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Balance-Sheets of Promotional Enterprises

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If one search the literature of the accounting profession he will find little to guide him in passing judgment on balance-sheet content and practice, as it is exemplified in balance-sheets of companies prior to operation where the company has acquired or is to acquire, for the company's capital stock, property the value of which has not been proven. Companies organized to acquire and exploit properties such as mining leases and options, patents, prospective oil deposits, chemical formulæ, manufacturing rights and the like are cases in point.

The procedure in most of these cases is substantially the same. There is someone who has conceived the idea of developing such property, usually a person of the promoter type, who, perhaps with an associate or two, acquires the property for a nominal price and then organizes a corporation and transfers the property to the corporation for a substantial block of the stock, or one who has the stock issued direct to the original owner of the property and receives stock for his promotional activities, after which the company proceeds to sell stock to the public on the basis of a prospectus which includes a balance-sheet giving effect to these transactions. The question which arises is: Does such a balance-sheet display a true picture of the financial condition of the company to prospective investors? In fact, does a balance-sheet as of this given date have any significance whatever to interested parties where stock has been issued for the properties in question and also for promotion services?

The corporate balance-sheet is generally understood to include the assets, liabilities and capital of a going concern at a given time. It is taken for granted by prospective stockholders that the various items shown as assets have asset value, either convertible through operations immediately or at some time in the future. But is this necessarily true of balance-sheets of promotional enterprises where the values placed on the properties are generally set by the board of directors, who may place such a value on the property acquired or to be acquired so as to permit the promoter to have control of the corporation without giving particular attention to the true worth of such property acquired from him? Manifestly inflated values naturally arise from this treatment.

A typical case is that of a company which will be designated as the Paymore Mining Corporation. The balance-sheet of this company at December 31, 1934, reads as follows:

PAYMORE MINING CORPORATION
Balance-sheet, December 31, 1934

Assets

Properties—consisting of 500 acres of patented and unpatented mining claims in Elko County, Idaho, valued by the board of directors at par value of stock issued for contract rights	$1,020,000
Organization expense	750
Total assets	$1,020,750

Liabilities

Current liabilities	
Due Mr. X for advances and expenses of organization	$ 750
Capital stock	
Authorized 2,000,000 shares of $1 par value Issued 1,020,000 shares	1,020,000
Total liabilities and capital	$1,020,750

It is proposed to issue the remaining 980,000 shares to the public at $1 a share. Upon investigation it is discovered that this company was organized by Mr. X, to whom the 1,020,000 shares of stock were issued in return for his assignment to the corporation of his rights in the leases and options. It is further discovered that Mr. X had made a cash outlay of only $3,500 to acquire the lease and option agreements, which provided for payment of $250,000 in cash over a period of four years to acquire title and payment of 15 per cent. of the gross proceeds from the property as long as operated by the Paymore Mining Corporation.

In general there have been several sets of criteria or rules which accountants follow in preparing and certifying balance-sheets for this type of enterprise. These may be referred to as:

1. The "good faith" rule,
2. The "true value" rule,
3. The "market value" rule,
4. The "nominal value" rule.

The legal decisions of most states follow the "good faith" rule. Under this rule a valuation placed upon an asset by the board of directors for stock issued for such an asset will not be impeached if the evidence shows that the directors had no positive grounds for believing their estimate to be erroneous. Under this principle bad faith must be proved. Bad faith consists in deliberately (i. e. with knowledge) over-valuing the consideration accepted for stock. Mere mistake or error in judgment on the part of the directors is not sufficient under this rule to vacate their valuation. It must be shown that the directors knew that their valuation was excessive. The "good faith" rule is manifestly faulty, both in theory and practice, since it makes good faith a criterion for establishing value. It is erroneous in theory since directors may be entirely sincere and honest in their opinion that a property has prospective value of a given amount, but as such value is dependent upon future circumstances and contingencies which may never arise, the effect is to give present tangible dollar value to something which is at present only a prospect. It is faulty in practice because the basis for establishing "good faith" value is usually a more or less arbitrary amount of stock issued for the property. The net effect of the situation is to put the cart before the horse. Capital stock reflects value, it does not impute value. The value of the property acquired in exchange for securities determines the worth of the stock, not vice versa. It is indeed absurd to say that, because a million dollars of capital stock was issued for a mining claim or patent, this mining claim or patent is now worth or will ever be worth a million dollars. It may eventually realize more, but then again it may be found to be worthless. But to say that a company owns property worth a million dollars (and that is what the balance-sheet purports to show) when all that has been done is to make a bookkeeping entry is to constitute the balance-sheet a vehicle for legal fiction rather than financial fact. That this is not merely an academic question is proven from a study of many registration statements of this type of enterprise registered with the securities and exchange commission. Many of these registration statements clearly show the promoters to be anything but timid in setting up inordinately high values for property in exchange for capital stock, and these values are entirely out of harmony with the cash cost to the promoters. We can justly be concerned over the appearance of these large values in balance-sheets because "the symmetry and balance of published statements have led to a popular impression that the figures contained in them are matters of final and undisputed fact to a greater degree than is warranted by circumstances." (*Report to Stockholders*, department of commerce, page 3.)

The "true value," in the absence of cash or cash equivalent consideration, is predicated on the assumption that there is available a satisfactory body of information from which it can be deduced what the fair and reasonable value would be in the given circumstances. True value may be tested by what persons independent of the organization would pay for the properties. The true value of a going concern can obviously be tested in the light of past operating history and the market value of its securities, assuming an uncontrolled market. With a company just beginning business, however, no such operating history is available. It has been suggested that true value may be obtained from an independent appraisal of the properties. Manifestly where the property values are obtained by scientific engineering technique and upon honest unbiased data intelligently interpreted, little fault can be found with this method of valuation, and balance-sheets based upon such values are highly significant. Unfortunately, however, if the experience of the securities and exchange commission in stop-order hearings is any indication, many appraisals of speculative and unproven properties filed with this commission are untrustworthy in proving a present property value. This may be due in part to the incompetence of the appraisers, but it is apt to be due to the fact that the assets of many promotional ventures can not be valued scientifically. It may be questioned whether anyone, regardless of his ability or training, is able to place a reasonably accurate present value on a wholly undeveloped project, be it a mine, patent or formula. Many eminent mining experts are of the opinion that it is not feasible to attempt to place an accurate present value on a mining property in the early stages of development. The value of a new patent, formula or manufacturing right is so dependent upon the market reception of the product that it appears unreasonable to attempt to value such an intangible before determining the actual marketability of the product.

The basis of the "market value" rule is that the value of the company's capital stock sold contemporaneous with or subsequent to taking over the property to be developed reflects the value of the property for which the company's shares are to be issued. In the words of H. A. Finney, "If some of a company's stock or bonds are sold for cash, the cash price establishes the value of the securities, and, hence the value of any fixed assets acquired by the issue of similar securities at approximately the same price." One can hardly deny that this method can be applied satisfactorily to valuing company property where there is a free and unrestricted market. However, the fact that a company not yet in the operating stage contemplates selling its stock at a certain price or that an underwriter has agreed to take a certain number of shares at a given price would not be a satisfactory basis for assigning an equivalent share value to the property acquired. Valuation of property at the cash value of shares issued for such property gives effect to an outside element, i. e. what independent persons are willing to pay for stock in the company; but such valuation is essentially dependent upon the directors' original valuation. This method is fundamentally unsound and illogical and may be dismissed as an unsatisfactory method of valuing property of promotional enterprises, because in promotional ventures there can be no free and open market for the shares. Furthermore, this method, like the "good faith" method, seeks to establish the value of property by looking to the equity accounts.

The followers of the "nominal value" rule argue that because of the difficulties inherent in the valuation of property which has not yet been proven the proper attitude to take should be that of ultra-conservatism and that where property, the value of which is prospective, is to be exchanged for stock, the value to be placed on such property should be a nominal value such as $1, $10 or $100. A balance-sheet prepared on this principle would be somewhat as follows:

MEXICAN STANDARD GOLD MINES CORPORATION
Balance-sheet, March 31, 1935

Assets

Cash in bank		$ 1,427.28
Fixed assets		
Lease and option for purposes of this balance-sheet	$ 1.00	
Cost of development to predecessors prior to acquisition by issuer	38,563.02	
Cost of development subsequent to acquisition	14,228.04	
Machinery and equipment at cost to predecessor company	4,962.80	57,754.86
Organization expense		8,643.74
Total assets		$67,825.88

Liabilities and capital

Liabilities		
Current wages	$ 522.00	
Current accounts payable	563.32	
Accrued taxes	270.00	
Cash advanced by stockholders	22,943.74	$24,299.06
Capital stock		
Authorized and issued fully paid for the lease and option	1,500,000 shares	
Less: stock donated to treasury	300,000 shares	
Outstanding, 1,200,000 shares of par value $1 each	$1,200,000.00	
Less: adjustment for purposes of this balance-sheet on account of carrying value of lease and option at nominal value of $1	1,156,473.18	
Net capital as adjusted		$43,526.82
Total liabilities and capital		$67,825.88

Such a policy as is reflected in the foregoing balance-sheet appears to be decidedly arbitrary, may be positively unfair to the issuing company and is apt to provoke endless controversy between the accountant and the client. While an issuer may not be able to prove a particular value for his property, there may be evidence of indeterminate value. Even though it may be agreed that there is no basis for a definite statement of value, it appears inaccurate, non-informative and unfair to compel the use of a nominal value. While a high value may influence some investors to buy, it is equally true that a nominal value may cause a prospective investor to become unwarrantably suspicious.

Is it not significant that practically all stop-orders issued by the securities and exchange commission to date involving promotional ventures have cited deficiencies on the balance-sheet? It may also be remarked in passing that very few registrations involving promotional ventures become effective with the commission without having to be amended one or more times. It would appear, therefore, that the present form A-1, which requires that the registrant furnish a balance-sheet, gives rise to an unsatisfactory statement of material fact. Being confronted with the necessity of placing a dollar valuation on his property, the registrant has usually adopted one of the valuation bases set forth above. In theory at least, the securities and exchange commission has adopted a fifth method, i. e. the method of full disclosure which is based on the principle that irrespective of the methods employed to set the value of properties acquired, so long as full complete statements of the methods of valuation are contiguous to the respective items in the balance-sheet the investor will not be tricked or misled into buying something which on its face may or may not represent value. As an illustration note the following taken from the balance-sheet of a registrant with the commission:

"*Manufacturing rights*.................................. $283,837.44

"The value of these manufacturing rights was fixed by members of the board of directors informally in 1933, after wind tunnel tests of a model plane in New York and long before the four-place 'Crusader' was built. Therefore, the figure given was, and still is, unliquidated, speculative and was adopted for necessary accountancy purposes only, to make stock fully paid and non-assessable, and for computing the tax required by the internal revenue department. The investor can not rely upon this figure in calculating the worth of this investment."

We may agree that the principle is sound as a general proposition but that in its application to the formal balance-sheet of promotional ventures it is unsound since even the balance-sheet of this type of enterprise purports to reflect present values at a given time. As such values may be only prospective and not subject to accurate valuation principles, the effect, even in the face of full disclosure, is to make the balance-sheet reflect a future value based on merely a pious hope rather than on financial fact. This anomalous situation can be relieved by making full disclosure without having to corrupt the formal balance-sheet which should reflect fact and not conjecture.

In the light of the above difficulties attendant upon showing formal balance-sheets for promotional enterprises, the following practice is suggested:

1. That a formal balance-sheet be not required by corporations in the promotional stage of development where an unbiased scientific appraisal of property acquired or to be acquired has not been made or where cash or cash value costs are not applicable.

2. That in lieu of the formal balance-sheet a textual or tabular statement of financial condition be set out consisting of the following:

A. A description of the particular assets the exploitation of which is to comprise the business of the registrant and all other major properties, if any, owned by the issuer. In each case the nature of the ownership, i. e. patented claims, unpatented claims, lease, license, formula or manufacturing right should be indicated.

B. Schedules of current assets and deferred charges and all liabilities properly classified as current, fixed or contingent, naming all affiliated companies or persons to whom debts are owed. A statement concerning all royalty payments should be made.

C. A schedule of capital stock containing the following information:
   1. Number of shares authorized.
   2. Number of shares outstanding.
   3. Number of shares in treasury.
   4. Number of shares issued to promoters for property and services.
   5. Number of shares issued to persons other than promoters for property and services.
   6. The cost per share of stock to directors, officers and promoters and the cost per share to public.

D. A statement of percentages of stock issued to promoters for property or services to the total stock to be presently outstanding on completion of the proposed financing. If more than one class of stock is outstanding, the percentage of total profits accruing to promoters as a result of their stock ownership should be stated.

E. A statement of cash receipts and disbursements, by years, from the date of organization.

F. Certification of these facts by a public accountant.

It is believed that this procedure will result in giving the investor full historical information concerning the financial data of the company, without giving rise to misleading statements of financial condition, will eliminate the necessity for making valuation experts of employees of the securities and exchange commission, will relieve the public accountant of having to except questionable values from his certificate, will free the balance-sheet from giving effect to values which are not proven and can not be proven in the light of the given circumstances, and will set out the significant financial information in such form as to make it understandable to the general reader.