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Correspondence: Earnings Per Share, Stock Dividends as Income; Fraud and Audits

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EARNINGS PER SHARE

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: The interesting article on earnings per share in the April JOURNAL raises the question whether the earnings per share when shares increase should be computed on the shares outstanding at the end of the period or on the average outstanding during the period; approves the average method, and proceeds to discuss means of arriving at an exact average.

The average would seem the correct divisor (except perhaps in those few cases where the increase in shares is the cause of a bond retirement warranting using as dividend the net income before deducting pertinent bond interest and discount) but there are two practical difficulties in obtaining an exact average: first, the necessary data are usually not available and, second, even if they were available it is impossible to relate the earnings to the share proceeds which produced them.

In many, if not most, cases there is available for the calculation:

As dividend—net income of the period.

As possible divisors—outstanding shares at beginning of period, at end of period or the simple average of the two.

We have, for example:

	A Co.	B Co.	C Co.
Shares outstanding at beginning of period	200	200	200
Shares outstanding at end of period	400	400	400
Net income of period	$4,200	$3,000	$5,400

From these figures earnings per share can be calculated:

	A Co.	B Co.	C Co.
On outstanding at beginning	$21.00	$15.00	$27.00
On outstanding at end	10.50	7.50	13.50
On simple average outstanding	14.00	10.00	18.00

Now suppose the undisclosed facts are:

	A Co.		B Co.		C Co.	
Quarters	Shares outstanding during quarter	Earnings	Shares outstanding during quarter	Earnings	Shares outstanding during quarter	Earnings
1st	200	$ 600	200	$ 600	200	$ 300
2nd	400	1,200	200	600	200	300
3rd	400	1,200	200	600	400	2,400
4th	400	1,200	400	1,200	400	2,400
Weighted average and total earnings	350	$4,200	250	$3,000	300	$5,400
Average per share		$12.00		$12.00		$18.00

In these cases we would show for A company earnings of $14 as against the true figure of $12; $10 for B company as against $12 and $18 for C company, whereas the latter may have, by a fortuitous investment of additional capital, raised its present and prospective earning power to $24 per share. And not only would the figure for each company be misleading but also the comparison between companies.

With the above in mind consider the record of the five companies named in the article as shown by Poor's *Manual:*

	Shares outstanding	Net income for 1928 and 1929	Earnings per share
United Fruit:			
1927	2,500,000		
1928	2,500,000	$20,606,393	$ 8.24
1929	2,625,000	17,802,992	6.78
Bethlehem:			
1927	1,800,000		
1928	1,800,000	11,743,422	6.52
1929	3,159,000		
1929 average	2,273,333	35,242,980	15.50
Paramount:			
1927	687,259		
1928	2,062,857	8,713,063	4.22
1929	2,700,000		
1929 average	2,444,795	15,500,000	6.34
Du Pont:			
1927	2,661,658		
1928	2,811,050	58,733,238	20.89
1929	10,339,242		
1929 average	10,196,777	72,300,627	7.09
Montgomery Ward:			
1927	1,141,251		
1928	3,410,983	16,276,016	4.77
1929	4,620,768	12,007,117	2.60

Summarizing these ten calculations the divisors used for earnings per share are:

	For 1928	For 1929
No change in shares outstanding	2	
Change in outstanding ignored and outstanding at end of year used	3	2
Average outstanding used		3

Also, how does a stock dividend affect the calculation? The increase in United Fruit shares is reported due to a stock dividend of 125,000 shares paid April 1, 1929. Is the true 1929 earning per share the above $6.78 (calculated on shares outstanding December 31, 1929) or the $6.86 calculated on the weighted average of shares outstanding in 1929. And to compare the two years should we divide by 2,625,000 in 1928 and get $7.85 or divide by 2,500,000 in 1929 and get $7.12?

Then again, how do the dividends per share compare with earnings per share? Assume A and B company dividends to be:

	A Co.			B Co.		
Quarters	Shares paid on	Paid per share	Total dividend	Shares paid on	Paid per share	Total dividend
1st...........	200	$ 2.00	$ 400	200	$ 3.33	$ 666
2nd...........	400	3.00	1,200	200	3.33	666
3rd...........	400	3.00	1,200	200	3.34	668
4th...........	400	3.50	1,400	400	2.50	1,000
Total.......		$11.50	$4,200		$12.50	$3,000

In both instances the entire earnings were paid in dividends but A company shows it paid 50 cents less, and B company 50 cents more, per share than was actually earned.

Quarterly reports do not solve the problem, although, of course, the variations would be within narrower limits.

As to the consideration received for the additional shares working to the benefit of the corporation from the time of issue it would seem that it must, for practical purposes, be assumed that it does.

It is a difficult problem, the nearest practical solution of which would be for corporations to report the *average* shares outstanding as well as those at the beginning and end of the period reported upon. Even that, of course, would not give the scientifically exact results discussed in the article in question. But is such exactness necessary; is not the per share earnings regarded more as an index than an exact statement of fact?

Yours truly,

Louis G. Peloubet.

New York, May 1, 1930.

STOCK DIVIDENDS AS INCOME

Editor, The Journal of Accountancy:

Sir: I have no doubt that the invtatiion to readers, in your editorial in the April number of The Journal of Accountancy, to give their views on the treatment of stock dividends has resulted in a deluge of replies, so I hasten to get mine in before I learn that the polls are closed. I have always found the subject a very interesting one, and my opinion is pretty definitely established, but I am still open to argument.

I believe that stock dividends, periodic or otherwise, large or small, should never be treated as income in any amount, should not be taken up on the books except by a memorandum entry, and should not affect total values in any way. I also believe that it is theoretically unsound to treat cash dividends as income, without reservations, but that is another story.

The great trouble with a discussion of this sort is the difficulty of getting away from income taxes. We are so steeped in the question of taxes and taxable income that it is very difficult to get back to what is income in theory.

It must also be borne in mind that values are only momentary and, by the time you have figured up your income, it has, very likely, become something else. Consider your example of the man who purchased the land for $1,000. Good accounting would not sanction the payment of a dividend out of the appreciation of $9,000, but good accounting could not object to the setting up of the profit on the books. With a firm offer, it would certainly be correct to say that at that particular moment, the property showed a profit of $9,000. There was, of course, no taxable profit. Mr. Freeman makes the example a little clearer by working his property and putting back real value, but the theory is the same. I find it impossible to disagree with the findings of the supreme court on the question, and I fail to see any reason for differentiating between one kind of a stock dividend and another. In no case does the stockholder receive or the corporation part with anything.

I am sorry to have to differ with Mr. Stagg, but it seems to be necessary. I quote him as follows:

> "It is surely optional to the recipient of such (stock) dividend, whether he sells it and thereby converts it into a cash income without reducing the book value of his original investment in the company, or whether he increases his investment in the company as compared with a year ago by holding it. The latter course would be identical with an investor in a company distributing cash dividends who, not requiring the cash, invested his dividends in additional stock in the same company."

I grant the stockholder the option of doing anything he likes with his dividend, but I can not be sure of the results. If he sells it, he necessarily gets cash but not necessarily income, and he will certainly not increase his investment in the company by placing another certificate, for which he paid nothing, in a safe-deposit box. Neither can I see that holding a stock dividend is in any way comparable to investing a cash dividend in more stock of the same company. In the first place, the stockholder merely maintains his relative position while in the second, if he lives long enough, he will have acquired the entire stock of the company.

Mr. Stagg also says:

> "It is respectfully submitted that there is not the clear-cut distinction that there should be between a stock dividend made as part of the regular distribution out of the current earnings . . . and substantial stock distributions amounting to as high as 100% or even more. . . ."

and the reason for this is that there is no difference. To prove this it is only necessary to use the ancient device of requiring the designation of a dividing point where one ends and the other begins. The stock dividend is a stock dividend, large or small, periodic or otherwise. That this may make trouble for the life tenant and remainderman is too bad, but it does not affect the theory in the slightest.

Mr. Freeman, in answering your February editorial, asks:

> "If a stock dividend is not income when it is received, how can it be changed into income by converting it into cash?"

My answer is that it can not. He continues:

> "If it is not income when it is received, what else can it be but capital?"

And my answer is that it is merely a scrap of paper. He also says:

> "Happily that theory (dilution of original cost upon receipt of a stock dividend) as applied to periodic stock dividends, has been rather definitely discarded."

This statement I find rather disconcerting, as it is the first I had heard of it. He infers that the courts have ruled that certain stock dividends are income. This also is news to me.

In conclusion, my opinion is that a stock dividend, large or small, periodic or occasional, split-up or capitalization of surplus, should never be called income, and that the only theoretically correct way to handle cash dividends is to follow the accepted procedure for parent and subsidiary—namely to charge the investment account with the earnings at the end of each year and credit all cash distributions to the same account. I admit the impracticability of this method, but submit that it is behind the petticoats of expediency that we, with the calm assurance of perfect propriety, include among items of income determined entirely on an accrual basis, a cash distribution from a corporation which may even be currently operating at a loss.

Yours truly,

J. Brooks Keyes.

Boston, Mass., April 28, 1930.

FRAUD AND AUDITS

Editor, The Journal of Accountancy:

Sir: Your report of the liability of the auditors in verifying existence of securities as published in the May Journal of Accountancy made interesting reading for me.

I presume all practising accountants are continually confronted with the question of just how far certain examinations and verifications should extend in order to leave no stone under which might be hidden the bugaboo of concealed fraud.

I had an experience not long ago in turning up a theft which was being perpetrated in a way I had never encountered before. I had dreamed of such a thing, but had never even heard that it had actually been found in the experience of public accountants. Possibly it may be new to some members of the profession.

The books of a firm were being audited. The manager of the concern was at the same time bookkeeper, cashier and almost everything else. He was not, however, a heavy stockholder, but was working on a salary. The audit was to be a brief one, chiefly for the purpose of making up the income-tax return of the firm. The purchases were made on 30 and 60 days time, and there were about 25 or 30 firms from which the company bought its goods in quantities ranging from $400 to $1,500 per invoice. The examination, as I stated, was not to be a detailed audit, but the auditor proceeded to check some of the purchases from the invoices into the purchase record in order to satisfy himself that the purchases were accounted for in the proper manner. More from force of habit than anything else, as he checked each invoice to the purchase record, he glanced over the additions on the invoices. Before long he found one over-added $100. The original typewritten footing on the invoice had been very neatly erased and raised $100. He laid it aside to call to the attention of the manager when he came in, but before the manager came in, the auditor had found two more invoices treated in the same manner, each with the footing raised $100. Examination of the cheque record and the canceled cheques showed that in each case the raised amount had been paid. Instead of calling the manager's attention, the auditor communicated with the makers of the invoices and asked for copies of the original invoices, together with credit memos for the overpayment. In each case, letters came back promptly informing the auditor that such overpayments had been called to the attention of the purchaser at the time payment was received, and that in each case the purchaser had written asking them to send him a refund check instead of a credit memo, because of certain peculiar ways in which he handled his records.

The rest was easy. Every invoice purchased for a considerable length of time back was carefully examined, and over a period of 15 months, twenty-one firms had refunded a total of $1,450. No firm had been worked more than once. The manager had received the refund check, put it in the cash drawer without making any record of it, and extracted a like amount of cash. Not all the changes had been made in footings of the invoices. Some of the changes had been made in extensions, and in two cases, the prices had been changed, but in each case the change necessitated a change in the footing. Some of the erasures were so neatly made as to be almost invisible except under a magnifying glass.

Suppose the auditor had been commissioned to make a detailed audit for the purpose of putting out a statement to obtain further credit, and had failed to catch these shortages, or had been employed by the stockholders to satisfy them that everything was O. K. Would he have been considered negligent in his duties, if later it had been found that he had not unearthed the fraud? The volume of business was such that these differences in the purchases did not noticeably affect the gross profit.

Yours truly,

O. M. Williams.

Colorado Springs, May 8, 1930.