ACCOUNTING, REPORTS TO STOCKHOLDERS, AND THE SEC

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I.

THIS is an exploratory essay only. Two jobs are attempted—both focused upon the adequacy and reliability of corporate accounting reports to stockholders. The first is to indicate a serious gap in the regulation of accounting reports to stockholders under the Securities Exchange Act and the extent of that gap as it is reflected in seventy corporate balance sheets and income statements for 1937. The second problem is of broader scope. An attempt is made to point out some of the limitations inherent in the nature of the accounting materials given to investors which may make “truth-in securities”, “full disclosure”—current catchwords—somewhat deceptive phrases, and to discuss the categories and classifications upon which the accountant rears an apparently precise and certain structure. A vigorous legal literature in the past two or three decades has made lawyers aware of the very general nature of many legal categories or rules, and the necessity for and the fact of their varying nature in changing environments. As the writers read and interpret recent accounting literature, a similar development has not yet taken place in that field. Many of the accountant’s most important categories—“income”, “cost”, “fixed assets”—and the criteria used in allocating particular items into one category or another—“extraordinary”, “maintain”, “current”—are as broad and permit as much discretion as legal rules. But one can find only occasional appreciation of this fact in an accounting literature largely preoccupied with existing techniques and repolishing of definitions.

This essay undertakes to break some additional ground in the inevitably forthcoming critical analysis of accounting categories and accounting

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The views set forth herein were developed by the writers as Sterling Fellows at the Yale Law School and are not to be taken as indicating the views of the Securities and Exchange Commission or members of its staff other than the writers.

conceptualism.¹ Little excuse is needed for undertaking this task. The Transamerica, Associated Gas and Electric, and Missouri Pacific Railroad delisting proceedings, and the McKesson-Robbins auditing investigation indicate that, to a considerable extent, the fight for protection of the interests of investors and public regulation of corporate enterprise has shifted to the accounting front.²

Despite the Securities Act and the Securities Exchange Act, corporate reports to stockholders remain unregulated to any effective degree.³ The Securities Act does not embrace securities already issued, or subsequent dealings in securities issued in compliance with its provisions. The original scope of the Act did not contemplate periodical supplemental reports after the securities were already in the hands of the public.⁴ Obviously, information supplied in a prospectus for the new issues becomes misleading and unreliable in a relatively short time.

To remedy these apparent deficiencies, among others, the Securities Exchange Act of 1934 was enacted.⁵ The objectives of the Act, in this respect, as later expressed by the Commission, were:

" . . . to make available to the average investor honest and reliable information sufficiently complete to acquaint him with the current business condition of the company, the securities of which he may desire to buy or sell."⁶

1. Hamilton and Till, *The Cost Formula for Price* (March 1, 1935) N.R.A., CONSUMERS DIVISION, REP. NO. 9, partially reprinted as *Cost as a Standard for Price* (1937) 4 LAW & CONTEMP. PROB. 321, is, undoubtedly, the outstanding piece of critical writing on accounting. BONBRIGHT, *VALUATION OF PROPERTY* (1937) contains many passages subjecting accounting to the functional approach. Of professional accountants, George O. May, senior partner of Price, Waterhouse & Company, seems most aware of the purposive nature of his techniques. See his DICKINSON FOUNDATION LECTURES, HARVARD GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, reprinted in (1937) 63 J. OF ACCTY. 333 and *Eating Peas with Your Knife* (1937) 63 J. OF ACCTY. 15.

2. In the Matters of: Missouri Pacific Railroad Company (Feb. 15, 1938) Sec. Exch. Act Release No. 1586; Transamerica Corporation (Nov. 25, 1938) Sec. Exch. Act Release No. 1950; Associated Gas and Electric Company (Jan. 13, 1939) Sec. Exch. Act Release No. 1985; McKesson & Robbins, Inc. (Dec. 30, 1938) Sec. Exch. Act Release No. 1975.

3. Some state corporation statutes contain accounting and reporting requirements. See the study by American Institute of Accountants of several state incorporation laws, cited in Payne, *The Effect of Recent Laws on Accountancy* (1935) 10 ACCOUNTING REV. 84, 87 *et seq.*

4. Section 15(d) of the Exchange Act, as amended in 1936, requires, under certain conditions, an undertaking by the issuer of new securities under the Securities Act, to file the supplemental and periodic information required of persons with securities listed and registered upon a national securities exchange.

5. See, generally, Hanna, *The Securities Exchange Act as Supplementary of the Securities Act* (1937) 4 LAW & CONTEMP. PROB. 256-68.

6. SECURITIES AND EXCHANGE COMMISSION, SECOND ANNUAL REPORT (1936) 2.

In Congress, the publicity features of the Exchange Act were particularly emphasized, and apparently the Act was regarded as providing sanctions which would result in the disclosure of corporate information to investors, existing and prospective, in securities already in the hands of the public and thus beyond the reach of the Securities Act.⁷

Unfortunately, the Exchange Act does not require that corporations follow Commission standards in their annual reports to stockholders.⁸ The Act applies only to corporations with securities listed on national securities exchanges and requires such corporations to file with the Commission and with the exchange annual reports which comply with the standards imposed by the Commission and the exchange.⁹

Reports filed with the Commission, except where regarded as confidential, are available in Washington to the public either by personal examination¹⁰ or by paying the cost of duplication.¹¹ Except as to an institutional or other substantial investor, who before the Exchange Act often managed to get the information anyway,¹² such cost is likely to be prohibitive and the effort to obtain it is so great that only the most self-conscious investor will bestir himself. Under a rule of the Commission, the national securities exchanges are required to keep the registration statements and periodic reports of issuers open for public inspection.¹³ This rule enables investors and investment analysts in cities where the exchanges are located to secure the information by examination. These are the only *official* sources and sanctions by which corporate information is made available to the investing public. In other non-official ways, perhaps a fairly large quantity of general information manages to trickle down into investor's hands. In instances where the Commission summarizes the reports in a press release, the financial sections of the daily or financial newspapers may publish the summary in a digested form.¹⁴ More important, a large percentage of investors rely upon the

7. H. R. REP. NO. 1383, 73d Cong. 2d Sess. (1934) 11-13.

8. Sections 14 and 6, governing the solicitation of proxies and registered exchanges, respectively, provide a possible statutory basis for the promulgation of rules regulating the form and content of corporate reports to stockholders.

9. See § 13(a) of the SECURITIES EXCHANGE ACT OF 1934.

10. SECURITIES EXCHANGE ACT OF 1934, § 24(b).

11. "10 cents per photostatic copy of each page, for all copies up to and including 100 in a single order; 7 cents per photostatic copy of each page, for all copies over 100 in a single order." Securities Act Regulations, Rule 121(a).

12. The FOURTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION for the fiscal year ended June 30, 1938, states that approximately 24,000 members of the public visited the Washington, New York, and Chicago Public Reference Rooms of the Commission "seeking registered public information, forms, releases, and other material". The Commission filled more than 3,500 orders for photocopies of material. Pp. 93-94.

13. Exchange Act Regulations, Rule X-24B-3.

14. Even this as a practical matter is of little use to the investor, since it is too summary an account—being a digest of a digest—and also, since most people discard their daily papers, it is unavailable when the investor wants it.

advice of investment services who presumably scrutinize and evaluate these reports with care. And perhaps more important still, brokers, large scale and institutional investors do obtain the information filed, and their judgment on the value of the security, presumably reflected in its market price, affords the ordinary investor some protection.

Thus reports to stockholders, unsupervised under the present rules of the Commission, remain the stockholder's most important source of corporate information.¹⁵ A study of balance sheets and income statements appearing in the 1930 and 1937 published reports of seventy large corporations, herein presented, indicates that, despite a marked improvement since 1930, such reports fall considerably below the accounting standards which the same corporation is required to meet in its reports to the SEC and to the exchange on which its securities are registered.¹⁶ The results

15. Non-voting investors in the business—bondholders, non-voting preferred, etc.—by a strange convention are not considered to be entitled to a yearly accounting from the custodians of their funds. Reports to stockholders, usually available on request without charge, or newspaper or financial chronicle digests of and comments on that report, are probably the non-voting investors' principal source of information.

16. The method followed in making the study was to select items in income statements and balance sheets which accounting authorities, investment analysts, and the Commission in its forms and regulations under both the Securities Act and the Exchange Act, regard as significant in reflecting the corporation's business condition and progress, and to note the number of corporations in 1930 as compared with 1937 which furnished information in regard to each item. While this method does not present a complete picture of the extent of the information supplied by any specific corporation, it does indicate in a general way what the 70 corporations chose to reveal in regard to specific items. The aggregation of these items and the number of corporations disclosing each, reflect, it is believed, in a rough measure, the extent of the financial information given to stockholders in the years selected. 1930—prior to the Securities Act—was selected rather arbitrarily as the year with which to contrast 1937. The 70 corporations, chosen because of their national scope and because their financial statements were available in the Yale University Library, are believed to represent a rather fair sampling of the 500 or 600 largest non-utility, non-railroad corporations in the United States. Presumably the larger corporations furnish more information to stockholders than smaller ones. If this assumption is true, this study is weighted toward greater disclosure.

The following is a list of the corporations studied: National Biscuit Co.; Quaker Oats Company; American Sugar Refining Co.; Holly Sugar Corporation; Liggett & Myers Tobacco Co.; R. J. Reynolds Tobacco Co.; Firestone Tire & Rubber Co.; United States Rubber Co.; International Salt Co.; Armour & Co. (Illinois); J. I. Case Co.; Deere and Co.; International Harvester Co.; Allegheny Steel Co.; Bethlehem Steel Corp.; United States Steel Corp.; Federal Mining & Smelting Co.; Old Dominion Company (Liquidating); Pittsburgh Coal Co. (of Penn.); Columbia Oil and Gasoline Corp.; Standard Oil Co. of Ohio; The Barber Co., Inc.; Johns-Manville Corporation; National Lead Company; American Window Glass Co.; Owens-Illinois Glass Co.; Air Reduction Co., Inc.; Allied Chemical & Dye Corp.; Union Carbide & Carbon Corp.; Virginia-Carolina Chemical Corp.; Atlas Powder Co.; Lehn and Fink Products Corp.; Parke, Davis & Co.; General Electric Co.; American Type Founders, Inc.; Baldwin Locomotive Works; Crane Company of Chicago; The Fairbanks Company; International Business Machines Corp.; Lima Locomotive Works, Inc.; Midvale Co.; National Cash Register Co.; Remington Rand, Inc.; United Shoe Machinery Corp.; Chrysler Corp.; General Motors

of this study are presented against a background of critical comments on accepted accounting conventions.

II.

INCOME STATEMENTS

Accountants and investment analysts today are agreed that the income statement is much more significant and informative to the investor than the balance sheet.¹⁷ The balance sheet is a highly technical document, as will be seen later, of relatively small value to one who wants to decide to buy or sell securities. It does not purport to give an investor *present values*; it merely reports that portion of historical and current disbursements which remain, after depreciation, obsolescence, depletion, and amortization have been charged periodically to the fiscal periods in which the capital assets are assumed to have been consumed. The income statement, however, is of cardinal importance, as the "value" of a business depends, not on the historical costs incurred in the process of building it up, but upon its earning capacity.¹⁸ In the not so distant past, many corporations omitted the income statement completely, but protests in accounting and economic literature, pressures from the New York Stock Exchange and the Securities Acts, have forced more and more corporations to disclose some information as to their current operations. Of the 70 corporations studied, three did not include any income statement

Corp.; Packard Motor Car Co.; Reo Motor Car Co.; Studebaker Corporation; E. I. Du Pont de Nemours & Co.; Hercules Powder Co.; Remington Arms Co.; American Chain and Cable Co.; Torrington Co.; Container Corporation of America; American Woolen Co.; Gotham Silk Hosiery Co., Inc.; Julius Kayser and Co.; A. G. Spalding & Bros.; Eastman Kodak Co.; Curtis Publishing Co.; Colgate-Palmolive-Peet Co.; Proctor & Gamble Co.; Warner Bros. Pictures, Inc.; Kaufmann Department Stores, Inc.; S. H. Kress & Co.; May Department Stores Co.; J. C. Penney Co.; Sears, Roebuck and Co.; American Stores Co.

17. This statement will not hold for banks, finance companies, or, possibly, public utilities.

The history of the recent shift in emphasis of investment analysts from the net worth of a business to the earning capacity is discussed in GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 299-313. While current literature emphasizes the importance of the income statement, most writers continue to devote a disproportionate amount of attention to balance sheets in their written treatments of the subject. See, for example, the REPORT OF THE AMERICAN INSTITUTE OF ACCOUNTANTS ON COOPERATION WITH STOCK EXCHANGES, REPORTS TO STOCKHOLDERS (1932).

18. The writers do not mean to suggest that the balance sheet can be ignored safely by investors. The results of current operations can be appraised best in light of the financial resources of the company to maintain those operations and to weather adverse business conditions. In addition, the balance sheet sheds light on the question of relative priorities of the different classes of securities. The use of both net worth and earnings gives an investor an additional test of attractiveness rather than a single one of earnings alone. See GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 350 *et seq.*

in their annual reports to stockholders in 1937,¹⁹ and the income statements of at least 17 of the corporations are considered by the writers to be totally inadequate.²⁰ In 1930, four corporations omitted income statements and the statements of at least 34 were obviously inadequate. In both years, there was a striking lack of uniformity as to form and content—1937 showing some improvement in this respect.²¹

As with all generic words, the abstraction "income", which the accountant uses with an appearance of certitude, acquires meaning only in a particular setting and in connection with a particular purpose. Income for the economist, income under income tax laws, income in the determination of national income, income to determine the relative rights of remaindermen and life-tenants in property held in trust, and income to the accountant for a partnership and for a corporation all vary enormously. Within each field the word acquires different shadings and permutations, with changing emphases.²² The contrast between the economist's point of view and the accountant's is particularly significant, especially since, with important social consequences, the accountant's viewpoint has dominated industrial life.²³ The economist regards "income" as

19. Curtis Publishing Co.; Torrington Co.; and United Shoe Machinery Co. A study of 1934 published annual reports indicated that 2½% of the corporations studied omitted income statements. Sunley, *Seen in Published Financial Statements* (1935) 15 C.P.A. 682.

20. The 1937 income statements of the following corporations of the 70 studied are rather obviously inadequate: Allied Chemical & Dye Corp.; American Sugar Refining Co.; American Window Glass Co.; The Barber Company, Inc.; The Fairbanks Company; J. I. Case Co.; Liggett & Myers Tobacco Co.; Lima Locomotive Works, Inc.; Midvale Co.; National Biscuit Company; National Cash Register Co.; Old Dominion Company; Quaker Oats Company; R. J. Reynolds Tobacco Co.; Remington Arms Co.; Studebaker Corporation; Union Carbide and Carbon Corp.

21. See STOCKWELL, *HOW TO READ A PROFIT AND LOSS STATEMENT* (1927) 4.

22. For a discussion of variations in the purpose of the corporate income statement and the consequences of such variations see HATFIELD, *ACCOUNTING* (1927) 380-2. See, also, CANNING, *THE ECONOMICS OF ACCOUNTANCY* (1929) 92-4; Kimball, *The Importance of Understanding Income and Profits* (1935) 10 *ACCOUNTING REV.* 131-5; Crandall, *Income and Its Measurement* (1935) 10 *ACCOUNTING REV.* 380-400; PATON, *ACCOUNTANTS' HANDBOOK* (1935) 1075-8; Littleton, *Concepts of Income Underlying Accounting* (1937) 12 *ACCOUNTING REV.* 13-22.

23. ". . . The nineteenth century carried to extravagant lengths the criterion of what one can call for short 'the financial results,' as a test of the advisability of any course of action sponsored by private or by collective action. The whole conduct of life was made into a sort of parody of an accountant's nightmare. Instead of using their vastly increased material and technical resources to build a wonder city, the men of the nineteenth century built slums; and they thought it right and advisable to build slums because slums, on the test of private enterprise, 'paid', whereas, the wonder city would, they thought, have been an act of foolish extravagance, which would, in the imbecile idiom of the financial fashion, have 'mortgaged the future'—though how the construction to-day of great and glorious works can impoverish the future, no man can see until his mind is beset by false analogies from an irrelevant accountancy . . ." Keynes, *National Self-sufficiency* (1933) 22 *YALE REV.* 755, 763. See also Hamilton and Till, *supra* note 1; Kimball, *The Importance of Understanding Income and Profits* (1935) 10 *ACCOUNTING REV.* 131-5.

the distributive rent, wages, interest, and profits accruing to each of the four factors of production—land, labor, capital, and the entrepreneur.²⁴ The accountant focuses his attention upon “profits” alone, as reflected in the costs and revenues of a particular business enterprise, from the viewpoint of its entrepreneur. Wages, rents, and interest flowing from a business enterprise are “income” to the economist, but the accountant considers them as “costs of production” and “expenses”. The “efficient business” constantly strives to keep these “expenses” down—“profit” is regarded as the sole desideratum of business enterprise. Cost and income recordation are, thus, designed in the interests of the businessman.²⁵

The accountant's function in a business enterprise is the rather narrow one of reflecting the interest of the owners and management.²⁶ In preparing the income statement, the accountant devotes himself to determining the portion of historical and current disbursements and receipts which should be allocated to the current fiscal period, when “expenses” are “incurred”, and when “revenue” is to be “recognized”. Judgment and discretion play a tremendous role. No accounting omniscient can say with assurance what charges should have been made for depreciation, depletion, amortization, and obsolescence during a particular year, what amounts should be provided for doubtful accounts, whether a borderline charge or disbursement is to be handled as an expense of the current fiscal period, a charge to surplus, or whether it is assignable to future income and consequently handled as an asset or deferred expense account, and whether or what extraordinary gains or losses should be credited or charged to income, to assets, or to surplus accounts. Large discretion is present in the choice of the various available and sanctioned methods of computing depreciation²⁷ or stating inventories.²⁸ Income for the year will vary sharply with the method selected.

24. Some economists have contended that government constitutes a fifth factor in production—with taxes as its legitimate share in distribution. See Wasserman, *Taxes as a Share in Distribution* (1938) 28 AM. ECON. REV. 103.

25. See Hamilton and Till, *supra* note 1, at 26–27. The accountant excludes psychical income which the economist includes; income to the accountant must be cash or an immediate, readily obtainable claim to cash. The accountant excludes economic costs such as salaries of the owners in individual proprietorships, rent on owned property, interest on capital invested by the owners, all of which are contained in his net profit figure, since he, usually, is interested only in recording costs resulting from explicit transactions. This limited interest enables the accountant to ignore some economic costs spawned by modern industry—waste of natural and human resources, etc. Despite these significant distinctions, it does not seem to be widely appreciated that accounting values are but one phase of economic values.

26. Some accountants have urged that the accountant is not confined necessarily to this parochial niche in the economic life of a nation, and that he can widen the scope of his work to reflect broader economic values. See Borth and Winakor, *Some Reflections on the Scope of Auditing* (1935) 10 ACCOUNTING REV. 174.

27. See REPORT OF COMMITTEE OF AMERICAN INSTITUTE OF ACCOUNTANTS ON CO-OPERATION WITH STOCK EXCHANGES, REPORTS TO STOCKHOLDERS (1932) 6. See the discussion on depreciation, *infra* p. 955 *et seq.*

28. See the discussion on inventories, *infra* p. 974 *et seq.*

The extent of the judgment factor in accountancy is not widely appreciated by investors—statistics and figures inevitably lend an air of mathematical certainty. It is fundamental, in the understanding of income accounts and balance sheets as well, to appreciate that the figures appearing in the annual reports of corporations “are largely the reflection of individual judgments”²⁹ and the judgments of other men, equally honest and competent, surveying the same economic phenomena, would have differed—perhaps sharply.³⁰

Divisions of the Income Statement. To present a reasonably informative picture of the activities, and sources of income and character of expenses of a corporation, total figures must be broken down into categories which describe broadly the business of the corporation for the year, and which furnish an investor some basis for analyzing the business and for intelligently forecasting future developments. According to the conventions of present day practice, such a segregation is obtained best by the rather arbitrary division of the income statement into the classical operating, non-operating, and non-recurring subdivisions.³¹

Most accountants agree that the first major division of the income statement, the operating section, should disclose the net sales and revenues, and the expenses resulting from and attributable thereto. Within this section, it is necessary, from the investors' viewpoint, that the major sources of operating income and the applicable expenses be itemized. The Securities and Exchange Commission has divided the operating section, roughly speaking, into income from the sale of goods, and income from the sale of services—each must be disclosed separately where the lesser amount is 10% or more of the sum of the two items. No further subdivision of the “gross sales less discount . . .” figure is required other than a separate listing, where practicable, of sales to parents and subsidiaries.³²

29. REPORT, *op. cit. supra* note 27, at 6-7. Many of the leading accountants share this view. See May, *The Accountant and the Investor* in NORTHWESTERN UNIVERSITY, ETHICAL PROBLEMS OF MODERN ACCOUNTANCY (1933) 26; American Institute of American Society, *Joint Report to the Securities and Exchange Commission on Forms 1-2 and 10* (1935) 15 C.P.A. 107, 111; and Sanders, *What is Most Satisfactory Form of Reports to Stockholders?* (1935) 3 THE CONTROLLER 162, 163.

30. See Editorial, *Three Decades of Profit* (Dec. 17, 1938) 133 THE LONDON ECONOMIST 584.

31. The Tentative Statement of the American Accounting Association apparently divides the income statement into operating and non-operating sections, but its terminology would be far more descriptive if the divisions were called “recurring” and “non-recurring” income. American Accounting Association, *A Tentative Statement of Accounting Principles Affecting Corporate Reports, Postulate 9, 10, and 11* (1936) 11 ACCOUNTING REV. 187, 189. Professors Sanders, Hatfield, and Moore, in A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 28-44, follow a similar classification. They do suggest, however, that in the operating section further subdivision is sometimes necessary. *Id.* at 28.

32. The SEC in Form 10-K requires the segregation of sales (and operating revenues if they equal 10% of the sum of the two items), dividends, interest, profits arising from

While the segregation of "goods" and "services" is of some benefit, it places sole emphasis on the distinction between them and ignores other possible breakdowns of the gross figure which may be much more significant to a stockholder. Furthermore, relatively few non-utility, non-railroad corporations receive as high as 10% of their total income from the sale of services. Investors are not so much interested in whether income comes from the sale of goods or from the sale of services, as they are in knowing from *what goods and what services* the income is derived. For instance, in the income statement of General Motors, it would be far more important for investors to know the percentage of the gross revenue derived from the sale of each line of cars, the percentage derived from the sale of Frigidaires, and from the corporation's other major activities than to know that a certain amount was derived from the sale of "goods" and the remainder from the operation of a railroad. In large corporations, with many diversified types of activity, the disclosure of net sales and operating revenues, cost of goods and services sold, and net operating income in total figures is not particularly enlightening to the investor. In fact, the larger the corporation and the more activities it engages in, the less significant gross revenue figures will be to an investor or investment analyst for purposes of forecasting.³³ Segregation within these items is necessary for intelligent forecasting and evaluation.³⁴

The second division, non-operating income,³⁵ usually includes the amounts received from interest, dividends, commissions and fees, rents, royalties, etc., which, while normally recurring, do not arise from the corporation's operations. This disclosure is significant to the investor in that it appraises him more fully of the relative importance of the operating and financial income of the enterprise. Of course, the amount of detail will and should vary somewhat with the nature of the business.

transactions in securities, and separate listing of "any substantial non-recurring items of miscellaneous other income, and any other substantial amounts." Form 10-K, Instructions, pp. 20-21. Forms A-1, A-2, and 10 are similar.

33. The reports examined were extremely deficient in this respect:

ITEMIZATION OF OPERATING REVENUE

Operating Revenue Section:	Number of Companies	
	1939	1937
One Figure	34	48
Some Segregation	3	6
Minor Sources Segregated	3	6

34. This problem has been considered by the Securities and Exchange Commission. See Address of Harold H. Neff, Director, Forms and Regulations Division, entitled "Revision of the Rules Affecting Registration under the Securities Act and the Securities Exchange Act," delivered before the Controllers Institute of America on January 19, 1939.

35. "The distinction . . . between operating and non-operating income is . . . always a relative one and will be determined in any given instance on the basis of major activities and supplementary or minor activities." 1 KESTER, ACCOUNTING THEORY AND PRACTICE (3d ed. 1930) 46.

The third major breakdown of the income statement is called by the accountant "non-recurring" income.³⁶ The accountant uses this term to categorize business events which are not conceived to be a part of the "normal" operations of the business, *e.g.*, profits and losses from the sale of fixed assets or portfolio securities, abandonment of property, fire and flood losses, etc. Frequently, these items are attributed directly to some surplus account and hence never appear in the income statement at all. The concern here, however, is not with the problem of credits or debits to income versus debits or charges to surplus³⁷ but with methods of reflecting the item involved after the decision to allocate it to income has been made. The purpose of segregating "non-recurring" income from other income is to reveal to the investor specific income items which "normally" may not be expected to recur in each major accounting period. Clearly, the inclusion of sizeable, sporadic items with "regularly recurring" income would present a misleading picture of the return to be anticipated from the enterprise. Sales of assets, however, a major item in this category, occur constantly in the large business, and it is somewhat misleading to have a rule of practice, which, without discrimination, labels them invariably as "non-recurring," thus asking the investor to discount their presence in the income statement. From the investor's viewpoint, the test should be whether submerging the transaction in some other item, "sales", or "other operating income," will distort his evaluation of the company's operations and future prospects of income.

Itemization within these major categories of income is an essential minimum of income disclosure. An investor is not interested merely in learning the total earnings for the current year which an indivisible total gives him; his primary interest in earnings is based, to a large extent, on the ability it gives him to forecast the future. Total figures must be broken down to enable him to obtain some information as to the sources of past income in order that his guess as to the future, precarious at best, is something more than a wild shot in the dark.³⁸

This discussion has accepted the classical segregations of the income account, and has been concerned with a criticism of its internal constructions. The classical division is not, however, inevitable or exclusive. Income statements of the future may use other starting points or a number of alternative starting points varying with the purpose at hand to describe

36. As remarked in note 31, *supra*, many accountants use the term "non-operating" income to include the items here classified as non-recurring. See PATON, ACCOUNTANTS' HANDBOOK (1934) 1093. For a discussion and illustration of the importance of segregating non-recurring items, see GRAHAM AND DODD, SECURITY ANALYSIS (1934) 353 *et seq.* See also SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 27.

37. See *infra* pp. 958, 965.

38. See GRAHAM AND DODD, SECURITY ANALYSIS (1934) 478 *et seq.* for a discussion, with illustrative case histories, of the importance of segregating sources of income.

functionally the phenomena encountered by the business enterprise.³⁹ Much hard work and critical thinking remain to be done on these accounting classifications.

Gross Revenue from Sales and Services. In modern accounting practice, the generally accepted view is that revenue is realized by a valid and enforceable sale.⁴⁰ The sale may be for cash, other valuable consideration, or for a legal claim, *e.g.*, note or account receivable.⁴¹ The sale is not only of great theoretical importance in the determination of when revenue is realized, but its aggregate total—net sales⁴² and operating revenues—

39. It has been suggested, for example, that the income statement be reclassified on the basis of "controlled" or "uncontrolled" costs. Uncontrolled costs are fixed interest charges, depreciation, etc., which accrue, irrespective of the volume of the business done. Controlled costs are costs which may be varied with the volume of the business; the most variable of these costs is raw materials, and, in the absence of labor unions, wages. The larger the uncontrolled costs, the less ability management has to adjust itself to unfavorable business conditions.

40. Logically, income is earned not by sales alone, but by each step in the process of production. No one specific event is responsible for its creation. Theoretically, each stage in production should be credited for its proportionate share of the revenue earned. Accountants, however, to avoid "counting their chickens before they are hatched," treat the sale as the crystallization of the earning process and of the amount earned. In long-term projects, however, such as shipbuilding or large construction projects, where the amount of the earnings can be reasonably estimated, income is frequently attributed to the productive process rather than to await its crystallization in the sale. See Husband, *Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles* (1937) 12 ACCOUNTING REV. 386, at 394.

41. The receipt of cash and cash alone is not an adequate basis for income determination. The accrual basis is generally used. If revenues were recognized only in terms of cash, comparison of the results of periods would be impossible, since revenues "properly allocable" to one period would not be recognized until another, and there would be no assurance that such errors would cancel each other in the long run.

42. In connection with any particular income statement it is important to note whether "gross" or "net" sales is the figure given when making comparisons. There is no uniformity of practice as to what is the beginning figure of the income statement, or what deductions are made from the gross figure to give the net sales figure. See HATFIELD, *ACCOUNTING* (1927) 351, 368; SANDERS, HATFIELD AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 28; and Sunley, *Seen in Published Financial Statements* (1935) 15 C.P.A. 682, 683. The accounting forms of the SEC require that the net sales figure (gross sales less discounts, returns and allowances) or gross revenue should be the first figures on the income statement.

Of the 37 companies in 1930 and 54 in 1937 giving a sales figure, the following chart indicates the nature of the beginning figures used:

	Number of Companies	
<i>Beginning Figures:</i>	1930	1937
Gross sales	3*	1*
"Sales"	9	10
Net Sales	15	31
Sales and Operating Revenue	10	12
	—	—
	37	54

*In 1930, 2 of these companies also gave net sales; and the one company in 1937 also gave net.

especially when segregated into major operating activities, is regarded by accountants as secondary only to net profits as the most significant figure in the income statement.⁴³ It aids in indicating whether a corporation is growing or declining, and it provides a measure for an analysis of the competence of the management. Many of the investment analysts' most important ratios depend upon its disclosure.⁴⁴ The usual reason given for refusing to disclose sales and cost of sales figures is the creation of consumer resistance where the gross profit margin is wide and that its publication invites competition or gives an advantage to existing competitors, especially where the competitors' figures remain undisclosed.⁴⁵

Under the Securities Exchange Act, and the regulations thereto, corporations coming within the Act are required to list net sales in their registration statements and periodic reports to the Commission and exchanges, unless under Section 24(b) written objection to its disclosure is filed with the Commission. The Commission then "may . . . make available to the public the information . . . only when in its judgment a disclosure of such information is in the public interest."⁴⁶ A large number of companies objected to the disclosure of these figures, and, in

43. J. M. B. Hoxsey, in his address to the American Institute of Accountants, *ACCOUNTING FOR INVESTORS* (1930) declared that so important is this figure regarded "that one of the great statistical companies has adopted the policy of refusing to recommend to its clients the securities of companies which do not give this information, on the ground that not enough information is disclosed to permit an adequate analysis". Dean Landis, as Chairman of the SEC, characterized sales and cost of sales as "the most important" figures for income statement analysis. *N. Y. Times*, April 14, 1937, p. 46, col. 1. See also GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 34; *TWENTIETH CENTURY FUND, SECURITY MARKETS* (1935) 581.

44. The following ratios of the investment analyst depend upon the disclosure of the net sales figure: Ratio of operating profit to net sales; ratio of net income to net sales; ratio of net sales to average inventory; ratio of net sales to receivables; ratio of net sales to fixed and to total assets, and to net worth; and ratio of operating expenses to net sales. See MONTGOMERY, *FINANCIAL HANDBOOK* (1925) 233; WALL AND DUNNING, *ANALYZING FINANCIAL STATEMENTS* (1930) 245 *et seq.*; Foulke, *Financial Ratios Re- come of Age* (1937) 64 *J. OF ACCTY.* 203, 212.

The following chart indicates the number of companies which gave sufficient information to compute the operating income—net sales ratio:

<i>Net Sales and Net Operating Income Figures:</i>	<i>Number of Companies</i>	
	1930	1937
Sufficient information to make the computation	28	48
Of these no adjustments were necessary in....	15	27
Adjustments were necessary in	13	21

45. See HOXSEY, *ACCOUNTING FOR INVESTORS* (1930) 15; *TWENTIETH CENTURY FUND, SECURITY MARKETS* (1935) 581. Sunley, *Seen in Published Financial Statements* (1935) 15 *C.P.A.* 682, 683, reports that of the apparently hundreds of statements examined by him, exactly 50% failed to indicate their volume of business.

See note 42 *supra*, for a summary of the opening items contained in the income statements of the 70 corporations included in this study.

46. *SECURITIES EXCHANGE ACT*, § 24(b).

the early years of the administration of the Act, the Commission was very liberal in granting such petitions.⁴⁷ Investigations later revealed that in most cases competitors and customers already had obtained the "confidential" information, and that disclosure had little effect upon buying policy.⁴⁸ As a result of this finding the Commission sharply reversed its policy and now denies most of the requests.⁴⁹ Generally speaking, these figures now reach the Commission and the stock exchange on which the security is listed and they are available, theoretically, to the public. But as we have seen, this does not assure that the information is revealed in the annual reports to the stockholders.⁵⁰ In the absence of rules of the exchange on which the security is listed to the contrary,⁵¹ the scope of disclosure in annual reports rests purely in the management's discretion. Of the 70 corporations included in this study (which it must again be emphasized probably are representative of the best accounting practices) 37 corporations or only 53% reported net sales to their stockholders in 1930, whereas 55 corporations or 79% reported the item in 1937. The 21% which did not report gross sales included such leading corporations as National Biscuit, Quaker Oats, J. I. Case, Allied Chemical and Dye Corp., and Union Carbide and Carbon Corp.⁵²

Cost of Goods Sold. "Cost of goods sold,"⁵³ assuming traditional classifications, is an equally significant figure to investors when coupled

47. For a rather full discussion, see Comment, *Confidential Treatment of Information Required by the Securities Exchange Act* (1938) 47 YALE L. J. 790, 794.

48. *Id.* at 795. Professor Sanders seems to have more faith in the protests against disclosure of sales figures than most commentators. See Sanders, *Accounting Aspects of the Securities Act* (1937) 4 LAW & CONTEMP. PROB. 191, 212-3.

49. See LANDIS, *THE ADMINISTRATIVE PROCESS* (1938) 42 *et seq.*

50. Compare the remarks of Wm. W. Werntz, Chief Accountant of the S. E. C., in an address delivered before the Controllers Institute of America on September 27, 1938.

51. Apparently the listing rules of the New York Stock Exchange do not require a disclosure of net sales or gross revenue, cost of sales, and selling, general and administrative expenses in the annual reports to stockholders.

52. Of the 70 corporations examined, the following did not disclose net sales in 1937: Allied Chemical & Dye Corp.; American Window Glass Co.; J. I. Case Co.; The Fairbanks Co.; Lehn and Fink Products Corp.; Lima Locomotive Works, Inc.; Midvale Co.; National Biscuit Co.; Old Dominion Co.; Parke, Davis & Co.; Quaker Oats Company; Torrington Co.; Union Carbide and Carbon Co.; United Shoe Machinery Co.; Virginia-Carolina Chemical Corp.; Warner Bros. Pictures, Inc. In June, 1938, Allied Chemical & Dye Corporation had a case pending in the Second Circuit Court of Appeals to determine the validity of the Commission's order under § 24(b) denying an application for confidential treatment of this and other figures. The National Biscuit Co., R. J. Reynolds Tobacco Co. and The Torrington Co. had all filed similar suits but later dismissed them. SECURITIES AND EXCHANGE COMMISSION, *THIRD ANNUAL REPORT* (1937) 179.

53. In concerns where services are sold rather than goods, "cost of goods sold" is not a workable concept, since the allocation of the direct costs of the services rendered is too difficult because "expenses" are inextricably mixed with "costs".

The figure "cost of goods sold" is normally subtracted from net sales and the resulting figure is usually called "gross profit" and by some as "margin of sales". The emphasis

with a disclosure of "net sales."⁵⁴ If sales and cost of sales of the past are revealed, the investor is furnished with some basis for predicting the relationship of such future costs as are included in "cost of sales" to future sales, and the resulting gross profit margin.⁵⁵ If both sales and costs of sales are given, any knowledge the investor may have as to the future increases or decreases in wages or other components of cost of sales and their possible effect upon the gross profit margin will be useful. In addition, a knowledge of sales and cost of sales provides the investor with a basis for accounting for variations in gross or net profit from one period to another.⁵⁶ Yet despite its required itemization under Securities and Exchange Commission regulations, only 47 of the corporations studied listed the amount of the item "cost of goods sold" in their 1937 annual reports to stockholders. In 1930, the number was 33. Very few of these corporations allocated "cost of sales" to minor operations, a segregation which, if the concept is to realize its maximum value, should be made where practicable.⁵⁷

The mere notation of the figure "cost of goods sold" on an income statement is not of much aid to an investor. Aside from the variations which might be expected to appear due to differences in the nature of businesses or industries, accountants, unfortunately, are not in accord as to what elements of expense should be included in the item "cost of goods sold." Investors are not so much interested in the exact way in which this item is finally defined as they are in having a complete description of the contents of the figure together with such uniformity and consistency in its application as may practically be obtained. Accounting

which has been placed on this item has been severely criticized by Professor Paton. Paton, *Shortcomings of Present-Day Financial Statements* (1934) 57 J. OF ACCT'Y. 108, 123-5.

54. The uses which may be made of the category "cost of goods sold" by the investor are outlined comprehensively in Morrison, *The Interest of the Investor in Accounting Principles* (1937) 12 ACCOUNTING REV. 37, 40-1. And see STOCKWELL, *HOW TO READ A PROFIT AND LOSS STATEMENT* (1927) 65.

55. A wide or narrow gross or net profit margin as compared with competitors in the industry is inconclusive, and suggests further investigation. Either may be a sign of strength or weakness. See Morrison, *The Interest of the Investor in Accounting Principles* (1937) 12 ACCOUNTING REV. 37, 41. In some situations, where the buyer is convinced that a rise in the cost of the product is imminent, a higher cost of production than that of competitors may be an inducement to purchase speculative stocks of a low price range. See GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 477-8.

56. The causes of variations in profits from one period to another in accounting terminology are outlined in 1 FINNEY, *PRINCIPLES OF ACCOUNTING—INTERMEDIATE* (1937) 477.

57. SANDERS, HATFIELD AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 30, recommends that this segregation be made. In many companies, undoubtedly, the percentage of error in attempting to segregate expenses may render the breakdown of dubious value. See Hamilton and Till, *supra* note 1, for a summary of the inherent difficulties in allocating and segregating costs.

Terminology defines "cost of goods sold" as "the cost of those goods that have been sold and delivered during the period covered by the account. This consists . . . in the case of manufacturing concerns of the total production cost of the goods sold, including raw materials, labor and manufacturing expenses."⁵⁸ "Total production cost of goods sold," and "manufacturing expenses" are themselves broad categories permitting great latitude in the inclusion or exclusion of specific items. With these loose phrases as their standard of judgment, accountants are called upon to allocate the myriad transactions encountered by modern business. Most items fall into familiar patterns which history and the traditions of the business assign to a particular category with little question; but borderline items must constantly occur, and there the discretion of the management, the quality and integrity of its judgment play important roles. These factors are, undoubtedly, not constant from business to business or from year to year within a business.

"Cost of goods sold," as used in accounting, is a rather artificial concept excluding other costs—selling, general and administrative expenses, maintenance and repairs, depreciation, taxes, etc.—which, from an economic standpoint, are as primary as those costs which "contribute directly" to the physical fabrication of the goods or services. But the concept has some utility, and if it is to be of service to investors as a basis of analysis and comparison, there should be some understanding as to what elements it includes and some consistency in its application from period to period by each business within an industry. Little uniformity is present today. Some corporations exclude wages; others include selling and administrative expenses, depreciation and even taxes in its determination.⁵⁹ Frequently, it is impossible to determine what

58. AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING TERMINOLOGY (1931) 109. Accounting terminology defines "manufacturing expenses" as "The cost of manufacturing, other than material consumed and direct labor." *Id.* at 60. This definition is almost the purest tautology.

59. The lack of uniformity is illustrated in the following chart:

<i>Contents of "Cost of Goods Sold"</i> <i>Figures given:</i>	<i>Number of Companies</i>	
	<i>1930</i>	<i>1937</i>
Did not include Depreciation, or Selling, Gen. and Adm. Exp.	8	17
Included Depreciation but not Selling, Gen. and Adm. Exp.	0	6
Included Selling, Gen. and Adm. Exp. but not Depreciation	16	19
Included both Depreciation and Selling, Gen. and Adm. Exp.	9	5
	<hr/> 33	<hr/> 47

While there were 37 companies in 1930 and 54 in 1937 which reported a net sales figure, 4 of them in 1930 and 6 in 1937 omitted the "cost of goods sold" item.

is included from the information given in the statements. The Securities and Exchange Commission, consistent with its approach to accounting problems generally, has proceeded very cautiously in obtaining adherence to an agreed definition, and merely requires an itemization of the amount of "cost of goods sold as regularly computed under the system of accounts followed."⁶⁰ Consistent treatment as to the component items in this concept within an industry seems highly desirable.⁶¹

Selling, General, and Administrative Expenses. The considerations which suggest disclosure of "cost of goods sold" apply equally well to "selling, general, and administrative expenses." Disclosure of its total is valuable for the purposes of comparison with previous years, with similar expenses of competitors, and as a basis of estimating net profit figures of the future. Despite its importance, only 13 of the 70 corporations listed it in 1930 and but 24 in 1937, even though the SEC includes the item in its four principal forms.⁶²

Selling expenses are usually defined to include all expenses in selling, salaries, commissions, advertising, etc. Administrative expenses are those expenses incurred in conducting a business as distinct from the expense of manufacturing, selling, etc. It usually includes the salaries of officers, rents of the general offices, office and general expenses. General expenses are considered to be those expenses which do not fall under the category of manufacturing, selling, or administrative.⁶³ Again, each of these concepts is extremely broad and loose, and unquestionably many borderline expenditures make it difficult for the accountant to determine proper allocation.

Accountants, at least in their reports to stockholders, usually follow, as does this paper, the division of total costs of operations into cost of sales, selling and distribution costs, and administrative and general costs. This classification puts into "costs of goods sold" only those costs which have an "observable effect" upon plant operations—labor, material, and

60. Form A-2, Instructions, p. 36; Form 10, Instructions, p. 21; and Form 10-K, Instructions, p. 20. The SEC in Exchange Act Release No. 174 permitted mercantile establishments to include occupancy, buying, and publicity costs in "costs of goods sold"; in the proposed new forms, however, publicity costs must be excluded.

61. See, as indicating another attitude, SANDERS, HATFIELD AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 31: "The division of expenses into those to be included in cost of goods sold and those to be treated as subsequent income deductions may be left to the judgment of the management. In making this division it should be borne in mind that usually, though not necessarily, it determines also the cost items to be included in the inventory valuation."

62. Form A-1, p. 24, and Form A-2, Instructions, p. 37 under the Securities Act; and Form 10, Instructions, p. 22, and Form 10-K, Instructions, p. 21, under the Exchange Act.

63. The above definitions follow those given by the American Institute's Committee on Terminology. AMERICAN INSTITUTE OF ACCOUNTING, *ACCOUNTING TERMINOLOGY* (1931) 59-60.

manufacturing overhead costs. These costs are assigned, by the cost accountant to the units sold. Other costs, selling, administrative and general expenses are often not allocated to the operations or units or period which they may affect, but are thrown into the income account of the period in which they are incurred.⁶⁴ Where these costs bulk large, the inconsistency in handling the two types of costs may make the income account of a particular period misleading not only to investors but to management. Underlying this practice is not only the practical difficulty of allocating selling and other costs to the period they affect, but an inarticulate premise that the "observable costs of production" are alone the "real" productive costs.⁶⁵ From an economic point of view, all of the costs supply utility and are productive.

In recent years, accountants, for purposes of securing more adequate internal control, have set up cost or expense classifications, other than on the traditional type of expense, based upon more functional lines. Under this new classification, the cost analysis may be in terms of operating or producing departments, by various revenue divisions, by territories, by types of commodities, etc.⁶⁶ The components of each classification change with the purpose and emphasis sought. While accountants have secured to management the benefits of these functional classifications, it has been assumed without question that the orthodox segregations are sufficient for investor purposes. Few, if any, studies have been made to see whether other classifications, along lines suggested by the work of the cost accountants, specifically directed toward the needs of investors, would serve those needs more adequately.

Maintenance and Repairs. It is a generally accepted principle of accounting that expenditures made for maintenance and repairs should be treated as a current operating expense, whereas expenditures for additions or betterments should be capitalized. The problem of allocating a particular expenditure to one of these two categories—perhaps the most troublesome question with which the accountant and auditors are confronted⁶⁷—brings into high relief accountancy's fundamental problem—charges to capital versus charges to current operations.⁶⁸

64. See PATON, ACCOUNTANTS' HANDBOOK (1934) 157-8.

65. *Id.* at 158.

66. See Cogburn, *Burden Application* (1938) 65 J. OF ACCT. 208-12; PATON, ACCOUNTANTS' HANDBOOK (1934) 157-8, 1332-63.

67. "In the audit of a large manufacturing establishment, this is the most troublesome account which the auditor is called to pass upon." MONTGOMERY, *AUDITING THEORY AND PRACTICE* (5th ed. 1934), 516.

68. "The intimate relationships of depreciation, repairs and betterments is seldom adequately treated in most books on accounting . . . The student is led to believe that these items are readily classified by the accountant from an examination of invoices, although nothing could be further from the truth . . ." Borth and Winakor, *Some Reflections of the Scope of Auditing* (1935) 10 ACCOUNTING REV. 174, 180.

Certain cases are clear. A new system of elevators is installed whose useful life will extend considerably beyond the current year's operations. Theoretically, there is little question but that its cost should be treated as an addition to the plant account to be written off through depreciation allowances during its estimated life. Minor, regularly recurring adjustments are made in the plant to keep it in good working order. Accountants agree that these should be charged to current operations. But the borderline cases, coming up in everyday operations, create more difficulty.⁶⁹ A part is replaced in an old machine; new tires are bought; a roof is re-shingled with new composition material rather than slate, or spruce is used rather than cedar—the cost and the utility may be greater, may be approximately the same, or may be less than the original. Increased utility may correspond with increased cost. Again, it may not; increased utility may result even though the cost of the new material is less than the old. The benefits of the expenditure may be fleeting, or may be extended beyond the current accounting period. In the past, accountants have considered the problem soluble by the manipulation of definitions. If the expenditure merely "replaced" "wear and tear on property," and was not an "improvement or addition",⁷⁰ if it merely "maintained" and did not "increase" "the efficiency of the property repaired", it was a "maintenance" or "repair"⁷¹ and chargeable to profit and loss; otherwise the expenditure was a "betterment" or "addition" and chargeable to assets.⁷² But these definitions were, like most definitions, tautological and merely spelled out the mental pictures invoked when the word itself was suggested. All the definition could do in an actual situation was to poise the problem and present it to the expert engineer or plant manager for his judgment—a judgment which might vary in individual experts, in different businesses, with different assets and for different purposes.⁷³ Usually these definitions were considered from the standpoint of broad classes of property or a whole enterprise, although in recent years better managed businesses have introduced detailed plant accounting and have reduced the size of the asset unit.⁷⁴

69. See the illustrations given in KOHLER AND MORRISON, *PRINCIPLES OF ACCOUNTING* (1927) 313-4.

70. This is the definition of "Betterment" in AMERICAN INSTITUTE OF ACCOUNTING, *ACCOUNTING TERMINOLOGY* (1931) 28.

71. See the definition of repairs, *id.* at 101. Not all "repairs" are allocated to profit and loss in accounting practice. "Repairs are divided into two groups—"ordinary" and "extraordinary". The latter is charged to asset accounts.

72. Treasury Regulations are responsible partially for perpetuating these definitions in accounting practice. See U. S. Treas. Reg. 94, Art. 23(a)-4.

73. Cf. SALIERS AND HOLMES, *BASIC ACCOUNTING PRINCIPLES* (1937) 483.

74. PATON, *ACCOUNTANTS' HANDBOOK* (1934) 526 *et seq.*, describes and criticizes these practices. See, also, MASON, *PRINCIPLES OF PUBLIC UTILITY DEPRECIATION* (1937) 23.

Few accountants seem to appreciate that the allocation of expenditures to capital or income on the basis of the prevailing metaphysical distinction between maintenance and repairs and additions and betterments violates, cherished principles of accrual accounting and historical cost.⁷⁵ The fundamental basis of accrual accounting is that expenditures should be allocated to the period whose operations they can fairly be said to benefit. Thus, that portion of an expenditure which benefits current operations should be treated as an expense, and the portion which benefits future operations should be capitalized and then amortized during the applicable periods. If an item whose benefits extend to future periods is classified as maintenance or repairs and is thus charged wholly to current operations, the result is that expenses for the current period are overstated and the income of that period correspondingly understated. Conversely, if future periods are not benefitted and the item is classified as an addition or betterment and capitalized, present income is overstated and future income understated.⁷⁶ The distinction between a capital expenditure and an income expenditure should not be rested on whether the property is either "bettered" or "maintained" thereby, but rather upon the relation between the anticipated useful life of the asset acquired and the length of the accounting period for which income is being determined.⁷⁷

Historical cost accounting principles are violated also by the application of the generally accepted definition of maintenance and repairs. Parts of a machine wear out and new parts are purchased at prevailing prices, not necessarily comparable with the cost of the original asset. If such replacements are charged to current operations, the asset account reflects the cost of the original asset, whereas in fact after a period of years the asset consists of numerous replacements purchased at entirely different prices. Finally, by virtue of this cumulative process, the books reflect not the cost of the assets now in use but assets long since consigned to the junk heap.

Such are the theoretical criticisms of the accepted definitions and distinctions between maintenance and additions as they are currently applied in practice. The writers do not overlook the practical difficulties which may in some situations confront the accountant in applying a strict accrual

75. But see PATON, *op. cit. supra* note 74; MASON, *op. cit. supra* note 74, and compare KOHLER AND MORRISON, *PRINCIPLES OF ACCOUNTING* (1926) 313-5; GRAHAM AND KATZ, *ACCOUNTING IN LAW PRACTICE* (1932) §§ 119, 120.

76. Cf. PATON, *ACCOUNTANTS' HANDBOOK* (1934) 526-7. Justice Brandeis, dissenting in *United Railways v. West*, 280 U. S. 234, 260-1 (1930), expresses this point of view as clearly as any other commentator.

77. "If the accounting period were increased from the customary year to a decade, most of which is now treated as capital expenditure would become chargeable to income; while if the period were reduced to a day, much of what is now treated as current maintenance would become capital expenditure." May, *Improvement in Financial Accounts* (1937) 63 J. OF ACCTCY. 333, 334.

system. In some businesses, or for some types of assets, a strict accrual system may involve an unreasonable amount of record detail for which more accurate results are not sufficient compensation.⁷⁸ The prevailing question-begging definitions, however, under which specific expenditures are categorized, prevent the application of accrual accounting even where bookkeeping economy is not a factor.

What other interests does the investor have in this problem? Obviously, an investor has a primary interest in the managerial-engineering problem of maintaining and advancing the plant's physical equipment to keep it abreast or, if possible, ahead of the normal progress in the industry. In the long run, the particular account charged for expenditures for this purpose is of secondary consideration. No balance sheet or income statement, unless the recorded sums are clearly inadequate, can indicate definitely whether management is doing its job in making the necessary expenditures for maintenance and betterment. Only the results of future operations may throw some light upon it. But the income statement and balance sheet reflect the judgment of the management as to the allocation of these expenditures. Since it is so often a close question of fact, especially under the current practice, as to whether a particular expenditure should be charged to current revenue or not, management is in a position to allocate those expenditures to suit its particular purpose. If a favorable showing is desired, expenditures which normally would be charged to current operations could be charged to assets, with the result that both assets and current profits are inflated.⁷⁹

Or if an unfavorable showing is desired, the reverse process is instituted. Often, distortions in allocation may come as a result of the desire of a plant manager to keep "costs" of operation down and thus increase the apparent profits by charges to asset accounts rather than to current operations.⁸⁰ The investor or stockholder is in no position to prevent

78. For large non-recurring types of expenditures, concededly, the general accrual method should be followed. But where the expenditures are frequent and constantly recurring, the theoretical solution may not always prove practical, due to the infinite amount of accounting detail necessary to carry it out. For instance, to follow the theoretically accurate method, where a firm has a large fleet of delivery trucks, would require a separate account for each truck. This amount of detail might be considered too expensive. Consequently, the cost accountant may devise a more practical method of arriving at a reasonably accurate figure. In the case assumed, the cost accountant of the firm, from past experience, might have found that during past years, with a given number of trucks, so much per mile must be spent for tires, so much for repairs and so much for partial replacements in order to maintain a reasonably efficient fleet of trucks. The sum of these items would then be treated as "maintenance and repairs" and charged to current operations. This device should work reasonably well where the number of items is large and constant replacement is necessary.

79. See MONTGOMERY, *AUDITING THEORY AND PRACTICE* (5th ed. 1934) 516.

80. See 1 MAY, *TWENTY-FIVE YEARS OF ACCOUNTING RESPONSIBILITY* (1937) 158-9; MONTGOMERY, *AUDITING THEORY AND PRACTICE* (5th ed. 1934) 517.

this manipulation. His first line of defense is the independent auditor who, he hopes, is able to resist the strong forces arrayed against him, and who will refuse to approve unreasonable allocations. His second defense is a disclosure of the allocation of these expenditures during a particular year to the income and the asset accounts, supported, where practicable, by more detailed and illustrative schedules.⁸¹ Comparison with previous years and with other companies in the same industry may bring to light practices sufficiently flagrant to put him on guard. Both itemization in the income account and the schedules of changes in assets and the accounts charged with maintenance and repairs are now required by the Commission. As important as this information is, very few corporations in their annual reports to stockholders, even in 1937, presented this figure in their profit and loss statements, and approximately just as few presented schedules of the changes in the asset accounts and the maintenance and repairs charges during the years examined. In 1930 only two, and in 1937 only four, corporations gave a maintenance and repairs figure in the income statement. Six companies presented schedules of changes in assets both in 1930 and 1937 and three companies tendered maintenance and repairs schedules in both years.

Depreciation. Until fairly recently, many corporations did not make any provision for depreciation in computing income. In an investigation conducted in 1916, the Federal Trade Commission discovered that out of 60,000 apparently successful corporations doing at least \$100,000 a year of business, fully one-half did not take depreciation into account at all.⁸² In the years before the Federal income tax laws made depreciation allowances profitable, it was not very difficult to disregard the *fact* of daily wear and tear on physical equipment in the urge to make favorable showings and pay dividends.⁸³ Depreciation—the loss in physical or functional value, due primarily to ordinary wear and tear and obsolescence—is as much a cost of doing business as is the cost of coal consumed in running the plant; it differs from other costs only in that it does not represent an immediate, current outlay of cash.⁸⁴

The annual provisions for depreciation affect both the income statement and the balance sheet. The debit entry represents an expense charge to income, increasing operating expenses and thereby diminishing income. The reciprocal credit entry to the depreciation reserve results in a reduction in the net book value of the asset on the balance sheet unless the reserve is presented on the liability side. The latter practice is objection-

81. The forms of the Securities and Exchange Commission require such itemization. See Form A-2, Instructions, p. 36 and Schedules II and VIII.

82. RIPLEY, MAIN STREET AND WALL STREET (1926) 174.

83. It was not until 1909 that the Supreme Court recognized that allowances for depreciation were a legitimate expense of operations of public utilities. See *Knoxville v. Knoxville Water Co.*, 212 U. S. 1 (1909).

84. This definition follows ACCOUNTING TERMINOLOGY (1931) 48-9.

able in that assets then will not reflect the estimated loss due to wear and tear; unsophisticated investors may be misled by the larger aggregate balance sheet totals.

An investor has essentially two major interests in accounting for depreciation. Is the allowance for depreciation treated as an operating expense? Are the allowances reasonable and adequate?

No respectable accountant today, despite a curious confusion as to the nature of accounting for depreciation,⁸⁵ would deny that the annual allowances should be treated as an operating expense and disclosed separately on the income statement. The SEC, of course, in all of its forms requires its itemization.⁸⁶ Despite this unanimity of opinion, 22 corporations of the 70 studied in 1930 did not separately note their depreciation charges for the year; of the 22, ten mentioned that depreciation charges had been deducted but did not disclose the amount; in 1937, sixty-six companies mentioned and disclosed a depreciation charge; four cavalierly continued to ignore it.⁸⁷

Depreciation allowances have always been a fertile source of manipulation of income; they may be played with either to pack or minimize current profits.⁸⁸ Unless the management is like Caesar's wife, a careful investor must be prepared to compare the depreciation charges of his company over a period of years (assuming he can obtain the figures) in order to see if a consistent depreciation policy has been followed and if this year's charges are not meager or overgenerous in relation to other years. A further comparison of the figures and methods of similar sized

85. See HATFIELD, ACCOUNTING (1928) 26; Hatfield, *What They Say About Depreciation* (1936) 11 ACCOUNTING REV. 15-26.

86. Form A-1, p. 24; Form A-2, Instructions, p. 36; Form 10, Instructions, p. 22; and Form 10-K, Instructions, p. 22 and Schedule X.

87. The following chart indicates roughly the accounting treatment of the depreciation allowances in the income statements examined:

<i>Depreciation Item in</i>	<i>Number of Companies</i>	
<i>Income Statement:</i>	<i>1930</i>	<i>1937</i>
Amount not disclosed separately	22	4
Item mentioned but not disclosed	10	0
Amount given	48	66
Deducted prior to operating income figure....	14	36
Deducted after operating income figure	43	28
Allocated—deducted in two places	1	2

88. Ripley, relying on Cole's "American Wool Manufacture," points out that it is practically impossible to determine whether the American Woolen Co. earned its preferred dividends in the 15 years prior to the World War since part of its surplus was the result of inadequate provision for depreciation. RIPLEY, MAIN STREET AND WALL STREET (1926) 177. On the other hand the National Biscuit Company, prior to 1922, resorted to highly excessive charges to depreciation in order to conceal its large profits. The policy was abandoned in that year—the company multiplied its number of shares by seven and quadrupled the amount of dividends paid. *Id.* at 180.

companies in the same industry is desirable.⁸⁹ Accounting authorities disagree sharply as to the preferable system of accounting for depreciation—retirement or depreciation systems. Among companies following the retirement system, there are no accepted methods of determining the amount of the annual provisions for retirements. Many companies arbitrarily allocate an amount which they deem sufficient to cover the currently expected retirements. Others appropriate a fixed percentage of the gross revenue or sales. Many varieties of allocation are also available under the depreciation system—the straight-line method, the reducing-balance method (used in England), the sinking fund method, the annuity method, and the working hour or production method. As the Report of the Committee of the American Institute of Accountants on Cooperation with Stock Exchanges pointed out, each of these methods is “. . . supported by respectable argument and by usage, and the charges against a particular year may vary a hundred per cent or more according as one or the other permissible method is employed.”⁹⁰ The wide area of discretion presently available to management in the choice of methods of depreciation and the important consequences of that choice upon the net income figure for the year, require, in the investor's protection, that the income statement should contain some explanation of the method used. Any change in method or significant changes in the technique or applying that method should be disclosed and the effect upon the year's income noted.⁹¹

Depreciation figures reported to stockholders frequently differ, as do other figures on the income statement, from the depreciation deductions allowed by the Bureau of Internal Revenue under the Income tax laws. As a result, net income for income tax purposes differs from net income for corporate purposes. In any given case, however, the divergence may be perfectly justifiable from the investor's viewpoint as well as the management's.⁹² It is not until the termination of a business that anyone can say with some certainty what depreciation charges should have been made during any particular year. Prior to that, the “proper” depreciation charge

89. Investment analysts' ratios are also helpful. GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 398 *et seq.*

90. REPORT OF COMMITTEE OF AMERICAN INSTITUTE OF ACCOUNTANTS ON COOPERATION WITH STOCK EXCHANGES, *REPORTS TO STOCKHOLDERS* (1932) 6.

91. See SANDERS, HATFIELD AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 32.

92. Such differences may arise from the fact that a different base is used for tax purposes than for corporate purposes. Companies with a long corporate existence often have undergone one or more reorganizations or mergers under which they are permitted to use the same base for income tax purposes as was used by the predecessor corporation, whereas the base for corporate purposes may be the reorganization or merger price. Similarly, the rates for depreciation prescribed by the Bureau of Internal Revenue may legitimately be considered too liberal or inadequate for corporate purposes and therefore a different rate may justifiably be used.

is a rather loose estimate, varying with the judgment of men, the past experience and traditions of the particular company and the industry, the method employed, and other innumerable variables. It is not at all surprising that a judgment reached for income tax purposes—a reconciliation of the conflicting interests of a taxpayer and his government—will differ from a judgment reached for the purposes of reporting to stockholders or for internal control. Nevertheless, since the depreciation estimate has a long history of abuse and since it is always a potential source of manipulation, investors should inquire more closely into the reasons for known differences.

Extraordinary Gains and Losses—Income vs. Surplus Allocations. A corporation sells a building or securities in its investment portfolio and suffers a loss. Shall this loss, in either or both cases, be reflected in the income statement, be charged against earned, capital surplus, or an anachronistic unsegregated surplus account, or be set up as an asset to be amortized out of income of future years?⁹³ Will the same rule apply if a gain was realized? The corporation decides to write its plant down because depreciation and obsolescence charges in past years proved to be inadequate or because the corporation wants to reduce future depreciation charges in order to increase the net income of future accounting periods. Shall this charge be reflected in the income of the year in which the decision is made or shall it be attributed to some surplus account? Similarly, how shall the writing off of goodwill, adjustment of prior years' inventories or taxes, abandonment of property, losses from flood or fire, moving expenses, recovery of items previously written off, and all other "non-recurring gains and losses" be handled? Is the same rule applicable to all of these items or to anyone of them irrespective of its history and surrounding circumstances? The problem is far from academic, for the policy followed in allocating these "extraordinary" incidents of a business will affect the reported income very materially. If the United States Steel Corporation, for example, had followed an alternative advocated by the Tentative Statement of the American Accounting Association in handling these extraordinary items,⁹⁴ its income account for 1935 would have shown a net loss of almost \$269,000,000 rather than the net income actually reported of \$1,146,708.⁹⁵ This incident is,

93. Another possibility is to carry the gain or loss as an additional item in the net worth section, leaving the existing surplus accounts untouched, and at some future time absorbing it in one or more of the surplus accounts. See SANDERS, HATFIELD AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 39. See generally HATFIELD, *ACCOUNTING* (1928) 245-6.

94. *American Accounting Association, A Tentative Statement of Accounting Principles* (1936) 11 ACCOUNTING REV. 187, 189-90. See postulates 8 and 11.

95. The corporation wrote its plant down \$270,000,000—charging a previously appropriated earned surplus account. The *Tentative Statement*, *supra* note 94, would have charged it to the income account for the year, or would have had the income figures for the past years recast.

of course, spectacular, but variations from 30 to 50% in the total income reported if another policy had been adopted are not uncommon.⁹³

The investor's needs in the handling of these gains and losses are two-fold:

(1) The itemization and segregation of these "non-recurring incidents" from the results of "normal" current operations;

(2) Greater agreement among accountants both in theory and in practice as to a workable general policy to be followed in allocating these items in order to minimize the possibilities of manipulation and to provide investors with a comparable basis for determining past results of the same company and other companies in the same or other industries.

Accountants are probably agreed that substantial "non-recurring profits and losses," whether reflected in the income statement, or elsewhere, should be itemized and segregated from the "ordinary recurring income" of the period.⁹⁷ Obviously, if these items are included in income without a specific indication of their presence and amount, the investor is misled in his estimate of the probable future earning power. Accounting practice, however, has been far from meticulous in its observance of this principle of segregation.⁹⁸

In the writers' study of 70 corporations, over twice as many itemizations of extraordinary credits or charges, whether to income or surplus, were found in 1937 as in 1930. While some of the increase may be attributable to a greater number of transactions affecting surplus in 1937, most of it seems due to a policy of non-disclosure in the 1930s. The extent of non-disclosure persisting today is very difficult to determine, since the item may be assimilated into another disclosed item or may be charged or credited without notation to some reserve account. Undoubtedly,

96. Hosmer, *The Effect of Direct Charges to Surplus on the Measurement of Income* (1938) 13 ACCOUNTING REV. 31, 43; Greer, *Uniformity in Accounting Statements*, PROCEEDINGS OF THE FIRST INSTITUTE ON ACCOUNTING (1938) 133.

97. Schedule A of the Securities Act requires a disclosure of all "charges . . . made against its various surplus accounts" and a differentiation of "recurring and non-recurring income." Subdivision (26). The Exchange Act leaves the scope and contents of the financial statements required to the discretion of the Commission. § 12(b) (J) and (K).

The instructions to Forms A-1 and A-2 under the Securities Act and Forms 10 and 10-K under the Exchange Act contain almost identical requirements as to disclosure of all substantial non-recurring debits and credits. In addition, the required surplus schedules must specify all additions and deductions from surplus and indicate whether "they are of the nature of capital or earned surplus items." Form A-2, Instructions, Schedule VII, at 46; and Form 10-K, Instructions, Schedule IX, at 32.

The listing requirements of the New York Stock Exchange also require a disclosure of "any substantial item of an unusual or non-recurrent nature." NEW YORK STOCK EXCHANGE, COMMITTEE ON STOCK LIST, REQUIREMENTS FOR LISTING APPLICATIONS (1937)

8. See also INVESTMENT BANKERS CODE OF FAIR COMPETITION (1934) 12; *Tentative Statement* (1936) 11 ACCOUNTING REV. 187, 189 (Postulates 8 and 11).

98. See GRAHAM AND DODD, SECURITY ANALYSIS (1934) cc. 31, 32, for specific instances of abuses of this sort.

credits are more likely to be revealed than charges. It seems clear that accounting morality requires both full disclosure and segregation in all instances of substantial non-recurring gains or losses.⁹⁹

There are few accounting problems on which both theory and practice are in such confusion as in the allocation of "non-recurring" incidents of a business. The problem raises a fundamental query as to the nature and function of an income account. One school of accounting, including most practitioners (to judge by their published reports) and many writers¹⁰⁰ have a mental picture of "normal" or "recurring" operations of a business, producing financial transactions "applicable to the period under review"—which are to be reported in the income statement while non-recurring transactions are not. The business activities and their resulting financial items which do not fall within this picture of the "normal" operations of the business are categorized as "extraordinary", "non-recurring", "not applicable to the period under review" and are dumped into some surplus account, preferably earned surplus. Vitality is supplied to this symbolism by the opposition to the capital gains tax.¹⁰¹ Unfortunately, the lines between "normal" and "abnormal" business activity are in practice very difficult to draw,¹⁰² and once drawn, may lead to serious distortions in the presentation of income. There is the tendency of management, except for income tax purposes, to classify all doubtful gains as income and to charge all doubtful losses to surplus. Depreciation may be kept at undersized figures in order to increase the reported net income—the eventual loss being charged to surplus, and not to income. And where an item is debited to surplus directly, it never is reflected in income reported—and the income statement becomes only a partial view of the total gains and losses encountered by the business.

99. In the Matter of American Terminals and Transit Company, 1 S.E.C. 701 (1936), the Commission held that the designation of a non-recurring income item as "other income" was misleading. One of the principal deficiencies cited in the Commission's Order for Hearing in the *Associated Gas and Electric Company* delisting case, was the "failure to charge to registrant's income account" certain extraordinary expense items. Securities Exchange Act Release No. 1985 (January 13, 1939).

100. See STOCKWELL, *HOW TO READ A PROFIT AND LOSS STATEMENT* (1927) 367; KESTER, *ADVANCED ACCOUNTING* (3d ed. 1933) 356-7; Rowe, *Surplus Adjustments* (1933) 56 J. OF ACCTY. 291-3; Littleton, *Dividends Presuppose Profits* (1934) 9 ACCOUNTING REV. 304; MARPLE, *CAPITAL SURPLUS AND CORPORATE NET WORTH* (1936) 144; 1 FINNEY, *PRINCIPLES OF ACCOUNTING—INTERMEDIATE* (1937) 112; and 1 MAY, *TWENTY-FIVE YEARS OF ACCOUNTING RESPONSIBILITY* (1937) 325. In England, gains and losses on the sale of capital assets are regarded as increasing or decreasing capital, and are not reflected in the income account.

101. The carry over is reflected clearly in 1 MAY, *TWENTY-FIVE YEARS OF ACCOUNTING RESPONSIBILITY* (1937) 319 *et seq.*; Littleton, *Dividends Presuppose Profits* (1934) 9 ACCOUNTING REV. 304, *et seq.*

102. See Hosmer, *The Effect of Direct Charges to Surplus on the Measurement of Income* (1938) 13 ACCOUNTING REV. 31, 44-5.

More important, perhaps than any of these reasons, the dichotomy of "recurring", and "non-recurring" items results in a diversity of accounting practices which makes comparison between corporations difficult, and permits an easy manipulation of these items to either income or surplus as management may desire. As a reaction to the uncertainty and abuses of the "recurring" school, the Tentative Statement of Accounting Principles of the American Accounting Association, proposes a drastic solution. Postulate 8 states:

"The income statement for any given period should reflect all revenues properly given accounting recognition and all costs written off during the period, regardless of whether or not they are the results of operations in that period: to the end that for any period of years in the history of the enterprise the assembled income statements will express completely all gains and losses."¹⁰³

The postulate contemplates an important change in the scope of the income statement; under the "recurring" view, reported income reflects only a portion of the total of the company's business activities of the year. The Tentative Statement proposes that income should include *all* changes in proprietorship from any causes during the period under review as well as any adjustments made to allow for profits and losses "which are not strictly applicable to the current period but which have been recognized in the accounts during that period."¹⁰⁴ In unusual situations, where the "material losses or gains recognized during the current period actually apply to earlier periods," the comment to Postulate 8 suggests either of two alternatives:

" . . . show the extraordinary charges or credits in the current income statement or . . . restate the income statement of the proper number of past periods. Should the latter alternative be adopted, the revised statements of past periods should accompany the statement for the current period. It seems obvious that in any series of statements of corporate results adjustments of previously stated profits should not be excluded—adjustments which have been known to outweigh the total stated gain or loss for a considerable period of years."¹⁰⁵

Postulate 8 and its accompanying comments suggest many advantages. It presents a total view of business activities; it is a simple rule, relatively easy to apply; it provides a more uniform basis for comparison between corporations (under postulate 11, these "non-recurring" items are to be segregated from the operations section in the income statement); it shuts off an important source of manipulation and abuse. On the other hand, the postulate may be too rigid and too simple a solution for a highly

103. (1936) 11 ACCOUNTING REV. 187, 189.

104. *Id.* at 190.

105. *Ibid.*

complex problem. It may well be that it does not serve necessarily the interest of all concerned—the corporation, stockholders, creditors, and the public, to have all of the transactions of the year reflected in the income statement. Some substantial adjustments and capital gains and losses have little relation to current operations and their inclusion in the income statement, even when segregated, may be misleading.¹⁰⁰ As Professor Hosmer has pointed out, application of the postulate to the United States Steel Company's \$270,000,000 plant write-down charge to earned surplus in 1935 may have had disastrous consequences for the corporation and its stockholders.¹⁰⁷

Hosmer has suggested that Postulate 8 should be accepted as a presumptive rule only; that presumptively all extraordinary gains or losses should be reflected in the income statement of the period in which they are recognized, unless the interests of the corporation, stockholders, creditors, or the public are affected adversely by such an allocation.¹⁰⁸ This formula, however, may be loose enough to enable management to rationalize under it many objectionable present practices.

The Securities and Exchange Commission under the Exchange Act has, until recently, permitted management a wide range of discretion in the allocation of "extraordinary" items. The instructions to the forms merely require disclosure and segregation of the "non-recurring" items reflected in the income statement,¹⁰⁹ and a complete itemization of all additions and deductions to surplus in an attached surplus schedule.¹¹⁰ These additions and deductions from surplus must "be so designated as to indicate clearly whether they are of the nature of capital or earned surplus items."¹¹¹ Nothing is said as to what items may or may not be

106. See SANDERS, HATFIELD AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 39.

107. Hosmer, *supra* note 102, at 49-50. If U. S. Steel had charged the \$270,000,000 to income, with a resulting \$269,000,000 loss for the year, the effect upon the price of the company's stock, and, perhaps upon business confidence, might have been of serious proportions. The alternative suggested by the *Tentative Statement* of recasting the income accounts would be very difficult to apply in practice since "the proper number of past periods" for which depreciation and obsolescence were computed wrongly is perhaps impossible to ascertain. Furthermore, recasting past income statements, of course, cannot undo the effects of their previous publication upon investors and the country at large. People have acted upon them already for good or evil. For future action, however, recasting may throw more light upon the corporation's past than retention of old figures known to be wrong.

108. Hosmer, *The Effect of Direct Charges to Surplus on the Measurement of Income* (1938) 13 ACCOUNTING REV. 31, 43 *et seq.* See also HONSEY, *WRITING DOWN ASSETS AND WRITING OFF LOSSES* (1933) 12.

109. Form A-2, Instructions, at 37; Form 10, Instructions, at 23; and Form 10-K, at 21.

110. Form A-2, Instructions, at 35 and Schedule VII; Form 10, Instructions, at 21 and Schedule VII; Form 10-K, Instructions, at 19 and Schedule IX.

111. Form 10-K, Schedule IX.

charged to income, earned surplus, capital surplus, or reserve accounts.¹¹²

In the administration of the Securities Act, the Commission has had sharp internal disagreements over the charging of certain items to capital surplus rather than to profit and loss. In the *Northern States Power Company* and *Chesapeake Corporation* cases,¹¹³ the registrants had written up their assets, creating large capital surplus accounts. Against this account, both companies wrote off millions in unamortized debt discount and expense instead of amortizing by charges to profit and loss. In a third case, the Thermoid Company, among other doubtful accounting practices, charged off debt discount against an existing capital surplus account.¹¹⁴ In another case, the Monongahela West Penn Public Service Company made a running "horseback appraisal" of its properties, crediting the writeup to an appraisal surplus, and in the following five years, charged abandonments of traction properties to this surplus. In all of these cases, the Commissioners unanimously disapproved the accounting, but the majority were content to force an amendment to the accountant's certificate stating the alternative treatment of charging to profit and loss and what the effect of such a procedure would have been. A minority of the Commissioners took the view that reservations in footnotes or an accountant's certificate were not enough, and that the company's earnings records and earned surpluses as stated in their registration statements were untrue and amounted to misrepresentations.¹¹⁵

In at least two subsequent instances, the Commission indicated a tendency to depart from the majority policy. In one case, a reproduction appraisal credited the resulting increase in "value" to capital surplus, and the company announced its intention of charging certain items such as organization expenses to this surplus. The Commission threatened stop order proceedings, and the company erased the entries and recorded its property at cost.¹¹⁶ In another case, the registrant wrote down the net cost value of plant and equipment to a valuation established by the officers and charged the write-down against capital surplus rather than earned surplus. The capital surplus was created specifically for this purpose by a reduction of stated capital pursuant to resolutions adopted by the directors and stockholders. The opinion of Carman Blough, then Chief Accountant of the Commission, issued as Accounting Release No. 1,

112. Form A-1, under the Securities Act, more than any other form, directs the registrant to allocate his extraordinary items along approved accounting channels. Instructions, at 32.

113. These cases are commented upon by Commissioner Healy in an address, *The Next Step in Accounting* (1938) 13 ACCOUNTING REV. 1, at 2-4, delivered before the American Accounting Association in December, 1937.

114. *Ibid.*

115. Healy, *supra* note 113, at 4-5. See, as supporting the minority view, *Accounting and the SEC* (1937) 12 ACCOUNTING REV. 309, 310.

116. Healy, *The Next Step in Accounting* (1938) 13 ACCOUNTING REV. 1, 5.

pointed out that the write-down of assets was a recognition of inadequate depreciation charges against the income of prior years, and then stated:

"It is my conviction that capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been chargeable against income. In case a deficit is thereby created, I see no objection to writing off such a deficit against capital surplus, provided appropriate stockholder approval has been obtained. In this event, subsequent statements of earned surplus should designate the point of time from which the new surplus dates.

"Accordingly, in my opinion, the charge here in question should have been made against earned surplus. In view of the stockholder action that has been taken, I see no objection to the deficit in earned surplus resulting from this write-off being eliminated by a charge to capital surplus created by the restatement of capital stock."¹¹⁷

Following changes in the personnel of the Commission,¹¹⁸ a firmer stand, approaching the minority view, was taken. The new administrative policy was announced in Accounting Release No. 4:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statement provided the matters involved are material. In cases where there is

117. SEC, Accounting Series, Release No. 1 (April 1, 1937). A similar position was previously taken by a committee of the American Institute of Accountants in a report to the Committee on Stock List of the New York Stock Exchange in 1932. Postulates 17 and 19 of the Tentative Statement of Accounting Principles state the same proposition. *American Accounting Association, A Tentative Statement of Accounting Principles* (1936) 11 ACCOUNTING REV. 187. The New York Stock Exchange has a standard clause in its listing agreement with corporations which reads similarly to Accounting Release No. 1.

William W. Wernitz, Chief Accountant of the SEC, in an address before the Annual Meeting of the American Accounting Association, December 28, 1938, at Detroit, stated that the Commission, in a number of cases settled over the conference table, has insisted that the absorption of an operating deficit through charges to capital surplus can be made only by stockholder's consent after full disclosure of all surrounding circumstances. Such transactions are considered to be quasi-reorganizations, whereby, through stockholder consent, earned surplus is relieved of the burden of absorbing past losses, thus facilitating the future payment of dividends.

118. Chairman James M. Landis resigned September 15, 1937, and was succeeded by Mr. William O. Douglas on September 21, 1937; Commissioner J. D. Ross resigned October 31, 1937; Mr. Jerome N. Frank took office on December 27, 1937; and Mr. John W. Hanes on January 14, 1938. The release was issued on April 25, 1938. Subsequently Mr. Hanes resigned (June 30, 1938), and was succeeded by Mr. Edward C. Eicher.

a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."¹¹⁹

It marks a major step forward to require that the laggards of the profession live up to the level of accounting practice for which there is "substantial authoritative support." The release, however, contains many problems of interpretation. What constitutes "substantial authoritative support?" Is the approval of a respectable minority of accountants sufficient? What will the Commission do if there is no generally recognized practice or literature in regard to the handling of a particular transaction? Is the release applicable to "closed" transactions of past years—in other words, would the result of the *Northern States Power Company* case have been changed if this release had been in existence? If so, a large percentage of balance sheets now filed with the Commission will require substantial restatement in the light of an audit going far back in the company's history. Furthermore, many a corporate dividend, authorized in reliance on the accountant's certificate, will, by the changed entries, now appear improper; directors, conceivably, may, thus, be subjected to criminal penalties and both stockholders and directors to restitution. These practical considerations suggest that it may be inadvisable to interpret Release No. 4 retroactively. On the other hand, other techniques, despite comparable inconveniences, constantly revise old practices in the light of current knowledge. Unless the costs of restatement are prohibitive, accountancy and business should not insist upon the preservation in today's accounting statements of the errors of the past.

Segregation of the Sources of Surplus. To the accountant, surplus is merely the balancing figure remaining after deducting the sum of the par or stated value of capital stock and all liabilities from the total of all assets. Surplus plus the amount of the capital stock represents the stockholders' equity in the assets of the corporation. The surplus reported may be only a book arithmetical surplus not realizable in the market place, and usually is no more than that where a substantial percentage of the total assets are fixed and are entered on the balance sheet at historical cost figures or at conjectural and usually sanguine appraisal figures.

Surplus arises from highly diverse sources. Earned surplus, paid-in surplus arising from the sale of stock at a premium, revaluation surplus, donated surplus, surplus from the sale of treasury stock, surplus from

119. SEC Accounting Series, Release No. 4.

the reduction of stated capital are among the subdivisions of generic surplus. Their categorizations reflect their origin.

Genealogy is of great significance to surplus. Earned surplus holds an honored position because of its relationship to earnings and to dividends. Some of the other surpluses are offspring of illicit affairs (revaluation surplus); others of less dubious ancestry are not welcomed in the best corporate circles (surplus from restatements of capital); still others have such ambiguous origins that they dare not, and frequently cannot, be revealed (unsegregated general surplus account). And commonly, all surpluses, other than earned, veil their past in the protective anonymity of the label "capital surplus."

Because of its relationship to earnings and dividends, earned surplus should be segregated and disclosed separately from all other surplus accounts. The Securities Act itself in schedule A provides specifically for a disclosure of the ". . . surplus of the issuer showing how and from what sources such surplus was created."¹²⁰ The Exchange Act is not explicit on this point, but the Instruction Book for Form 10-K provides for the division of this item into (a) paid-in surplus and/or (b) other capital surplus; and (c) earned surplus.¹²¹

In practice, however, these divisions, for past accounting periods, often are impossible to ascertain. The surplus account may never have been segregated in the past, and no one can tell in what proportions dividends are to be taken to have been charged against its earned and non-earned components. No one further can tell how other past charges or credits—*e.g.*, capital gains and losses, should be apportioned now in the general surplus account. And accounting theory, much less accounting practice, is not crystallized sufficiently to enable one to say with certainty whether certain doubtful items are to be charged against earned rather than capital surplus, or the converse.¹²²

These inherent and historical difficulties have prevented the Commission from insisting upon its divisions of surplus in all cases. Surplus must be segregated, but

" . . . if in the accounts, separate balances for these are not shown at the beginning of the fiscal year, *i.e.*, if the company has not, up to the opening of the fiscal year, differentiated in its accounting for surplus as above indicated in (a) and/or (b) and (c), then the surplus may be stated in one amount."¹²³

120. Securities Act, Schedule A (25). See also Instruction Books for Forms A-1, at 32, and A-2 at 46, n. 1, for the schedules and detail required by the Commission under the Securities Act.

121. Schedule IX, at 32. Similar requirements are contained in the Instruction Book for Form 10, Schedule VII, at 26.

122. Cf. Sanders, *Accounting Aspects of the Securities Act* (1937) 4 LAW AND CONTEMP. PROB. 191, 200-2; SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 92-7.

123. Form 10-K, Instructions, at 19.

In the future, however, segregation of capital and earned surplus will be required.¹²⁴

There has been a marked improvement in the disclosure of sources of surplus from 1930 to 1937 in the 70 corporations studied. In 1930, 44 corporations of the 70 had a single general surplus figure and no other; in 1937 the number had dwindled to 8. In 1930, 26 corporations indicated an earned surplus figure. Many of these divisions are, presumably, arbitrary segregations of an old general surplus account.¹²⁵

III.

BALANCE SHEET ASSET FIGURES

Fixed Assets. The properties and resources of a business—the accountant's assets—are divided broadly by the accountant for reporting purposes into two major groups—fixed and current assets. Fixed assets include those assets which are held more or less permanently, are not for sale, and, excepting investments, ordinarily are consumed in the production of goods and services; their cost recovery is achieved only in the gross revenue received from the sale of such goods and services. Current assets, on the other hand, are assets which will be converted into cash or notes and accounts receivable in the forthcoming accounting period. Numerous other classifications of the resources of a business are possible, of course, but from the viewpoint of cost and income recordation, and the presentation of the liquidity of the business, the almost universally employed categories of fixed and current assets are presently regarded as the most useful. As one might expect, however, there is no clean cut distinction between them, and accountants are troubled frequently by

124. A new form, now in the process of preparation may contain the following provisions concerning the segregation of surplus: "That companies organized since January 1, 1928, give a complete segregation of surplus as between (a) paid in surplus, (b) surplus arising from revaluation of assets, (c) other capital surplus, and (d) earned surplus." Healy, *The Next Step in Accounting* (1938) 13 ACCOUNTING REV. 1, at 8.

125. The following chart indicates the number of corporations disclosing the important surplus divisions:

TREATMENT OF SURPLUS AND SURPLUS RESERVES

<i>Names of Surplus Accounts</i>	<i>Number of Companies</i>	
	1930	1937
One Item, usually called "surplus"	44	8
Earned surplus	26	57
Capital surplus	12	30
Paid-in surplus	10	5
Revaluation	1	0
<i>Appropriated Surplus Reserve Accounts</i>		
Companies with one figure	23	16
Companies with reserves itemized	37	44
Companies with reserves included in Capital and Surplus section	6	3

borderline items. A variety of rules of thumb exist which are employed in distinguishing the two classes.¹²⁶

Within the category of fixed assets, accountants crowd into a few simple sub-categories—land, buildings, equipment, and one or two other groupings¹²⁷—all of the phenomena of the physical and manmade world which pass in the market place. This compression of a world into three or four neat pictures is accompanied by an intellectual exploit by which the physical world is transmuted into dollar values; Michigan soil and Texas mules, by the use of a quantitative unit, are made comparable and sometimes identical. All of this is presented in precise, unequivocal terms.¹²⁸

Since dollar symbols do not attach inherently to physical objects, some rational principle must be employed as the basis of making the transmutation.¹²⁹ "Cost", "reproduction cost", and "sound value" or similar phrases attempting to express "current value"¹³⁰ have been most widely

126. PATON, *ESSENTIALS OF ACCOUNTING* (1938) 745, states that the principal tests used in distinguishing fixed and current assets are: ". . . degree of liquidity; (2) normal term or length of life; (3) rate of transfer to expense or loss; (4) technical character or method of use; (5) nature of business and intent of management."

127. Instruction 1 to the Form A-1 balance sheet, under the Securities Act, requires a schedule indicating the major classifications of the plant, property, and equipment account. Similar segregation is required by Schedule II of Forms 10 and 10-K under the Exchange Act. Forms 10 and 10-K require that, where practicable, depreciation reserves shall be shown to correspond to classifications of property, "separating especially depreciation, depletion and amortization".

The following chart indicates the disclosure of these accounting requisites in the 70 corporations studied:

<i>Fixed Assets and Related Reserves</i>	<i>Number of Companies</i>	
	1930	1937
Single entry	8	0
Single entry (net)	4	2
One Figure and one Reserve	39	41
Itemized but no Reserve indicated	2	0
Itemized with one Reserve	8	11
Itemized with allocated Reserves	9	17
Reserve on Liability Side	14	6

128. Compare Hamilton and Till, *supra* note 1.

129. A minimum of disclosure impels, regardless of the alternative employed, an adequate description of the basis used in recording fixed assets. In the recent delisting proceedings instituted against the Associated Gas and Electric Company, one of the deficiencies cited was the "failure to explain adequately the basis of determining" the amount of fixed assets. In the Matter of Associated Gas and Electric Company, Securities Exchange Act Release No. 1985 (January 13, 1939). In 1937, only 43 of the 70 annual reports examined contained any indication of the basis—not an impressive record. It was, however, a decided improvement over 1930 when only 21 of the 70 indicated the basis.

130. See May, *The Influence of Accounting on the Development of an Economy* (1936) 61 J. OF ACC'Y. 11, 17, pointing out that in a single act of the English Parliament the word "value" is said to have been used in twenty-seven senses.

used in accounting history. With few exceptions,¹³¹ accountants deny that accounting should purport to set forth current values for fixed assets,¹³² since it is almost impossible to attribute verifiable market or realizable values to specialized plant equipment permanently committed to a business. "Reproduction cost"—at best a factor of remote interest to investors—leads to a periodic revaluation of the assets with its attendant expenses, and involves accountants or appraisers in a highly speculative game of estimating what it would cost to reproduce a specific piece of property which no one is actually thinking of duplicating. The accountant finds it safest, therefore, to resort to historical cost figures, and accountancy becomes "... not essentially a process of valuation, but the allocation of historical cost and revenues to the current and succeeding fiscal periods."¹³³ As such, the dollar values attributed to fixed assets on the balance sheet must be viewed, not as an available source of funds for the business or an indication of what the corporation is "worth" as of the date of the accounting statement, but as charges to future operations whose predominating function is to insure cost recovery and a proper computation of income. Few investors appreciate that the asset figures must be interpreted so narrowly.¹³⁴

Thus the balance sheet, especially where fixed assets bulk large, is primarily an historical document reflecting original costs (or costs less depreciation). Such costs, at best, represent the "fair value" of the assets as of the date of *acquisition*. Frequently, however, they include sums "im-

131. See May, *supra* note 130, at 15-21. There are a few dissenters, however. See Husband, *Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles* (1937) 12 ACCOUNTING REV. 386; Lorig, *Remarks on Tentative Statement* (1937) 12 ACCOUNTING REV. 401-3.

132. The SEC has not as yet passed upon the question of whether a balance sheet, under the Securities Act, may include writeups, "based on a proper appraisal", of the increased value of assets over original cost. In the matter of Breeze Corporations, Inc., Securities Act Release No. 1786 (1938), a stop order proceeding, the Commission was faced with the question of whether the inclusion in the balance sheet of a substantial appreciation in the book value of registrant's intangibles was materially misleading. The Commission sidestepped the question of writeups since it found that the appraisal methods employed were arbitrary and unsound. See also, In the Matter of Unity Gold Corporation, 1 S.E.C. 25 (1934); In the Matter of Haddam Distillers Corporation, 1 S.E.C. 37 (1934); In the Matter of Continental Distillers and Importers Corporation, 1 S.E.C. 54, 79 (1935); and In the Matter of American Terminals and Transit Company, 1 S.E.C. 701, 720 (1936).

133. *American Accounting Association, Tentative Statement of Accounting Principles* (1936) 11 ACCOUNTING REV. 201.

134. Financial analysts use capitalized earnings as their principal basis of judging the value of a business. Capitalized earnings, however, usually, except perhaps in the case of public utilities, bear little relation to either original costs, reproduction costs, or revaluation appraisals of the fixed assets. Accountants do not conceive it to be their function to correlate balance sheet figures with capitalized earnings, or to note separately the latter on the balance sheet.

prudently invested" in the business as a result of engineering mistakes, insiders' profits, and other elements. Original cost, while more objectively verifiable than the estimates of the appraiser, frequently is an elusive concept also, the contents of which vary according to purpose and definition. It may refer to the cost of construction to the builder or to the cost of acquisition to the owner to whose order it was made or to the cost of acquisition incurred by the present owner.¹³⁵ Thus any specific piece of property may have a number of "costs".¹³⁶ In accountancy, "original cost" or "historical cost" usually refers to the cost to the present owner, except in the public utility field where two sets of cost figures are required by state and federal commissions—" . . . cost of . . . property to the person first devoting it to public service" and cost to the present owner.¹³⁷ Cost to the present owner is often no more than an estimate rather than a precise, ascertainable fact to be stated dogmatically on the balance sheet. Where corporate stock is given in exchange for property, resort must be had to the "value" of the property or the stock to determine "original cost",¹³⁸ and "value", as Bonbright has shown,¹³⁹ is not a very clear concept. And where two properties are purchased jointly in a lump sum payment or where plant assets are constructed by the company itself, the difficulties of segregating the joint costs or allocating overhead requires resort to the techniques of appraisers

135. In the Matter of Breeze Corporations, Inc., Securities Act Release No. 1786 (1938), predecessor companies of the issuer effected substantial writeups by arbitrary appraisals of intangibles. The registrant's acquisition of these assets at the inflated figures was not an arms-length transaction and the Commission held that the statement of the cost figures without the inclusion of an additional statement showing to what extent these figures represented writeups by the predecessor companies was materially misleading.

136. 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 140-1.

137. FEDERAL POWER COMMISSION, UNIFORM SYSTEM OF ACCOUNTS PRESCRIBED FOR PUBLIC UTILITIES AND LICENSEES SUBJECT TO THE PROVISIONS OF THE FEDERAL POWER ACT (1937) 6.

138. In a number of cases under the 1933 Act the Commission has issued stop orders suspending the effectiveness of registration statements for securities of enterprises in the promotional stage on the grounds that the balance sheet did not properly record the cost or value of assets acquired through the issuance of securities. In each of these cases the Commission indicated that the basis for the asset figure should be "sound" appraisal methods competently and honestly applied or the fair market value of the stock at the time the property was acquired. See In the Matter of Unity Gold Corp., 1 S.E.C. 25 (1934); In the Matter of Continental Distillers and Importers Corp., 1 S.E.C. 54 (1935); In the Matter of Big Wedge Gold Mining Co., 1 S.E.C. 98, 107 (1935); In the Matter of American Terminals and Transit Co., 1 S.E.C. 701 (1936); In the Matter of Yumuri Jute Mills Co., 2 S.E.C. 81, 85 (1937); In the Matter of National Boston Montana Mines Corporation, 2 S.E.C. 226, 250 (1937); In the Matter of Rickard Ramore Gold Mines, Ltd., 2 S.E.C. 377, 389 (1937); In the Matter of Bering Straits Tin Mines, Inc., Securities Act Release No. 1498 (July 2, 1937); and In the Matter of Virginia City Gold Mining Company, Securities Act Release No. 1615 (Nov. 16, 1937).

139. BONBRIGHT, VALUATION OF PROPERTY (1937).

or cost accountants; their resultant figures—a "fair allocation"—may be little more than a shrewd guess. Cost figures, furthermore, are usually stated minus accrued depreciation allowances, which means, of course, that the depreciated cost figures are subject to all of the judgment factors that enter into the estimate of the depreciation allowance. Struggles of public utility commissions with operating utilities and of the Interstate Commerce Commission with railroads in the determination of "original costs" indicate that more is involved here than specious fault finding. Investors cannot regard cost figures as mathematically precise quantities which do not include a complex of speculation and discretionary elements virtually inherent in the cost recording process.

Current Assets. Not all the assets of the corporation, however, are presented on the balance sheet at their historical cost. Under prevalent accounting practice, valuation enters in the representation of current assets. These assets consist of cash, realizable securities, and inventories intended to be converted into cash in the course of the year—items, unlike fixed assets, of estimable market value. The market value of these assets is of importance to creditors of the company, and, in view of their interests and the accountant's tradition of conservatism, no more than this value is frequently shown on the balance sheet. This is the well known rule of "cost or market, whichever is lower". A balance sheet, therefore, presents, at the very least, two "values". Apples and horses are added together, *mirabile dictu*, but the result is neither four apples nor four horses but a very strange medley of the two. An identical pecuniary symbol attributed to each obscures the working of this magic. And no balance sheet exhibits as few as two different bases of values. Frequently, distinct categories of items in inventory will be represented at different bases on the same balance sheet.¹⁴⁰ Investment securities, securities of affiliates, marketable securities may not be valued by the same criterion.¹⁴¹ As we have seen, "cost" itself is far from being a readily determinable unitary concept. On a single balance sheet, reflecting a long corporate history, "cost" may be used in a number of different senses. This may be and frequently is true in a single balance sheet of all the other bases used in determining the value of assets.¹⁴² In view of these circumstances,

140. As in the 1937 balance sheets of such corporations as American Sugar Refining Co.; Holly Sugar Corporation; Armour & Co.; Federal Mining and Smelting Co.; Columbia Oil and Gas Corp.; Baldwin Locomotive Co.; Warner Bros. Pictures, Inc.; May Department Stores Co.

141. PATON, ACCOUNTANTS' HANDBOOK (1934) 319, lists the following principal bases of security valuation for accounting purposes: "(1) Actual cost or amount invested; (2) market price; (3) appraised or estimated value; (4) value on issuing company's books; (5) cost modified by accumulation or amortization; (6) maturity value."

142. Doran, *The Impact of Economics on Accounting* (Jan. 1939) EDISON INST. BULL. 26, 28; COMMITTEE OF AMERICAN INSTITUTE OF ACCOUNTANTS ON COOPERATION WITH STOCK EXCHANGES, REPORTS TO STOCKHOLDERS (1932) 6 [Reprinted in 1 MAY, TWENTY-FIVE YEARS OF ACCOUNTING RESPONSIBILITY (1937) 115]. In addition, adjustments for price level changes are seldom made.

inherent in an all-purpose balance sheet called upon to serve the divergent functions of internal control, interests of creditors, taxation, and reports to stockholders, investors must regard the "total assets" figures of a corporation with substantial skepticism.

Current assets, representing the working capital of the business, are the most significant items on the balance sheet to management, investors, and creditors. The questions arising in their disclosure, from the investors' viewpoint particularly, are: what items are to be included in this category (basis of classification), what basis of "value" should be used in computing each category of items, and the extent of the disclosure necessary to serve the investors' needs.¹⁴³

Accounting literature indicates that many companies exclude all items from current assets which are not readily convertible during the course of a year. But this rule is by no means followed universally.¹⁴⁴ An investor is interested in knowing the company's particular scheme of classification, (it may have one which is no more than a very rough working rule) in order to evaluate its current credit position in the light of the highly significant ratio of current assets to current liabilities, and other ratios,¹⁴⁵ and the current credit position of competitors. Disclosure is also of value in inducing the corporation to use the same basis for current liabilities as for current assets—a necessary step in the analysis of the current credit position. Under both Securities Acts, the Commission regulations provide that "items classed as current assets should be generally realized within one year," but "generally recognized trade practices with respect to individual items, such as installment receivables or inventories long in process are admissible, provided such trade practices are stated."¹⁴⁶ The word "generally", while probably a necessary grant of discretion, may permit items to enter which would distort an investor's estimates. But while the Securities and Exchange Commission may consider basis of classification of current assets a significant item of disclosure, not a single corporation of the seventy studied, in either 1930 or 1937, revealed its basis of classification for either current assets or current liabilities.

Marketable Securities. When this item is included in current assets, it should represent only securities having a ready market, which can be

143. Even in regard to this very significant figure, there were six companies in 1930 and two in 1937 which did not give a total for current assets. In 1930, nine companies included obviously improper items such as treasury stock and bonds; and in 1937, eight companies made such improper inclusions. The S.E.C. has found similar deficiencies. Accounting Series, Release No. 7 (May 16, 1938) 3.

144. See Sanders, *Reports to Stockholders* (1934) 9 ACCOUNTING REV. 201, 208.

145. See GRAHAM AND KATZ, *ACCOUNTING IN LAW PRACTICE* (1932) 168; Bowman, *Reporting upon the Corporate Investment* (1938) 65 J. OF ACCTY. 396, 407-10. On investment analysis ratios generally, see authorities cited *supra* note 44.

146. Form 10-K, Instructions, at 14.

liquidated without a material impairment of their values.¹⁴⁷ Since this item figures so largely in the analysis of current assets, it is desirable that the basis of determining the balance sheet amount be shown. The Securities and Exchange Commission requires that if the amount is not shown on the basis of current market, such aggregate amount should be stated parenthetically.¹⁴⁸ Of the 70 corporations studied, only 23 indicated the basis in 1930; by 1937, the number had jumped to 48. Great diversity exists in the basis employed.¹⁴⁹

Notes and Accounts Receivable. Since notes and accounts receivable appear as a current asset on the balance sheet, they should consist of items which, normally, will be liquidated in the regular course of business during the succeeding fiscal year. Receivables from officers, employees, and parent and subsidiary companies, if included, should be listed separately. Such receivables have a long record of abuses in corporate history and experience has shown that they often remain on the books for years. Inclusion of these items in current assets may thus result in an overstatement of the current position. Where significant differences in the light of trade practices exist, notes and accounts receivable should be listed separately. The Securities and Exchange Commission permits the consolidation of the two items under the Exchange Act, but requires detailed segregation under the Securities Act.¹⁵⁰

147. "Include only securities having a ready market. State in the balance sheet the basis of determining the balance sheet amount and, if not shown on the basis of current market quotations, state such aggregate amount parenthetically." Form 10-K, Instructions, 14. It is understood that the proposed new forms contain a provision requiring in addition a parenthetical statement of the original cost of the securities.

Professors Sanders, Hatfield, and Moore indicate an additional requirement: "this market should be sufficiently stable to absorb an orderly liquidation of the particular securities held by the company without materially impairing the currently quoted values, or at any rate without reducing them below the prices at which the company carries them in its balance sheet." SANDERS, HATFIELD AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 72. Thus DuPont de Nemours & Co. does not list its vast holdings in General Motors as a current asset. See, also, Accounting Series, Release No. 7; and In the Matter of American Gyro Company, 1 S.E.C. 83, 87 (1935).

148. Form 10-K, Instructions, at 14, quoted *supra* note 147. Forms 10 and A-2 contain similar instructions.

149. In a study of 155 balance sheets and income statements published in 1934, the valuation of marketable securities 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 par', stocks 'at market'." Daniels, *Corporation Financial Statements* (1934) 6 MICHIGAN BUSINESS STUDIES 51, n. 1.

150. The instructions to Forms 10 and 10-K permit "Notes and Accounts Receivable" to be combined. Instructions, at pages 17 and 15, respectively. Form A-1, Item 54, requires segregation in considerable detail, and apparently segregation is also required in Form A-2. Form A-2, Instructions, p. 31. In the tentative drafts of the proposed new forms, trade notes and accounts receivable are to be segregated, but a consolidated reserve is permitted.

Adequate reserves should be set up, as a deduction from listed assets, "to cover any difference between the book amount and reasonably probable realization."¹⁵¹ The judgment of management and its accountants in the light of current conditions and the company's past experience will determine the margin.¹⁵² Normally, unless warranted by increasing volume of sales on credit or greater anticipated losses, the reserve, unlike the depreciation reserve, should not increase from period to period, since it is considered applicable to existing and presumably collectible receivables only. Such an increase may indicate that a "secret" reserve is being created. Unless a company has a background of dissimilar results in the collection of notes as distinguished from accounts receivable, there is little point in setting up a separate reserve for each. Few accountants would disagree, in principle, with these working rules.

Of the 70 corporations studied, 34, in 1930, presented a single figure for both notes and accounts receivable, and 24 of the 70 did not provide a reserve. In 1937, 23 corporations presented a single figure for both accounts and 19, despite the standard of accounting practice prescribed by the SEC, did not disclose a reserve.¹⁵³

Inventories. In view of its importance in the analysis of the current credit position of the company and in the determination of income, full disclosure of information as to inventories is of material benefit to the investor-analyst. In addition to the desirability of segregation of major classes of inventories which is required by the Securities and Exchange Commission,¹⁵⁴ the investor is primarily interested in the bases used in

151. SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 73.

152. There are two generally accepted methods of determining the amounts of the annual allowances for losses from uncollectibles. One is by analyzing the individual accounts and the other is by basing the allowance upon the general past experience of the company. See PATON, ESSENTIALS OF ACCOUNTING (1938) 411 *et seq.*

153. The statistics for notes and accounts receivable and related reserves of the 70 corporations are as follows:

<i>How Disclosed:</i>	<i>Number of Companies</i>	
	<i>1930</i>	<i>1937</i>
Single entry ("net" not indicated)	16	4
Single entry ("net" indicated)	8	15
One entry and one reserve	10	9
Itemized but no reserve	15	2
Itemized and one reserve	17	30
Itemized and allocated reserves	3	8
Reserves on liability side	25*	3†

*In 1930, two companies had the reserve separated, ten mentioned doubtful accounts in the name of the entry, and thirteen had reserves for contingencies with no mention of doubtful accounts.

†Three companies listed reserves for contingencies with no mention of doubtful accounts.

154. Form 10-K, Instructions, at 15.

the determination of the valuation of inventory. There are numerous possibilities; cost, replacement cost (market), cost or market whichever is lower, base stock, selling price, retail method, and others. The same corporation may, and frequently does employ, a different basis for distinct items in the inventory.¹⁵⁵ And the same basis because of the nature of the materials with which it is concerned, means something entirely different with varying items in the inventory.¹⁵⁶

The particular inventory method chosen has an important effect in the determination of income. "Cost or market, whichever is lower," perhaps the most widely used method,¹⁵⁷ seems to have been adopted in this country on the advent of the Federal Income Tax law, largely as an immediate method of reducing taxable income.¹⁵⁸ But the accountants who adopted it for this purpose were shortsighted. While the method results in an understatement of income in the first period, it causes an overstatement in the very next.¹⁵⁹ Either may have serious consequences for an investor.

Andrew Barr has shown that under the first-in, first-out method of determining cost advocated by Paton, higher profits are noted in the income statement with rising price levels and lower profits with falling prices.¹⁶⁰ These gains and losses are "realized" gains and losses only if the fiction of first-in, first-out is not questioned. The replacement cost method (market), however, in its own way, clearly results in the inclusion of unrealized profits in the case of rising prices and losses not incurred in the case of falling prices. A growing school of accountants and economists are now advocating adoption of such methods as the base-stock method, the last-in, first-out, and the inventory reserve method as more satisfactory means of eliminating fictitious gains and losses.¹⁶¹

In view of the important differences in the statement of income resulting from the adoption of one method rather than the other, an investor cannot "give the same weight to profits of companies in the same business

155. Examples are found in the 1937 annual reports of American Sugar Refining Co., Holly Sugar Refining Co., Firestone Tire & Rubber Co., Bethlehem Steel Corp., Pittsburgh Coal Co., Columbia Oil & Gasoline Corp., and others.

156. See PATON, *ACCOUNTANTS' HANDBOOK* (1934) 418, 420.

157. Of the 70 annual reports studied, 39 in 1930 and 45 in 1937 employed the "cost or market" method.

158. Paton, *Comments on "A Statement of Accounting Principles"* (1938) 65 J. OF ACCTY. 196, 202.

159. See GRAHAM AND KATZ, *ACCOUNTING IN LAW PRACTICE* (1932) 191; Paton, *Comments on "A Statement of Accounting Principles"* (1938) 65 J. OF ACCTY. 196, 203; and Barr, *Comments on "A Statement of Accounting Principles"* (1938) 65 J. OF ACCTY. 319-23.

160. Barr, *Comments on "A Statement of Accounting Principles"* (1938) 65 J. OF ACCTY. 319-23.

161. Fictitious inventory profits have serious economic consequences. See Arthur, *Inventory Profits in the Business Cycle* (1938) 28 AM. ECON. REV. 27-40.

without knowing whether the profits to which their calculations are applied have been computed on the same basis or how great the effect of a difference in method might be."¹⁶² Few investors, and not all accountants, seem to realize this fact. And even when the same basis is employed in estimating distinct items in the inventory of the same company or where the same basis is employed by two different concerns, results may be far from uniform.

A "cost" of an individual item in the inventory seems a simple matter to determine. But so simple a word turns out to be the most generic of concepts, and its estimation creates endless difficulties for the accountant. Investigators for the Bureau of Internal Revenue in 1919 discovered, for example, that it meant very little to note that a particular company was on a "cost" basis; the nature of the basis could only be brought out by a careful study of the theories and procedures adopted by the management in working up its estimate.¹⁶³ First is the question of how cost is to be defined. It usually includes invoice price, transportation charges, handling prices, and insurance. Sometimes buying expenses and unpacking costs are added. There is also the very difficult task of allocating costs to specific items in instances of joint products and by-products. The highest arts of the cost accountant may produce no more than an arbitrary division. The second major question which arises is what method is to be used in determining invoice costs. Many methods, each producing different results, compete for attention: first-in, first-out; last-in, last-out; average cost; weighted average cost; base stock method; actual cost of specific lots on hand, and others. Mere enumeration of these competing methods indicates some of the difficulties inherent in cost determination. Almost equal difficulties exist in the determination of the other available bases of inventories.¹⁶⁴

The SEC, thus far, has adopted no rules on inventory valuation other than to require a statement of the method of valuation adopted by the company.¹⁶⁵ William Werntz, Chief Accountant of the SEC, reports that practically all of the generally recognized methods of inventory

162. May, *Influence of the Depression on the Practice of Accountancy* (1932) 54 J. OF ACCT'Y. 336 [Reprinted in 1 MAY, TWENTY-FIVE YEARS OF ACCOUNTING RESPONSIBILITY (1937) 87].

163. PATON, ACCOUNTANTS' HANDBOOK (1934) 423-4.

164. See PATON, *loc. cit. supra* note 156. For variations in the meaning of "market" see "The Valuation of Inventory", in *Report of the Special Committee on Inventories to American Institute of Accountants* (1938) 65 J. OF ACCT'Y. 29, 30.

165. The forms require: "State separately in the balance sheet, or in a schedule therein referred to, major classes of inventory such as (a) raw materials; (b) work in process; (c) finished goods; (d) supplies, and the basis of determining the amounts shown in the balance sheet. Any other classification that is reasonably informative may be used." Form A-2, Instructions, p. 31; Form 10, Instructions, p. 17; and Form 10-K, Instructions, p. 15. It is understood that the proposed revision of accounting forms requires, in addition, a description of the basis to the extent practicable.

valuation have been used by one company or another in the statements filed, and that the Commission seldom has found occasion to object to the use of any particular system.¹⁶⁶ Werntz, however, has expressed serious doubts as to whether the mere designation of the system followed—"cost or market", for example—constitutes sufficient disclosure.¹⁶⁷ The apparent solution is to call for more detail, but the problem is not so easily disposed of. As Werntz reports,

"When a requirement was proposed calling for a clear indication of what was meant by cost or market, numerous commentators made the point that if the operations of a company were at all complex, several pages of explanation would be required by reason of the use of diverse methods. Others indicated that not much less than a text on cost accounting would suffice to illumine 'standard' costs . . ."¹⁶⁸

What does all this mean to the investor? First of all, he must learn to be extremely cautious and skeptical in his use of inventory figures both for credit ratios and for comparative purposes with corporations in the same industry. Secondly, he must not place too much faith in the disclosure of the basis of valuation since the nature of anyone of the bases varies so greatly depending upon the method and procedure employed, and the item with which it is concerned. Inventory figures, as so many other figures in accounting, must be taken as broad, loose estimates, as (if the procedure and theories followed were acceptable) one of a number of alternative pecuniary valuations attributable to the

166. WERTTZ, AN APPROACH TO ACCOUNTING PROBLEMS (An Address delivered before the Indianapolis Chapter of the National Association of Cost Accountants on December 14, 1938; before the Illinois Society of Certified Public Accountants on December 16, 1938) 7.

167. *Ibid.*

168. *Ibid.* Consistency in the application of a particular method from year to year and a clear indication in the company's accounting statements of any changes in method from year to year may provide more protection to the investor than attempts at detailed description of the method employed. The Bureau of Internal Revenue's regulations, designed, of course, clearly to reflect income for income tax purposes, do not prescribe specific methods to be followed, admitting that "inventory rules cannot be uniform". The emphasis is on consistency, and " . . . greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations." Treasury Regulations 94, Art. 22(c)-2. The Bureau, however, is interested in the income, from year to year, of individual businesses only. Consistency in the application of a particular method over a period of years will, theoretically at least, result in the ultimate absorption of *fictional* inventory profits or losses produced by a method in a particular year. Investors, however, have a broader interest. They are interested in a method of inventorying which reflects most fairly the inventory for the *particular* year since they may decide to buy or sell on the basis of the income statement for the particular year. Furthermore, they are interested in a greater uniformity of inventory methods from corporation to corporation and more detailed disclosure of the methods followed so that a basis of comparison of operating results of different corporations is available.

units of goods in the inventory. Accounting technique in its present stage of development cannot do more than this.

Disclosure of an accepted basis, however, assuming that the basis has been followed honestly and with an effort at consistency from year to year, does give an investor an opportunity to make his rough calculations; looseness of concept does not imply that concepts are not valuable. While 1937 shows some improvement over 1930 in disclosure of the basis of inventory figures, its record is not altogether clean.¹⁶⁹

IV.

Reports to stockholders, whether judged by the standards set by the SEC or by one's own lights, seem very inadequate. On vital counts, investors are left conjecturing—sales, cost of sales, depreciation, inventories and surplus generally are so inadequately described that an investor does not have a minimum of information upon which to form an intelligent opinion on buying or selling.¹⁷⁰ The seventy corporations included in this study represent the best in American reporting practice—yet their accounting to stockholders falls far short of the minimum requirements which these very corporations must meet in their reports to the SEC. Unless accounting morality with respect to annual reports to stockholders improves substantially within the next few years, imposition of standards of conduct by the SEC seems necessary in the interest of the shareholding public.

Accounting conventions and rules of thumb attempt to bring "a sprawling domain of unsubdued facts"¹⁷¹ and an almost infinite number of individual transactions into clean cut, neat categories each denominated with some pecuniary value. Classification of these myriad and individ-

169. Presentation of Inventory figures:

	<i>Number of Companies</i>	
	<i>1930</i>	<i>1937</i>
Inventory Itemized with Amounts Indicated ..	16	17
<i>Basis Employed:</i>		
Not indicated	19	5
Cost	8	6
Cost or Market	39	45
Miscellaneous	6	16

170. The Twentieth Century Fund came to a similar conclusion: "... We have found that, despite some improvement during the past few years, a majority even of those companies whose issues are listed on the New York Stock Exchange do not disclose enough information to render their balance sheets and income accounts intelligible to the average, well informed investor." TWENTIETH CENTURY FUND, *SECURITY MARKETS* (1935) 601.

171. Hamilton, *Cost as a Standard for Price* (1937) 4 *LAW & CONTEMP. PROB.* 321.

ualized events into categories and sub-categories—the components of which bear to the observer some similarity to each other—is, of course, essential if the phenomena of modern business are to be controlled. The types of classifications and categories developed in any discipline—and accounting is not an exception—are the products of a long evolution; the reasons for their origin, usually unknown to us now, may have been to serve some temporary convenience or more persistent business need. Their survival today in accounting practice is not conclusive of their survival value for all accounting purposes.

Most of the classifications in accounting are broad and generic—very, loose abstract words and phrases into which we attempt to pack the divergent transactions of business life. Like most abstractions, they have no “real meaning” apart from concrete situations and specific purposes for which the abstraction is being employed. No single definition of “value”, for example, however convenient and simplifying it might be, can describe the word’s changing meanings with changing purposes. “Value” for rate making purposes is a term meaningless to anyone unfamiliar with the struggles in American public-utility law.¹⁷² The accountant’s “valuation” of inventories at “cost or market, whichever is lower,” makes sense only in the light of its use by “conservative” accounting practice to report the accountant’s “realized income”. Another set of “values” used by the accountant, “historical costs”, is meaningful only in the light of the accountant’s conception of his function as a reporter of “the allocation of historical costs and revenues to the current and succeeding fiscal periods.”¹⁷³

A fuller realization by accounting practitioners and teachers of the generic nature and purposive character of accounting categories should lead to a paring off of the broader concepts, the elimination of those which are meaningless or which no longer serve specific needs adequately, an application of existing concepts and the formulation of new ones in terms of specific situations and specific functions, and to a healthy skepticism to counteract the appearance of certitude induced by mathematical symbols. More concretely, it should lead to a realization that accounting rules designed to serve the interests of management in private business may reflect, inadequately and unfairly, the interests of employees, consumers, and the public in the enterprise, and that such rules may be rather irrelevant as applied to the fiscal activities of a government.¹⁷⁴ It should lead, further, within the precinct of accounting for management, to a far greater development in the preparation of accounts for specific purposes—to “single purpose” statements, varying according to the purpose for which

172. See 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 1168.

173. *American Accounting Association, A Tentative Statement of Accounting Principles* (1936) 11 ACCOUNTING REV. 187.

174. See note 23, *supra*.

they are prepared. A statement which attempts to account for the money presently invested in the business and to record costs during each income period—the historical balance sheet—cannot serve the purpose of determining the “present financial worth” of a business; and rules designed to insure adequate tax returns, or rate control, or internal control for management, or to reflect liquidity for creditors—all intermingled in the present “all purpose” balance sheet—hardly suffice to guide an investor in his trading of securities.¹⁷⁵ Professor Bonbright has indicated the technique for the development of the functional account:

“It is to be hoped that the accounting profession will give far more attention than it has heretofore given, to the effect on the ‘proper’ balance sheet and earnings statements of the specific purposes for which these financial documents are customarily used. A good beginning could be made by assuming, first, that no use will be made of the company’s reports except by buyers and sellers of the corporate stock. In the light of this single assumed objective, all of the alternative procedures of accounting, such as the valuation of fixed assets at original cost versus replacement cost, the use of straight-line versus sinking-fund method of depreciation, the booking of current assets at cost versus the lower of cost and market, and so forth, might be subjected to a critical rating of their relative merits. This task having been accomplished, the accountant might then forget the stockholder and assume that an ‘ideal’ set of financial reports is such a set as will best fit the needs of the credit department of a commercial bank. Still other objects . . . would be taken up in turn. The result of this inquiry would be the creation of standards for ‘single-purpose’ balance sheets and earnings statements. Further research would consider the question whether a workable multiple-purpose scheme of accounts might not be so devised that, by the aid of pencil and paper, a reader could reconstruct the accounts to fit his own requirements.”¹⁷⁶

The SEC has accepted the all purpose accounting categories as sufficient for investors and has confined its role to an insistence upon more adequate disclosure within the framework of those categories and upon a conformance with the standards of accounting conduct recognized by the better textwriters and more careful practitioners. Almost alone of all agencies—governmental or private—the SEC has the resources, staff, and sanctions where necessary, to undertake the work of a reclassification of business data pointed toward the needs of stockholders and investors. If the exploratory remarks in this essay are well conceived, investors and the general public will inevitably benefit if the SEC finds it possible to undertake this task.

175. See, as expressive of another point of view, Berle, *Accounting and the Law* (1938) 13 ACCOUNTING REV. 9.

176. 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 253-54.