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Modified Statements Giving Effect to Proposed Financing

BY HOMER N. SWEET

(Of Lybrand, Ross Bros. & Montgomery)

[EDITORIAL NOTE: The following article by Mr. Sweet appeared in the November, 1925, issue of the *L. R. B. & M. Journal.* Because of its timeliness and excellence permission has been obtained to reprint it. Unfortunately, limitations of space have precluded reproduction of the entire article. With much regret it has been necessary to omit Mr. Sweet's discussion of no-par-value stock, of modified statements of earnings, and of accountants' certificates and similar matters in connection with modified statements.]

INVESTMENT banking houses purchase new issues of industrial bonds and stocks and offer them for sale mainly on the strength of the representations of financial condition and earning capacity. It is customary for bankers to offer the securities for sale before the bonds or stock certificates have been delivered or even issued; hence, the phrase "when, as and if issued." Nor does the corporation receive funds for the securities until after the offering to the public. Yet a statement of financial condition to be enlightening to prospective purchasers, must exhibit the assets, liabilities and capital accounts as they will appear after consummation of the various transactions incident to the financing. A balance sheet as of a prior date, adjusted to give effect to proposed financing yet to be consummated, is called a modified balance sheet.

Modified balance sheets are given wide circulation and publicity. The banking house which organizes the syndicate shows them to other houses through which wholesale lots of the securities may be sold. They are reproduced in the bankers' circulars or prospectuses and are distributed by mail to hundreds and thousands of their customers. Salesmen of the banking houses will show the balance sheets to prospective purchasers of the securities. The balance sheets are filed with the authorities who administer blue sky laws in various states. Financial advertisements in the newspapers mention the amounts of net assets and net current assets derived from the modified balance sheets.

No greater responsibility devolves upon the public accountant in any branch of his work than that which attends the certifying of modified balance sheets. A material error in a modified statement certified by a public accountant would reflect seriously upon his reputation, not to mention the possible legal consequences of his negligence. The accountant should take every prudent precaution, within the legitimate scope of his work, to save his clients, the bankers and himself from making inadvertent misrepresentations of fact.

Bankers for their own protection usually insist on having certified statements as a condition of their buying industrial bonds or stocks for sale to their customers. Industrial issues are seldom offered without mention in the advertisements and circulars that the accounts and statements have been certified by independent auditors. When large syndicates are organized, many of the participants will join without making extensive investigation into the finances of the corporation and will depend chiefly upon the reports of the accountants and appraisers. The accountant is, therefore, regarded as in a responsible relation to members of the syndicate as well as to the ultimate buyers of the securities, although his employment is by the corporation.

What has been said about a modified balance sheet applies with equal force to a statement of earnings which the accountant may be called upon to certify. Usually the accountant is asked to certify the earnings as well as the balance sheet.

Bankers often look to the accountant for correct information about details of the modifications that have been effected in the balance sheet and details of income, depre-

ciation, interest, dividends, etc. The bankers need this information to answer the questions that are likely to be asked by customers and other inquirers.

Conditions Precedent to Certification of Modified Balance Sheet

Notwithstanding the wide circulation of certified balance sheets and income figures as representations in the offering of industrial securities and the onerous responsibility which the accountant assumes in certifying to those statements, the technical books and journals furnish little guidance to the practical accountant concerning the principles and pitfalls of this important branch of accountancy. The only formulation of principles relating to modified balance sheets of which the writer is aware is in the report of a special committee of the American Institute of Accountants, which was published at pages 168 and 169 in the year book for 1923. That report is instructive and the recommendations in it should be observed carefully by public accountants. The accountant may properly certify to a modified balance sheet, according to the recommendations of that committee, under certain conditions. In abbreviated language those conditions are:

1. That the subsequent transactions shall be the subject of agreement between responsible parties.
2. That the subsequent transactions shall be scheduled to take place reasonably soon, say within four months, after the date of the balance sheet.
3. That the accountant shall have satisfied himself that no other transaction or development has occurred to affect adversely the company's financial condition.
4. That the character of the transactions to which effect is given shall be clearly disclosed on the statement.
5. That the accountant shall have satisfied himself that the proceeds of the financing can and will be applied in the manner disclosed on the statement.

To the above conditions the writer believes there should be added three more:

a. That certification of a modified balance sheet must be predicated upon a thorough audit of the entire balance sheet.
b. That effect must be given in the modified balance sheet to all the contemplated transactions, not excluding any, that may affect the equities of the investors.
c. That the accountant shall have satisfied himself that no representation at variance with the facts he has verified is to appear in the circular.

With this declaration of general principles in mind, we can profitably proceed to discuss their applications.

The classes of transactions to which effect is given in a modified balance sheet are: issuance of securities, application of proceeds from securities, revaluation of fixed assets, assumption of liabilities and disposition of discount and bond premiums.

Issuance of Securities

The agreement between the bankers and the corporation is the authority on which the accountant can rely for many of these facts:

Amount and description of securities to be authorized and issued.

Essential terms to be embodied in new bond indenture or capital stock provisions.

Definitions of current assets.

Amendments to be embodied in existing bond indenture or capital stock provisions.

Properties to be mortgaged or released from prior mortgage or pledge.

Voting trusts for control of stocks owned in subsidiary companies.

Price to be paid by bankers to the corporation for the securities.

Commission, if any, to be paid to the bankers for their services apart from the price to be paid for the securities.

Liability for fees of appraisers, accountants and lawyers.
Stock to be reserved for warrants.
Options for later purchases of additional stock or bonds.
Basis of immediate conversion or exchange of securities.
Basis of future conversion privileges.
Arrangement for distribution of stock dividends.
Arrangement for creation of surplus by reduction of capital stock.
Arrangement for creation of special surplus by write-up in valuation of properties.
Application of proceeds from sale of securities.

Any of the above may have a bearing on captions and amounts in the balance sheet. Each provision in the agreement between the corporation and the bankers must be carefully studied to ascertain whether it has any relation to the balance sheet. Some of the less obvious applications may well be considered here.

The contract may provide for the authorization of a larger amount of bonds than are to be presently issued and the interest rate on the future issues may be left open for determination at the time of issue. If the amount of authorized bonds is mentioned in the balance sheet, the explanations must be so phrased that the interest rate on the current issue will not be made to apply to the entire amount authorized.

If current assets are defined, the classification of current assets in the modified balance sheet should correspond with that definition, provided it does not violate sound accounting principles. The amount of net current assets mentioned in the circular should not, without notice, be inconsistent with the definition of current assets which is to be written into the indenture. When there are subsidiary or affiliated companies, careful consideration must be given to the question whether a consolidated balance sheet or a partially consolidated balance sheet or a balance sheet not consolidated is the best representation of financial condition, as far as current assets are concerned, for the purposes of a particular offering of securities. Determination of the proper form of the balance sheet must be judged largely on the proposed terms of the indenture and the representations to be made in the circular.

Amendments to be embodied in existing bond indentures or capital stock provisions may necessitate revision of the descriptions of those securities as they have appeared on previous balance sheets of the company.

Careful attention should be given to any provisions about mortgaging of properties and release of properties from prior mortgage or pledge. These provisions may affect notations of hypothecations on the face of the balance sheet. The accountant should check his record of hypothecations against the list of properties to be brought under the mortgage. By this comparison he may detect inconsistencies between his tentative balance sheet and proposed statements in the draft of the circular.

If the first mortgage covers only fixed assets of the parent company and there are large holdings of real property by subsidiary or affiliated companies, a balance sheet which consolidates the fixed assets of all the companies may be misleading to a purchaser of the bonds unless suitable explanation be made on the balance sheet or in the circular.

If stocks owned by a parent company in subsidiary companies are placed in a voting trust to insure control by a special committee in lieu of a direct lien on the stocks or assets of the subsidiaries, that fact should be noted on the balance sheet.

Proposed distribution of stock dividends should be given effect in the capital and surplus accounts. Any proposal to declare stock dividends out of unrealized surplus created by writing up asset accounts should receive thorough investigation on the part of the accountant. Unless he can determine for himself that integrity of enhanced value in the asset ac-

count is fully demonstrated he may be justified in withholding his certification of the balance sheet. In any event, there should be a disclosure in the preamble of the balance sheet of the source of any unrealized surplus purporting to be available for distribution in stock dividends.

The agreement may specify the terms of conversion or exchange of securities. Guided by those specifications, the accountant should make appropriate adjustments in the balance sheet.

If the balance sheet is to be set up on the assumption of the exercise of an option which has not lapsed, that fact should be disclosed on the balance sheet.

If the company has any of its own shares or bonds in the treasury which by agreement are to be reserved for warrants or options, appropriate explanation thereof should be written against the item of "treasury securities." Notice may properly be written on the balance sheet of the fact that authorized shares unissued are, by agreement, to be reserved for warrants or options.

* * *

Application of Proceeds

The authority for application of part of the proceeds may be found in the contract with the bankers. The cost of acquisition of new properties to be defrayed out of proceeds of financing will be specified in a contract between the corporation and the seller. The cost of new construction should be supported by a contract or by estimates of reliable engineers. Reduction of floating debt, often one object of new financing, is an example of application not ordinarily covered by contract: evidence of the company's intention should be covered by a letter from a responsible officer of the corporation. The amount of cash to be added to working capital out of the proceeds of financing should be confirmed by a letter from the company.

When outstanding bonds or preferred stock are to be retired from the proceeds of new financing, the bond indentures or preferred stock provisions should be carefully read to ascertain the call price and the date of redemption. If the date of redemption of the old issues is subsequent to the date of sale of the new securities, then the corporation may be put to the expense of double interest; that is, it may pay interest for a time on both the old and the new securities. This excess interest may be partially offset by interest to be earned on funds from the new securities while on deposit until withdrawn for redemption of the old securities. The net expense for double interest should be allowed for in the estimate of expenses of the new financing.

Certain adjustments may be suggested which the accountant should not accept as legitimate modifications in a balance sheet giving effect to financing. One is the application of proceeds to the reduction of current liabilities below a normal amount of payables. A corporation in active business must show at any date some indebtedness for unpaid purchase invoices, expenses and accrued items. To reduce current liabilities below a normal amount on a modified balance sheet would have the effect of representing a condition which could not exist.

Another type of adjustment also to be avoided is the reduction of liabilities accomplished by an assumed liquidation of accounts receivable or other assets not the subject of a contract of sale. Accounts receivable of a business acquired may be disproportionately high, but in absence of enforcible guarantees the corporation which buys them has no rights superior to those of any other concern, by which it can lay claim for early collections. Even though the accounts receivable are good accounts judged by the usual tests, the corporation cannot fairly represent the asset on the balance sheet except as accounts receivable.

Revaluation of Fixed Assets

Independent appraisals may be accepted by the accountant as the basis for

revaluation of fixed assets, provided the corporation declares in writing its intention to adjust the book values of the fixed assets to accord with the appraisals. The accountant should examine the report of the appraisers carefully to determine the amount of the adjustment to be made in book values. The appraisal may not cover all classes of property which the corporation has carried on its books as fixed assets, or it may not cover fixed properties of all branches and outlying stations of the corporation. On the other hand, the appraisal may include non-durable tools which the corporation may be carrying as inventory.

Conceivably the book value of fixed assets might be less than the appraised value because of excessive allowances on the books in prior years for depreciation. If that be so, the write-up in book value to accord with the appraisal may properly be carried to the credit of earned surplus. More often, however, the appraised value is higher than book value for two reasons: appreciation in prices and the fact that visible depreciation as observed by the appraisers is usually less than straight-line depreciation accumulated on the books. It is well settled practice, therefore, that a write-up in book value of fixed assets, which does not represent realized earnings, should be credited to a special surplus account entitled, for example, "Surplus arising from revaluation of fixed assets." If the appreciation were credited to the regular surplus account for undivided profits, the financial statement would to that extent be misleading.

That is the practice to be observed if the same corporation is to continue the business with a written-up book value of plant. Should the plant assets, however, be purchased by a new corporation and securities issued on the basis of appraisal, then the question of the special surplus does not arise.

It is not out of place to anticipate at this point what effect a revaluation of fixed assets may have on future net earnings as influenced by provisions for depreciation. Depreciation of property acquired by a new corporation should be reckoned on the cost of the property. If that cost is higher than the former book value, depreciation expense will be larger for the new corporation than it was for the predecessor company. On the other hand, if the same corporation continues the business, the amount added to plant account by way of revaluation can be amortized by charges to the special surplus account and depreciation expense can be computed on the former book value. Depreciation expense chargeable against annual income would then be on a basis comparable with past allowances.

Surplus arising from revaluation must not be dissipated by charges that do not amortize the value added to plant account. If charges for losses or any extraordinary expenses were made to surplus arising from revaluation, the balance in that account would be reduced to zero before all the amortization shall have been written off. The remaining balance of appreciation on the asset side could be later depreciated only out of income.

Liabilities Assumed

Acquisition of the net assets of a business usually involves the assumption of liabilities by the buyer. The purchaser, however, may not assume all the liabilities of the predecessor business. Mortgage liability and liability for federal taxes for certain periods are examples of obligations of the seller that may not be taken over by the buyer. The agreement of purchase will specify what liabilities the buyer undertakes to assume.

The contract between the corporation and the bankers will disclose which party is obligated for fees and other expenses incident to the flotation of securities. In addition to fees of appraisers, accountants and lawyers, financing entails expense for engraving of certificates, state taxes, transfer taxes and the like; also, possibly, double

interest, which has already been discussed. A liability should be included in accounts payable on the modified balance sheet for the estimated amount of these expenses.

The expenses for a bond issue may be carried as a deferred debit, subject to amortization over the life of the bonds, or they may be charged immediately to surplus.

Disposition of Discounts and Premiums

When the proceeds of new financing are to be applied in whole or in part to the retirement of a previous bond issue, the accountant has to pass upon the disposition of premiums, if any, to be paid in retiring the old bonds, the balance of unamortized discount on the old bonds and the discount on the new bonds. Premiums on the old bonds are an immediate charge to surplus in the modified balance sheet: this accords with sound accounting practice and with the income tax regulations. The balance of unamortized discount on the old bonds should likewise be considered as a charge to surplus for the modified balance sheet.

Discount on the new bonds may be carried as a deferred debit in the modified balance sheet subject to amortization over the life of the bonds. It should be said that deferring and amortizing the new bond discount are obligatory, rather than permissive, if future income is to be charged with total actual interest which includes amortization of discount besides interest paid to the bondholders. The Interstate Commerce Commission, however, grants to companies under its jurisdiction the option of carrying bond discount as a deferred debit in the balance sheet, subject to annual amortization, or charging off the discount forthwith to surplus. The objection that charging discount to surplus when bonds are issued overstates annual net income in subsequent years is not merely a theoretical one when the bond indenture provides that dividends shall not be paid on the common stock except out of earnings accruing subsequent to a specified date. Certainly annual earnings regulated by such provisions should, in justice to the bondholders, be charged with a pro rata share of the bond discount.

To say that premiums and discounts on old bonds should be charged to surplus does not settle the problem in all its ramifications. A further question still remains to be answered, viz., to what surplus account should the charges be made: to earned surplus, or to capital surplus, or to surplus arising from revaluation of fixed assets?

To charge premiums and discounts to surplus arising from revaluation from fixed assets would reduce the balance of that account below the amount of appreciation in the fixed assets account. It has been pointed out already that exhaustion of the special surplus account before the write-up in value has been entirely extinguished would shunt the remainder appreciation eventually into the income account. In effect, the result would be equivalent to postponing the writing off of the premiums or discount for the time being and later charging them to income under the guise of amortization of fixed assets. Such a practice is unsound and deceptive. Premiums and discounts should not be charged to surplus arising from revaluation.

Whether premiums and discounts may properly be charged to capital surplus is a question that accountants decide in the negative, except when the company is incorporated in a state whose statutes beyond a doubt sanction the availability of capital surplus for dividends.

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Editorial Comment

AN illustration of the unsatisfactory statements which result from failure to observe all of the principles enunciated in the foregoing may be found in the balance sheet which appeared in connection with a recent offering of securities.

The offering was an issue of preferred stock of a certain corporation. It was made for the purpose of securing funds with which to retire an issue of bonds outstanding. The preferred stock was sold to the public by bankers, pursuant to an agreement between the corporation and the bankers, dated a few days prior to the announcement of the new issue.

The balance sheet, however, which appeared in the circular advertising the offering, adjusted to give effect to the proposed financing, bore a date approximately six and one-half months earlier than the date of the agreement and the consummation of the transactions contemplated therein.

Obviously, it is not possible, in making an offering of securities, to present up-to-the-minute financial statements. An interval of time must be allowed for accountants to satisfy themselves as to the correctness of the statements covering which their certificate is desired, and for the arrangement of legal and other matters involved in the financing.

This interval should be as short as possible. A special committee of the American Institute of Accountants, which made a study of the subject, has recommended four months as a maximum. Certainly, it should be no greater. Prospective investors are entitled to financial statements as nearly current as can be obtained. Accountants asked to certify to a balance sheet giving effect to proposed financing should ascertain that the period of time is reasonably short between the date of the balance sheet and the date of the subsequent transactions in respect of which the balance sheet is to be adjusted.

Accountants should exercise particular pains in endeavoring to prepare accurate, clear, and informative statements giving effect to proposed financing, because of the wide use to which such statements are put, and the reliance which is placed upon them.

The nature of the adjustments, reflecting proceeds and their application, should be set forth clearly. For use of the bankers, a balance sheet in columnar form frequently is prepared, showing first, the assets and liabilities before adjustment; exnt, the new capital obligations and application of their proceeds; and finally, the adjusted figures. This is a preferable arrangement, and whether or not re-arranged later should be incorporated in the report in order that the "trail," as it were, may be of record. An alternate plan is to show only the figures in the balance sheet after adjustment, accompanying the latter with a detailed statement of the changes which have been made. This, obviously, is not as clear or as satisfactory as the plan first mentioned.

Usually a more condensed balance sheet than the columnar form suggested above is desired for circulation among prospective purchasers of securities. This statement should show all essential facts concerning the adjustments, either as a part of the heading of the balance sheet, or in a footnote thereon, or be stated in the certificate. The number and complexity of the adjustments should be considered in determining the most appropriate position for displaying this data.

Whether or not the details are shown in the heading, the latter should indicate that the balance sheet has been adjusted to give effect to certain proposed financing, and reference to the fact should be made also in the certificate.

It is not necessary to show the price at which securities involved in a refinancing are to be sold to bankers, since naturally bankers object to disclosure of this information to the public.

For their own protection, and for the information of outside parties, accountants should show the sources of their information as to the adjustments on account of proposed financing to which they give effect in financial statements. The American Institute of Accountants' committee, to which reference has been made above, recommended that "it should be made clear that the transactions embodied have been definitely covered by contracts."

PRESS OF WILLIAM GREEN, NEW YORK