value in the ordinary course of business operations should be indicated, if lower than cost.

³ When estimated replacement value is below cost, such value should be noted; when above cost, such value may be noted.

⁴ Supplies may be listed here rather than under "inventories."

⁵ See discussion in text, p. 102. If installment accounts are current, they should of course be so shown.

⁶ "Adjusted cost" means plus (or minus) accumulation of discount (or amortization of premium).

⁷ This item should be accompanied by a footnote giving estimated market value or indicated book value of equity on the issuing companies' books.

CORPORATION FINANCIAL STATEMENTS 121

Equities

Current Liabilities:			
Notes payable to banks.....		xxx	
Notes payable—other.....		xxx	
Trade accounts payable.....		xxx	
Advances from customers and deposits.....		xxx	
Dividends payable.....		xxx	
Purchase money obligations due following year ⁸		xxx	
Accrued taxes, interest, wages, and other expenses.....		xxx	
Provision for income taxes.....		<u>xxx</u>	xxx
Deferred revenue or income.....			<u>xxx</u>
Total current liabilities.....			xxx
Fixed Liabilities:			
Bonds of subsidiaries—par ⁸	xxx		
Less held in treasury and sinking funds.....	<u>xxx</u>	xxx	
Less unaccumulated discount.....		<u>xxx</u>	xxx
Bonds of the Blank Corporation—par ⁹		xxx	
Plus unamortized premium.....		<u>xxx</u>	xxx
Bonds of the Blank Corporation due following year ¹⁰ ..		xxx	
Purchase money obligations.....		xxx	
Reserves for employee pensions and other benefits ¹¹ ..		<u>xxx</u>	xxx
Total liabilities.....			<u>xxx</u>
Minority Interest:			
Preferred stock of White Company outstanding (____ shares at par).....			xxx
Common stock of Green Company outstanding (____ shares, paid-in value).....		xxx	
Equity of above shares in surplus of Green Company and its subsidiaries.....	<u>xxx</u>	<u>xxx</u>	xxx
Capital and Surplus of the Blank Corporation:			
7% cumulative preferred stock—authorized 10,000 shares; issued and outstanding, 8,000 shares at \$100 par value ¹²			xxx
Common stock of no par value—authorized 100,000 shares, issued 80,000 shares at paid-in value.....		xxx	
Less 5,000 shares reacquired and held in treasury ^A		<u>xxx</u>	
Common shares outstanding at paid-in value.....		xxx	
Amount paid in on subscriptions to 10,000 shares of common stock ¹³		xxx	
Paid-in and other capital surplus.....		<u>xxx</u>	xxx
	Subsid- Blank iaries Corp.		
Reserves for self insurance.....	xxx	xxx	xxx
Reserves for retirement of preferred stock.....	xxx	xxx	
Surplus appropriated for additions to plant.....	xxx	xxx	xxx
Reserves for contingencies.....	xxx	xxx	xxx
Surplus.....	xxx	xxx	<u>xxx</u>
Total capital and surplus of the Blank Corporation ^B			<u>xxx</u>
Total equities.....			<u>xxx</u>

^A Pending legal retirement or reissue of treasury stock, surplus in an equivalent amount is unavailable for dividend purposes.

^B The Blank Corporation is contingently liable for notes receivable discounted of \$_____.

⁸ Represents currently due portion of serial long-term obligation to be paid from current funds. See discussion in text, p. 99.

⁹ Details regarding company of issue, due dates, rate of interest, and so on should be given, in a separate schedule if considerable.

¹⁰ Assuming that the funds for payment are excluded from current assets. A note giving this information should accompany the item. See text, p. 99.

¹¹ Assuming a contractual nature of the pension or other agreement. See text, p. 91.

¹² If there are dividends in arrears, the amount should be noted.

¹³ Assuming payments on stock subscriptions are not returnable. See discussion of stock subscriptions in text, p. 96.

THE BLANK CORPORATION
CONSOLIDATED INCOME SHEET
For the Year 19—

I ¹	Sales ²			XXX
	Less: Returns and allowances.....	XXX		XXX
	Sales discounts.....	XXX	XXX	
	Net sales.....			XXX
	Deduct: Sales tax.....			XXX
	Balance.....			XXX
II	Production (or merchandise) cost of product sold ³			XXX
	Margin on sales.....			XXX
	Selling and general operating expense ³			XXX
	Operating income.....			XXX
III	Add: Net income of minor activities ⁴	XXX		
	Other net income ⁴	XXX		
	Total.....	XXX		
	Deduct: Non-operating charges ⁵	XXX	XXX	
	Total net income.....			XXX
IV	Interest on current obligations.....	XXX		
	Interest on bonds and other fixed liabilities.....	XXX		
	Add: Accumulation of bond discount.....	XXX		
	Amortization of bond expense.....	XXX	XXX	XXX
	Net income before income taxes.....			XXX
	Provision for income taxes.....			XXX
	Net income.....			XXX
	Amortization of goodwill.....			XXX
	Balance of net income.....			XXX
	Minority interest:			
	Dividends on subsidiaries' preferred stock.....	XXX		
	Dividends on subsidiaries' common stock.....	XXX		
	Equity in net income retained.....	XXX	XXX	
	Consolidated net income (applicable to the Blank Corporation) ⁶			XXX
	Dividends on preferred stock.....			XXX
	Net income for common stock.....			XXX
	Dividends on common stock.....			XXX
	Income retained in the business.....			XXX
	Appropriations to surplus reserves ⁷	XXX		
	Extraordinary deductions (or additions) ⁸	XXX	XXX	
	Addition to surplus.....			XXX
V	Surplus balance, January 1, 19.....	XXX		
	Deduction arising from correction of opening inventories ⁹	XXX	XXX	
	Total surplus.....			XXX
	Stock dividends.....			XXX
	Surplus balance, December 31, 19.....			XXX

¹ Roman numerals are not part of the statement. They are included in order to identify the underlying divisions of the income sheet as described in the text, pp. 14-17.

² After elimination of intercompany sales. See discussion in text, p. 115.

³ Some note should be made of the amount of depreciation charges, which ought to be included as operating deductions in their entirety, with the possible exception of any amount included in a special non-operating charge for expense of idle capacity. Use of a note or footnote or segregation of the amount of depreciation in the statement proper are possible methods.

⁴ If it is impracticable to show certain items net of expense, they may be added to "margin on sales."

⁵ Deduction of inventory write-downs and idle capacity expense are examples of items to be included here.

⁶ A footnote may refer to the share in net income of subsidiaries not consolidated.

⁷ Itemized and described. It is desirable at this point to bring in amounts of special losses charged to reserves. See text, p. 79.

⁸ Adjustments from corrections of depreciation rates should also be included here. See text, p. 78.

APPENDIX B
CATALOGUE OF COMPANIES

Annual Reports of Corporations—Industrials

Advance-Rumely Corporation
Air Reduction Company, Inc.
Allied Chemical & Dye Corporation
Allis-Chalmers Manufacturing Company
Amalgamated Leather Companies
American Agricultural Chemical Company
American Bank Note Company
American Brake Shoe and Foundry Company
American Can Company
American Car and Foundry Company
American Chicle Company
American Cyanamid Company
American Encaustic Tiling Company, Ltd.
American Hide and Leather Company
American Ice Company
American Locomotive Company
American Machine & Foundry Company
American Multigraph Company
American Radiator & Standard Sanitary Corporation
American Safety Razor Corporation
American Seating Company
American Smelting and Refining Company
American Steel Foundries
American Sugar Refining Company
American Tobacco Company
American Zinc, Lead and Smelting Company
Anaconda Copper Mining Company
Armour and Company
Arnold, Constable Corporation
Art Metal Construction Company
Artloom Corporation
Associated Dry Goods Corporation
Atlantic Refining Company

Baldwin Locomotive Works
L. Bamberger & Co.
Beech-Nut Packing Company
Belding Heminway Company
Best & Company
Bethlehem Steel Corporation
Bloomingdale Bros., Inc.
Bohn Aluminum and Brass Corporation
Bon Ami Company, The
Borden Company, The
Borg-Warner Corporation
Briggs Manufacturing Company
Brown Fence & Wire Company
Brown Shoe Company, Inc.
Bucyrus-Erie Company
Burns Bros.
Burroughs Adding Machine Company

California Packing Corporation
Calumet and Arizona Mining Company
Calumet and Hecla Consolidated Copper Company
Canada Dry Ginger Ale, Incorporated
J. I. Case Company
Celanese Corporation of America
Celotex Company, The
Central Alloy Steel Corporation
Cerro de Pasco Copper Corporation
Certain-teed Products Company
Chicago Pneumatic Tool Company
Chrysler Corporation
Cluett, Peabody & Co., Inc.
Commercial Solvents Corporation
Congoleum-Nairn Inc.
Congress Cigar Company
Consolidated Cigar Corporation
Consolidated Oil Corporation
Consolidation Coal Company, The
Continental Baking Corporation
Continental Motors Corporation
Continental Oil Company
Corn Products Refining Company
Coty, Inc.

Crowley, Milner & Company
Crucible Steel Company of America
Cuban Cane Products Co., Inc.
Cudahy Packing Company
Cutler-Hammer, Inc.

Davison Chemical Company, The
Alfred Decker & Cohn, Inc.
Deere & Company
Devoe & Reynolds Co., Inc.
Diamond Match Company
Dictaphone Corporation
Drug Incorporated
E. I. du Pont de Nemours & Company

Eastman Kodak Company
Eaton Axle & Spring Company, The
Elk Horn Coal Corporation
Endicott Johnson Corporation
Eureka Vacuum Cleaner Company

Fairbanks, Morse & Company
Firestone Tire & Rubber Company
First National Stores, Inc.
Fisk Rubber Company
Ford Motor Company of Canada
Foundation Company, The
Fox Film Corporation
Freeport Texas Company

General American Tank Car Corporation
General Asphalt Company
General Cigar Company
General Electric Company
General Fireproofing Company
General Foods Corporation
General Motors Corporation
General Railway Signal Company
Gimbel Bros., Inc.
Glidden Company, The
B. F. Goodrich Company, The

Goodyear Tire & Rubber Company, The
Gotham Silk Hosiery Co., Inc.
Granby Consolidated Mining, Smelting and
Power Company, Limited, The
Grand Union Company, The
W. T. Grant Company
Great Western Sugar Company
Greene Cananea Copper Company
Gulf Oil Corporation of Pennsylvania

Hartman Corporation, The
Hart Schaffner & Marx
Houston Oil Company of Texas
Hudson Motor Car Company
Humble Oil & Refining Company
Hupp Motor Car Company

Indian Refining Company
Ingersoll-Rand Company
Inland Steel Company
Inspiration Consolidated Copper Company
International Business Machines Corporation
International Cement Corporation
International Combustion Engineering Corporation
International Harvester Company
International Paper and Power Company
International Salt Company
International Silver Company
International Shoe Company
Island Creek Coal Company

Jewel Tea Co., Inc.

Julius Kayser & Co.
Kelsey-Hayes Wheel Corporation
Kennecott Copper Corporation
G. R. Kinney Co., Inc.
S. S. Kresge Company
Kroger Grocery & Baking Company, The
B. Kuppenheimer & Co., Inc.

Laguna Land and Water Company
Lambert Company, The
Lehn & Fink Products Company
Liggett & Myers Tobacco Company
Liquid Carbonic Corporation, The
Loew's Incorporated
Loose-Wiles Biscuit Company

R. H. Macy & Co., Inc.
Magma Copper Company
H. R. Mallinson & Co., Inc.
Marlin-Rockwell Corporation
Marmon Motor Car Company
Mathieson Alkali Works (Inc.), The
May Department Stores Company, The
Maytag Company, The
McCrorry Stores Corporation
Melville Shoe Corporation
Miami Copper Company
Midland Steel Products Company
Miller Rubber Company, The
Minneapolis-Moline Power Implement Company
Motor Wheel Corporation
Mullins Manufacturing Corporation
Munsingwear, Inc.

Nash Motors Company, The
National Biscuit Company
National Cash Register Company, The
National Dairy Products Corporation
National Department Stores, Inc.
National Fireproofing Corporation
National Steel Corporation
National Tea Co.
Newmont Mining Corporation
New York Air Brake Company, The

Oppenheim, Collins & Co., Inc.
Otis Elevator Company
Otis Steel Company, The

Packard Motor Company
Paramount Publix Corporation
Parke, Davis & Company
Pathé Exchange, Inc.
Penick & Ford, Ltd., Incorporated
J. C. Penney Company
Pennsylvania Coal and Coke Corporation
Phillips Petroleum Company
Phoenix Hosiery Company
Pillsbury Flour Mills, Incorporated
Pittsburgh Coal Company
Pittsburgh Plate Glass Company
Pittsburgh Steel Foundry Corporation
Pond Creek Pocahontas Company
Porto Rican American Tobacco Company
Postum Company, Incorporated
Pro-phy-lac-tic Brush Co.
Punta Alegre Sugar Company

Quaker Oats Company, The
Quincy Mining Company

Real Silk Hosiery Mills, Incorporated
Remington Rand Inc.
Reo Motor Car Company
Republic Steel Corporation
R. J. Reynolds Tobacco Company
Richmond Radiator Company
Ross Gear & Tool Company
Royal Typewriter Company, Inc.

Safeway Stores, Incorporated
Schulte Retail Stores Corporation
Sears, Roebuck and Co.
Seiberling Rubber Company
Frank G. Shattuck Company
Shell Union Oil Corporation
Shubert Theatre Corporation
Simmons Company
Sloss-Sheffield Steel and Iron Company
Socony-Vacuum Corporation
Spicer Manufacturing Corporation

Standard Brands Incorporated
Standard Oil Company of California
Standard Oil Company (New Jersey)
Stewart-Warner Corporation
Stromberg Carburetor Company of America, Inc.
Studebaker Corporation, The
Swift & Company

Telautograph Corporation
Texas Corporation, The
Texas Gulf Sulphur Company
Thompson Aeronautical Corporation
Tobacco Products Corporation
Transue & Williams Steel Forging Corporation
Trico Products Corporation

Underwood Elliott Fisher Company
Union Carbide and Carbon Corporation
United American Bosch Corporation
United Biscuit Company of America
United Cigar Stores Company of America
United Electric Coal Companies, The
U. S. Industrial Alcohol Company
United States Rubber Company
United States Steel Corporation

Vadco Sales Corporation
Victor Talking Machine Company
Virginia-Carolina Chemical Corporation

Westinghouse Electric & Manufacturing Co.
Wheeling Steel Corporation
White Sewing Machine Corporation
Williams Oil-O-Matic Heating Corporation
Willys-Overland Company, The
Wilson & Co., Inc.
F. W. Woolworth Co.

Yale & Towne Manufacturing Company, The
L. A. Young Spring and Wire Corporation

Annual Reports of Corporations—Utilities

American Power & Light Company
American Telephone and Telegraph Company
Associated Gas and Electric Company

Central Maine Power Company
Cities Service Company
Commonwealth & Southern Corporation, The
Commonwealth Edison Company
Connecticut Electric Service Company, The
Consolidated Gas Company of New York
Consolidated Gas Electric Light and
Power Company of Baltimore
Consumers Power Company

Detroit Edison Company, The

Eastern Utilities Associates
Edison Electric Illuminating Company
of Boston, The
Electric Bond and Share Company
Electric Power & Light Corporation

International Hydro-Electric System

Memphis Power & Light Company
Midland Utilities Company
Montana Power Company, The

North American Company
North American Edison Company
Northern States Power Company

Oklahoma Gas and Electric Company

Pacific Gas and Electric Company
Peoples Gas Light and Coke Company, The
Public Service Corporation of New Jersey
Puget Sound Power & Light Company

San Antonio Public Service Company
South Carolina Power Company

Southern California Edison Company, Ltd.
Southwestern Gas and Electric Company
Standard Gas and Electric Company

Toledo Edison Company, The

Union Electric Light and Power Company
United Light and Power Company, The
Utah Power & Light Company

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