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By George O. May

I am not one who believes that any benefit can be derived from the mere contemplation of misfortune, and I should not, therefore, undertake to address you today were it a question merely of dwelling on the unfortunate immediate effects on the profession of the unparalleled depression through which we have been passing. I deeply regret the loss of employment by many worthy members of our profession and the difficulties which some of our practitioners have experienced; but I should not feel that the depression would be worth our study unless we could derive either some legitimate satisfaction or some instruction, or both, from the process.

I think we can derive satisfaction from the abundant evidence of the importance of our profession which the depression has elicited. The numerous defalcations which have unfortunately but naturally resulted from it have brought home the importance of detailed audits by outside auditors in the case of those companies which are not of sufficient magnitude to justify the maintenance of an adequate system of internal check. Other incidents have demonstrated the importance of external audits in the case of companies at the other extreme of the range: namely, those companies which in their magnitude and importance have sometimes been deemed to be above the need of auditing. I think that in both fields we can look forward confidently to a permanent growth in the work of the profession as the result of this temporary depression and that the outlook is favorable to those carrying on efficiently either large practices or small. It is, however, the lessons which we can learn from the depression that I propose particularly to consider.

It is in times of stress that defects and inadequacies of a structure become most readily apparent; and it has seemed to me that it would be worth while to consider what defects in the economic structure the present depression has revealed, and how far accountants have any responsibility therefor or any opportunity to bring

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about improvement in the future. Obviously, the depression is not the resultant of any single cause but of a multiplicity of causes. Of the many to which it has been partly attributed, most lie in fields with which the accountant as such is not concerned, and this group includes those in regard to which controversy has been the keenest—such as the relation to the depression of the development of intense post-war nationalism; tariffs; war debts; the gold standard, etc. Some, however, seem to me to relate to phases of our economic life with which the accountant has a very direct concern.

First of all, I propose to discuss a phase of the question with which, as chairman of your committee on coöperation with stock exchanges, I have been much concerned in recent months. No one doubts that one of the major contributing causes to the depression was the enormous volume and extravagantly high prices which characterized the dealings in corporate stocks in the period prior to the collapse of 1929. An outstanding characteristic of that movement was the new emphasis laid on earning capacity as the measure of value of such securities; and, as frequently happens when new recognition is given to an old truth, we have seen during periods of inflation and deflation this truth applied in a most reckless and ill-advised manner, not only by investors, but by many who have undertaken to advise others. Such people were no doubt right when they argued that earning capacity was usually the main criterion of value. They may have been right in their second proposition, that the fair value of securities of a given type was a multiple—ten, or fifteen, or twenty—of the earning capacity attached to the security. They were, however, hopelessly wrong when they predicated their calculations on the assumption that the earning capacity was fairly measured by the past or prospective earnings for a comparatively short period, without any adequate knowledge of the way in which the figures of earnings employed in their calculations were derived.

Nothing has astonished me more in conversations with men fairly well versed in financial matters than their failure to appreciate the importance of methods of accounting in relation to corporate earnings and to capital values predicated on earnings. We accountants know how varied are the methods commonly and legitimately employed, how great the effect of a difference of methods on the earnings of a particular short period may be, and how erroneous may be conclusions as to capital value based on such earnings. An illustration may make clearer the point I have in mind.

Let me take a simple case of one of the unemployed who joined the apple selling rush in the winter of 1931. He started on the first day believing that he could sell two crates of apples, which cost him $2.00 each, at a profit of more than one hundred per cent. At the end of the first day he found that he had sold the contents of one and collected $5.00. The wholesale price of apples remained unchanged and it was quite clear to him, and it must be to everyone else, that he had made a profit of $3.00.

The second day, however, complications arose. As a result of the rush, the wholesale price of apples had risen to $2.25 a crate, and at that price he bought one crate. He was also able to increase his price slightly, and the sale of one crate produced $5.50. Apples were still quoted wholesale at $2.25 when he ended his day's work, and the question arose in his mind whether his profit for the day was $3.25 or $3.50. Looking at the matter one way, he had $3.25 more cash than he had at the beginning of the day, and he had one crate of apples on hand just as he had at the beginning. Looking at it another way, the crate of apples that he had bought that day had cost him $2.25 and was still worth that sum, and what he had sold was the crate of apples bought the previous day at $2.00; and as he had realized $5.50, he had made a profit of $3.50.

The third day, the public demand for apples began to decline. He was able to buy another crate of apples for $2.00, and the sale of one crate produced only $4.50. To make matters worse, he found that by the end of the day the wholesale price of apples had fallen to $1.75. He was sorely puzzled to determine how much profit he had made that day. He still had a crate of apples, as he had had in the morning, and he had $2.50 more cash, so that from this standpoint his profit was $2.50. If, however, he took the view that what he had on hand was the crate he had bought that day, and that what he had sold was the crate which had cost $2.25 the previous day, his profit was only $2.25. Looking at it in a third way he perceived that at the close of the previous day he had had a crate of apples that had cost him and was worth $2.25; at the end of that day he had a crate of apples which was worth $1.75 and $2.50 in cash, a total of $4.25, so that from this standpoint his gain for the day was only $2.00.

He concluded that, anyhow, the business was an unsatisfactory one, and decided to buy no more apples; and on the fourth day he was able to sell the contents of the crate he had on hand for $4.00.

Looking back over the experience of the four days, it was clear that he had bought four crates of apples at a total cost of $8.25 and had sold the contents for a total of $19.00, and thus had made a total profit of $10.75. It was apparent, however, that the profit from day to day varied according to the way in which the stock he carried over from day to day was treated. The only day in which the amount of profit was clear was the first day. The following table shows the distribution of profits between days on the different theories, which I may now describe in the terms in which they are commonly described by accountants, to whom all three methods are familiar:

	First day	Second day	Third day	Fourth day	Total
On the basis of stating the inventory at latest cost, the profit was..............	$3.00	$3.50	$2.25	$2.00	$10.75
On the basis of inventorying at cost or market, whichever was lower...............	3.00	3.50	2.00	2.25	10.75
On the basic stock method (that is, valuing stock at a uniform price)...........	3.00	3.25	2.50	2.00	10.75

If next we assume three men, A, B, and C, having exactly the same experience but using the three different inventory methods respectively in the order above named and reporting their profits accordingly—then if we were to appraise the value of the respective businesses by multiplying the profits shown in, say, the second period, by a uniform multiple we should reach the conclusion that the businesses of A and B were worth substantially more than that of C; while if we made the calculations a day later and used the third period as our basis we should conclude that C's business was by far the most valuable of the three.

Of course, on the illustrative case assumed the conclusion is fantastically absurd; but enlarge the scale of the illustration in volume, time and complexity, so that it will deal with years and millions of dollars instead of days and dollars, and you have exactly the situation that has been presented in the period that has elapsed between the close of the last depression in 1921 and the present time.

Nor do the three methods of computing profits for the different periods exhaust the variations in commercial practices. Some corporations, for instance, would treat the reduction of inventory from cost to market value as a charge to surplus, and show:

Net income	
First day	$ 3.00
Second day	3.50
Third day	2.25
Fourth day	2.25
	$11.00
Less—Charge to surplus	
Third day	.25
	$10.75*

Now investors, and even some who undertake to advise investors, are apt to give the same weight to profits of companies in the same business 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. And as most of you probably know, such computations have frequently been made on the basis of profits for a single year, if not for a shorter period. I remember, for instance, the case of a banking house acquiring the business of a large corporation for the purpose of resale to the public on an agreed basis measured by the earnings of a past year, without any specification of the way in which the earnings had been or were to be determined except that it was to be in accordance with good accounting practice; and as this paper was being written I happened to see a publication of a firm of investment advisors containing this language: "When the statement is made that the majority of common stocks are overvalued at current levels, it is meant that they are selling at higher values than are justified by a six to nine months' improvement in earning power at the best rate foreseeable."

By comparing the figures in the table I have already given you will notice that the method of valuation at cost or market, whichever is lower (which is by far the most commonly employed of all

* Those desiring to pursue the question further may be interested to compare the annual reports for 1931 of the National Lead Company, the Goodyear Tire & Rubber Company and the American Smelting and Refining Co. Such a comparison affords much food for thought, and I was very interested, therefore, to see a question in a recent examination paper on accounting principles of the Harvard Graduate School of Business Administration, calling for a discussion of the difference of method between the Goodyear and National Lead companies.

methods), results in showing larger profits in a period of rising wholesale and retail prices and lower profits in a period of declining prices than the basic stock method. For this reason, it has been argued that the basic stock method is really a safer and saner way of measuring earnings than the cost or market basis. I think it must be admitted that the cost or market basis is designed primarily to afford a sound balance-sheet value, and that some change of method, or some change in the form of presentation of results, may be called for at this time, when the income account is becoming recognized as potentially at least more significant than the balance-sheet. But without passing on this minor question, I think we can agree on the major point that, particularly in times of changing prices, it is very important that those who undertake to appraise capital values on the basis of current earnings should know just how the earnings are computed.

I chose my illustration from the field of inventory valuation, but this is by no means the only part of corporate accounting in respect of which legitimate methods vary. Methods of treatment of plant and equipment, for instance, vary even more widely. I noticed recently a statement by an economist that the heavy investment in capital equipment characteristic of the present age tended to make the process of readjustment in a period of falling prices more painful and prolonged than it would otherwise be.* Certainly, this characteristic of heavy capital investment gives rise to the most difficult problems of modern accounting—problems which can not be solved by any precise mathematical or logical processes but require foresight and judgment in their handling if even measurably accurate solutions are to be reached.

The questions what expenditures ought to be capitalized and when expenditures so capitalized ought to be charged off are not easy to answer, and experience shows that corporations adopt an infinite variety of methods in dealing with them. At the one extreme are the methods prescribed by many public-service commissions, according to which all additions and improvements are capitalized and units of property are charged off only as they are actually retired or are about to be retired, when the charge may be made against either operating expenses or surplus. At the other extreme is the method formerly employed by General Electric Company, by which all capital expenditures are charged off against income in the year in which they are incurred, no

* *Economic Tendencies; Aspects of Pre-War and Post-War Changes*, Frederick C. Mills.

charge being made, naturally, for depreciation of previously existing plant. Between these extremes the accounts of corporations reflect every gradation from over-liberality to over-conservatism in attributing charges to capital and amortizing them through depreciation charges or otherwise. Here, again, anyone appraising the stock of a corporation on the basis of its earnings should know what methods of accounting have been followed.

It may be suggested that the accountant who audits the accounts of a corporation and satisfies himself that they are presented on a fair basis has no further responsibility to the individual investor or analyst who may draw unwarranted inferences from the accounts. That is, no doubt, quite true; but if the profession is to render the fullest possible service, surely it must keep in touch with the trend of economic developments and try to meet the legitimate demands that grow out of such developments.

Now, one of the major economic developments of recent years has been the change in the nature and status of corporate securities. This change has been brought about by two tendencies in the development of corporations—first, the tendency to consolidate businesses into large units and, secondly, the ever-widening diffusion of security holdings. The great social significance of these tendencies was recognized some years ago by the Social Science Research Council and that body instituted a study which resulted in the publication of a work bearing the title, *The Modern Corporation and Private Property.** From this work it appears that roughly forty per cent. of the business wealth of the country (other than banking) is controlled by the two hundred largest corporations. It also appears that the control of the two hundred corporations in turn is roughly as follows:

	By number	By wealth
Management control	44%	58%
Legal device	21%	22%
Minority control	23%	14%
Majority ownership	5%	2%
Private ownership	6%	4%
In hands of receiver	1%	negligible
	100%	100%

It was impracticable to carry the study further to cover smaller, but still large corporations, but the analysis shows clearly how

* *The Modern Corporation and Private Property*, A. A. Berle, Jr., and Gardiner C. Means.

very far the separation between beneficial ownership and control of corporate property has already proceeded, and doubtless the process will continue in the future.

Concurrently, there has been a constant attempt to make corporate stocks, which in essence are capital assets, more and more into a liquid security, readily marketable and suitable as collateral for demand or short-time obligations. The three tendencies combined seem to me to have created a legitimate basis for the demand for full and more enlightening information in regard to the operation of the larger companies whose securities are widely distributed and subject to continuous market dealings. If market values are to be fairly appraised, information throwing light on the earning capacity is of the first importance. The reports issued by such corporations must not be regarded as having only historical interest—it must be recognized that their principal value lies in enabling thousands or tens of thousands of stockholders to deal intelligently with their investments in corporations and potential investors to form reasonably informed opinions on the attractiveness of the stocks of corporations at the prices at which they are available. And I think the accountant should take cognizance of this situation and do his part toward securing the fulfillment of the requirements to which it gives rise, and I think his part can be made a very important one.

To my mind, the first essential is to bring about a better understanding by investors of what accounts are or should be and what they are not and can not be. Investors should be brought to realize that the value and significance of corporate accounts depend partly on the methods of accounting employed by the corporation and partly on the degree of wisdom and honesty displayed in applying those methods. And here it is important to note that the use of the most conservative method may, for a short period, result in an overstatement of earnings. If, for instance, during a year of depression a corporation which capitalized nothing and charges no depreciation suspends all construction work, the results for that year will be presented in an unduly favorable light, although the accumulated surplus may still be conservatively stated.

In the second place, it seems to me highly desirable that the reports and accounts of corporations should be made more fully explanatory, so that investors and others interested will know generally what methods of accounting have been followed and be in a position to appraise the value of the resulting figures accordingly. This development seems to me infinitely preferable to the alternative which at once suggests itself of uniform methods imposed by external authority. I think, also, that in the formulation of methods of accounting the preëminent importance of earning capacity should be recognized and the consequent importance of furnishing to stockholders and investors an income account which will give as fair an indication of the earning capacity of the business during the period to which it relates as can be given.

I think it only fair to add that, from a fairly wide international experience, I believe information is more fairly given in respect of corporate affairs in this country than in perhaps any other important commercial country. This, however, ought to be so, for the simple reason that the three tendencies to which I have referred (those towards concentration into larger units, diffusion of shareholdings, and the creation of a status of liquidity for corporate stocks) have proceeded much further in this country than elsewhere.

Your committee on coöperation with stock exchanges, of which I am chairman, has been much impressed with the determination of the New York stock exchange to exercise its influence more than in the past in the direction which I have indicated and with the possibilities of helpful coöperation on the part of accountants. This committee during the past year has given much consideration to the subject, and the views which I am expressing today are in a large measure the result of that consideration.

It is quite true that the public accountant has no power to initiate improvements in corporate methods of accounting or reporting, nor to exercise pressure to bring them about. The initiative lies theoretically with the shareholders; practically, with the directors or officers of corporations. The power to exercise pressure resides mainly in those bodies which afford a market in which dealings mainly take place. But the accountant who has earned the confidence of his clients can, by influencing them, contribute greatly to the success of the movement. Most corporation executives will, I believe, be found willing to afford reasonable information to their shareholders if the question is placed fairly before them.

I venture, therefore, to express the hope that accountants in their audit practice and in their conferences with corporate officers regarding the form and content of annual accounts will bear constantly in mind the desirability of indicating clearly on what bases assets and liabilities are stated and results computed; the growing relative importance of the income account as compared with the balance-sheet; and the fact that the value of the income account depends on its being a fair indication of the earning capacity of the business under the conditions existing during the year to which it relates as determined by a fair and consistent application of acceptable methods of accounting.

There are one or two other problems in accounting which have assumed much greater importance as a result of the depression, and with which I should like to deal briefly. One is the acquisition by corporations of their own capital stock.

It would be out of place to discuss the broad question whether corporations should enjoy the unrestricted right to acquire their own capital stock, though accountants who have seen the unfortunate consequences that flowed from some such acquisitions in the latter part of 1929 and in 1930, and the abuses of the right in certain cases, can not fail to recognize that there is a case for some restriction. I propose to deal only with the treatment in accounts of purchases actually made.

I have never been able to agree with the view that a corporation's own stock is ordinarily an asset of the corporation, though I have been willing to recognize the practical convenience of treating it as such where stock is acquired as a part of a related series of transactions which include its resale in the immediate future. Certainly, if it is to be classified as an asset it should be excluded from current assets (unless under contract for early realization) and should be separately disclosed. Even if such stock may be shown as an asset, it is incorrect, in my view, to include dividends thereon in the income of the corporation.

It is even more important that accountants should set their faces against the practice of treating a resale of the corporation's capital stock as producing a profit which can properly be credited to the income account. My objection to the practice is threefold:

In the first place, the view taken by the bureau of internal revenue that a corporation can not derive income from dealings in its own capital stock appears to me sound in theory. A special case is presented where the corporation has agreed with the subscriber to preferred stock to repurchase that stock at a fixed price.

There is some argument that when it purchases stock and thereby extinguishes such an obligation for less than its face value it makes a profit which is analogous to the profit on the retirement of a bond at less than par. But in the case of purchase and resale of a pure stock, I think the bureau's rule is economically as well as legally correct.

In the second place, the case for permitting corporations to trade in their stocks is much weaker than the case for permitting mere acquisition. It is a plausible argument that the purchase of capital stock, when it is selling below its fair value and the corporation has available funds, is advantageous to all the shareholders: to those who sell or may want to sell, by tending to prevent the price from falling still further below its fair value; to other shareholders, by increasing their proportionate interest in the company on favorable terms. It is not easy to see in what circumstances a similar plea could be offered in relation to the resale. The acquisition of stock seems to me to be justifiable only for retirement or for use in some way other than in ordinary trading operations (e.g., for issue to employees or in conjunction with a new acquisition of property); and such use should not be regarded as giving rise to income.

Thirdly, there is the important practical reason that recognition of such profits would open the way to a particularly vicious abuse in the case of corporations which have stock outstanding that is selling at a price substantially below the figure at which it is stated in the company's balance-sheet. If the view were accepted that a profit which would be a legitimate credit to income might be derived from the purchase and sale of the capital stock of the corporation, the management would be able to buy the stock, and if the price should rise, to derive from resale a profit which could be credited to income; while if the price should decline, the company would be in a position to cancel the stock and thus to avoid any charge to income account, showing, instead, a credit to capital surplus arising from the cancellation of the stock acquired at less than book value.

Another practice is that of writing down the property accounts of a corporation and correspondingly reducing the depreciation charges against income. Whether such a procedure is proper seems to me to depend on the facts in relation to the property and on the way in which the transaction is effected and disclosed. Some would argue that the exhaustion of capital value (depreciation) during a year is a question of fact unrelated to the values at which the assets are carried; but this contention seems to me to be applicable where the object is to determine the profits of an enterprise (which is no doubt sometimes the proper objective of the investor or analyst), rather than in the ordinary case where we are trying to determine the profits of a continuing company which is carrying on the enterprise.

There must be continuity in corporate accounting, and the figures at which property legitimately stands on the books of a corporation can not be ignored in calculating its depreciation charges. If a company has acquired assets at less than their fair present value, it is entitled to reap the benefit in its income account as the assets are gradually used up in service. The converse is in theory equally true; but, as a practical matter, if as a result of either purchases or revaluation at a time when price levels were higher a company is carrying depreciable assets at a figure clearly and substantially in excess of the fair value which such assets possess today and seem likely to possess in the near future, it seems to me desirable to permit it to deal with the excess book value as a capital loss and by formal action to reduce the book value of the assets to a fair figure and thereafter compute depreciation on the basis of the reduced value, unless such action would prejudice the position of a senior security which the corporation has a legal or moral obligation to preserve intact. If the company could legally accomplish the desired result by reorganization, it seems desirable to permit it to do so without that expense, provided that the same respect is shown for prior interests as would be enforceable in a reorganization, and that the action taken is fully disclosed and formally approved by the shareholders.

Such a course seems particularly justifiable where the market value of the stock of the corporation is far below the value at which it appears in the balance-sheet. In such circumstances, it would be pedantic and foolish to insist that the company should by excessive depreciation charges make real a value for the capital stock which at present exists only on the books, especially as such a course would necessarily reduce reported earnings and tend to reduce the current market value of the stock so far as that value is predicated on earnings.

It is, however, always desirable to consider the collateral effects of any such action, as, for instance, in relation to taxes; and certainly no adjustment should be made unless the present value is carefully determined, the excess is substantial and the management is satisfied that the level of values to which the properties are to be reduced is likely to persist for a period of years. Much embarrassment has been occasioned to companies which in the period of inflation wrote up their properties to values which have since proved to have been only temporary; and it is easy today to err in the opposite direction.

Moreover, the new value should be fair. It is obviously improper to reduce the book value to a value below the fair value, thus reducing the charge for depreciation to a figure which is less than the actual exhaustion of values that is taking place and overstating the earnings of the company. Experience shows this point to be one of very considerable importance; the attempt is sometimes made to pave the way for the future inflation of earnings by deliberate understatement of present assets.

As I have indicated, also, the rights of prior security holders should be respected. If, for instance, a corporation has issued prior securities on a representation as to the amount of assets available as security therefor, this would seem to imply at least a moral obligation to charge depreciation on a scale sufficient to maintain such values; and the reduction of book value, followed by a reduction of depreciation charges, might in such a case easily result in distributing by way of dividends sums that ought rightly to be retained for the protection of prior securities.

Action would seem to be permissible and desirable where the facts are such as those set out in the annual report for 1931 of the Union Carbide and Carbon Corporation, from which I quote:

"During the past year a detailed survey of all plants, items of equipment and other fixed assets has been made to determine the changes which have taken place in their productiveness and replacement value. Since the formation of the corporation in 1917, there have been improvements in manufacturing methods and changes in location of plants to areas permitting more favorable manufacturing and distribution operations. Because of the decrease of approximately 21% in general construction costs during the past two years, the present book value of many items of property acquired, constructed or appraised during periods of high labor and material costs exceeds the present replacement value.

"The constantly changing costs of labor and material make it impossible to maintain property records sufficiently flexible to show at all times the true replacement value of the fixed assets of the corporation.

"However, when the change in values is as great as that which has occurred in the last few years, a restatement is desirable. To permit the records to continue to show the values of earlier years might easily become misleading; especially to those who lay great emphasis upon the 'book value' in evaluating the corporation's securities.

"Accordingly, in the balance-sheet submitted herewith the value of buildings, machinery and equipment has been written down to the extent of $39,794,031.11. A portion of this was charged directly to surplus and a portion to the reserve for depreciation. The amount charged to reserve has in turn been restored by a transfer from surplus as a provision for unidentified obsolescence, thus leaving the reserves for depreciation, etc., intact. It is true that many items of property, such as real estate, mining lands and water powers, have enhanced in value much beyond their cost and that this is nowhere reflected in the records. The enhancement of such items not being structures can not be measured by the cost of labor and materials.

"Aside from the consideration of a nearer approach to accuracy, the readjustment of the account will relieve the consolidated income from the burden of annual depreciation and amortization charges on property or values which do not contribute to earnings."

The percentage of reduction in capital value was less than the percentage of decrease in general construction costs, so that depreciation calculated on the reduced values would presumably be sufficient to provide for replacement of the property at current price levels; the revised value was carefully ascertained; the excess of book value to be dealt with was substantial; the amount of prior securities outstanding was small; the action taken was fully disclosed and the amount written off was charged against a previously existing surplus.

There are other questions which have arisen or the importance of which has greatly increased as a result of the depression. On the other hand, the depression has both demonstrated the unsoundness and minimized the importance of the practices of treating stock dividends as income in the amount of the market value of the stock received, and regarding the proceeds of the sale of rights as wholly income, by means of which stocks of holding companies which formed the apices of pyramids were raised to heights from which they have since crashed, in some cases to complete ruin. This paper has, however, already reached its appointed length; and it has seemed to me better to concentrate our attention today on a small number of important issues, rather than to attempt to cover too wide a field.

In concluding, may I say that I recognize that the issues I have discussed are of particular importance to companies whose securities are listed on exchanges and to members whose practice brings them into contact with such companies. I should like therefore to explain that the choice is not due to any failure to recognize that such practice constitutes only a small percentage of the accounting work of the profession today, but to a desire to deal with questions in relation to which I could feel that my experience both in my practice and in my capacity as chairman of one of your special committees qualified me to express an informed opinion.