Interpretation of Financial Statements

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By John R. Wildman

Financial statements, as instruments of service to business, have probably attained a place of more importance in the United States than in any other nation in the world. In no country is a greater effort being put forth in an endeavor to interpret and utilize financial information in the conduct of business affairs. The fields served by financial statements include credit, investment, administration and management, government, engineering, law and accountancy. Such information is used also in relation to contracts of operation, business transfers, fiduciary integrity, bankruptcy and receivership and business reorganization.

The problem of interpretation is to determine significance. The problem of interpreting financial statements is concerned with determining first: What are the representations made by means of the statements? second: If the representations are true, what is their significance?

An unqualified item of merchandise inventory appearing among the current assets in a balance-sheet is a representation which custom fairly well has established that the goods are sound and salable, and that they have been valued at the lower of cost or market. The significance is that the amount invested in such goods may be expected, within a period of time consistent with the credit terms, money conditions and average efficiency in making collections, to pass with the addition of profit through the form of accounts receivable into cash which will be available for the liquidation of current liabilities.

The significance of a merchandise inventory may be obscured if some other item in the balance-sheet affecting the inventory is not shown in relation thereto or clearly described in order that it may be so related by an interpreter of the balance-sheet. An interesting case which arose recently presented a situation in which a company was obligated under contract to make certain future deliveries at a loss. Materials which had been bought on a rising market had to be used to manufacture the goods for delivery under the contract, with no possibility of procuring other materials to substitute at a lower price. It was known that the loss would

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amount to a large sum and that it would fall on certain materials in the inventory which were carried at the lower of cost or market.

In the practical controversy which ensued over the representations in the balance-sheet, three different positions were taken by different parties as to a reserve which had been created through a charge against surplus for the purpose of anticipating the loss. One party contended that it was a current liability. The second party held that it was a general reserve, on the ground that surplus had been charged and that as long as creditors were thereby protected against the paying out of cash as dividends while they waited for settlement of their accounts every necessary purpose had been served. The third party insisted that the reserve should be deducted from the inventory item, inasmuch as there would be less in the way of value with which to satisfy creditors than appeared in the current-asset group.

The last view appears to be the correct one. The reader of the balance-sheet is entitled to understand from the inclusion of a merchandise inventory item in the current-asset section that when the inventory shall have been converted into cash it will be at a greater rather than a lesser value. While such goods as inventory should contain no element of profit, after having been turned over the cash resulting will carry an item of profit. Thus he concludes that more rather than less will be available to satisfy current creditors.

There are various ways of developing significances. Consider the much-neglected income statement. Instead of the conventional additions and subtractions of figures leading to a result which merely ties the surplus into the balance-sheet, you may see therein some of the reflections of operating and general and financial management. Particularly, if you will reduce the figures to a dollar basis, you may see how the dollar receivable from customers has been divided among the parties who contributed to the cost of the goods or services supplied to such customers. If your imagination will permit: First, there is the supplier who furnished the materials; next, there are workmen who fashioned the goods; then, the salesmen who sold them; clerks who kept the records; managers who administered the enterprise; parties who lent their money; those who furnished property or service facilities; the government which exacted a tax; capital invested in property which wore out and had to be replaced; other capital losses, and, last, the profit which went to the proprietor—fanciful, no doubt, but interesting and perhaps a concept which some day will be developed and elucidated so as to be extremely useful as a means of interpretation.

Significances such as our minds are capable of grasping at the present time are suggested principally by comparisons of various kinds. One may compare current figures with similar figures of prior periods; or figures of one enterprise with like figures of a similar enterprise; or specific figures with various standards. Thus may be indicated the trends of various activities and the efficiency of those responsible for the direction of them. The cost of the goods may be getting out of proportion to the profit. Selling expenses may be too high. The margin of operating profit may not be sufficient to sustain the load of property expense. The net-profit factor indicating the percentages taken out of the enterprise may show that some of the profit should have been left in to be devoted to strengthening the organization and assuring its future. In one instance statistics of this character drew sharply into the foreground an expense for borrowed money which was excessive. Investigation disclosed the fact that working capital was being obtained through hypothecation of accounts receivable at interest rates of 24 per cent per annum.

Returning to the balance-sheet, perhaps one of the most difficult items thereon to interpret is the one frequently designated as surplus. The significance of surplus, in the absence of qualification, is that it is an accumulation of profits resulting from operations and in the discretion of directors may be declared away as dividends. The consideration of surplus raises a number of interesting questions. One of these questions is: May anything other than profits arising from operations be considered surplus which is subject to the declaration of dividends? In other words, may a corporation write up its property values on the basis of an appraisal or on the judgment of directors as to values and credit an amount equal to the increase in value to the surplus account, subsequently declaring a dividend out of such surplus? If this is permissible, may not the same reasoning and formula be applied to capital stocks of other corporations carried as investments? In the case of a wholly owned subsidiary with a surplus of its own, what is to prevent the holding company from revaluing its investment on the basis of the book value of the subsidiary and crediting the increase in value to surplus? Again, in a case where preferred shares of other corporations are carried as investments at a cost which is less than par, why may not the holding company carrying this investment write their value up to par and take into surplus the amount of the increase in value?

The leading case on this question is *Williams* v. *Western Union Telegraph Company*, 93 N. Y. 162. In this case the court defined surplus as the excess of assets over liabilities and capital. After this definition, the decision continues: "Such surplus belongs to the corporation and is a portion of its property, and in a general sense may be regarded as a portion of its capital, but in a strictly legal sense it is not a portion of its capital and is always regarded as surplus profits."

Without devoting too much time to this question it appears that from a legal point of view any excess of assets over liabilities and capital may be regarded as surplus profits. This concept, however, is attended by certain dangers from the point of view of business policy, in that there is considerable question as to the soundness of declaring dividends payable in cash out of surplus represented by unrealized profits. Obviously, it must be admitted that such course would be legal and that a way might be found to obtain the cash with which to make the payment of dividends. In view, however, of the accounting differentiation between surplus derived from profit on operations and that arising from valuation of assets, any surplus item appearing on a balance-sheet is subject to investigation. From a credit point of view, this matter is important, since it is related to the appropriations for dividend purposes of cash which more properly should be applied to the liquidation of current liabilities.

A second point for consideration in relation to surplus is the effect of various state laws permitting the issuance of shares without par value. In some states, apparently, there is serious conflict between the law on one hand and economic principles, good accounting and rational business administration on the other. The Maryland laws governing corporations, for example, permit the issuance of both preferred and common shares without par value, for such consideration as may be fixed by the board of directors or by the charter of the corporation. The state of Delaware, likewise, permits corporations to issue shares of capital stock, both common and preferred, without nominal or par value, for such consideration as may be fixed from time to time by the board of directors. Thus, it becomes possible for a corporation to issue its shares, receive large sums of cash in exchange therefor, credit some nominal amount per share to capital and place the remainder in the surplus account. There may be no question that this procedure is legal when properly authorized by action of the directors, and in all probability surplus so derived might be appropriated later for dividends. There is grave doubt that any reputable and well meaning corporation consciously would subscribe to the policy of paying dividends out of capital, yet the way seems to be open by the laws in some states, and if surplus so derived is not segregated, directors may unwittingly declare dividends therefrom.

The point at issue is that any attempt to interpret a balance-sheet must give serious consideration to the item of surplus. The casual reviewer is not justified as he should be in assuming that surplus unqualified by further description has been earned and may be appropriated for dividends, if sufficient in amount, without detriment to the creditors. Good accounting practice has adopted the policy of earmarking surplus derived in ways other than from earnings, in order that there may be a clear understanding as to the surplus available for dividends. These segregated items have been described in various ways by different accountants as capital surplus, as surplus arising from valuation of assets, or as surplus representing the excess of capital received for shares of stock in excess of the stated value thereof. While perhaps inconsistent with the principles of accounting, nevertheless a surplus item not otherwise described is open to challenge as to its origin. In a somewhat recent offering, common shares were shown on the balance-sheet at a nominal value of ten cents each, while the remainder of the proceeds of sale was merged with other surplus from earnings and revaluations and constituted about fifty per cent of the total surplus item. Only a person with knowledge of facts beyond those disclosed by the balance-sheet could have determined the relative amount of capital surplus involved.

Analysis of items which appear in financial statements is another means of bringing out significances. Analysis sometimes discloses strange bed-fellows. In the balance-sheet of an average-sized industrial company, marketable securities were shown as a current asset. The line of cleavage between current and fixed assets in the matter of investments long since has been established.

According to the generally accepted practice, securities held for control, financial, operating, or trade advantages—securities which can not be disposed of without detriment to the holding company—are classified as fixed assets. Securities which may be disposed of at will and converted with readiness into cash are permitted by accountants usually to be included in the current-asset group. Consequently, no objection apparently may be raised to the inclusion of marketable securities in the grouping for current position if the securities are as represented. One even might overlook a small amount of treasury stock in certain circumstances if the amount involved were negligible as compared with the total of marketable securities. But when a corporation includes in such caption a young railroad, the book value of which is equal to half the amount represented to be marketable securities, it seems that one reasonably might demur at such inclusion. The justification advanced in the case referred to was that the railroad was not necessary to the operations of the industrial concern; that it could be sold at any time; and that as a matter of fact the owning corporation then was entertaining an offer of purchase. Imagination in business is well recognized as a valuable asset. It is wonderful to behold sometimes the point to which imagination may be stretched in order to gain a favorable current or other position.

Consolidation of financial statements sometimes brings out odd relationships which have a bearing on significance. What may appear to be a favorable condition of one corporation, when judged on its own statement, often suffers when brought into consolidation with the condition of other companies to which it is related. One company which in itself is fairly prosperous may be having its life blood sucked away by some unwisely conceived or badly operated subsidiary or other poor relation. Business men who are thoroughly familiar with one line sometimes become interested in fads and fancies in other fields, and risk their success by dabbling in industries where they are not qualified to operate. For this or whatever other reason there may have been, a certain prosperous concern went into a related line and organized a subsidiary company in which it acquired all the capital stock. The venture had a hard struggle and was a constant drain on the parent company. As a means of meeting current financial needs, the subsidiary issued trade acceptances to the parent company, charging the inter-company account thereof. The parent company, which had good financial contacts with several banks, discounted the acceptances. The proceeds were advanced to the subsidiary and credited by the latter to the inter-company account. Thus, the subsidiary had received cash and issued acceptances payable. On the face of the parent company's balance-sheet appeared no trace of the transaction which involved a large sum, further than a footnote which mentioned a contingent liability for trade acceptances discounted. Only when the balance-sheets were consolidated was the true significance of the trade-acceptance situation revealed. What might have appeared on the parent company's balance-sheet to be a contingent liability on account of general trade relations was as a practical matter a direct liability to the banks.

Independent consideration of one unit in a group of enterprises is unsafe without consideration of related companies. Kiting of one kind or another often is concealed through inter-company accounts. Receivables of one company which may go to make up a favorable current position are payables of another company in the group. Securities, likewise, may contribute to a satisfactory financial condition, when in fact some of the securities may be those of underlying companies with deficits. In a case which is the subject of current gossip, one company, with a substantial deficit, is said to have reorganized its corporate structure and leased its plant and operating facilities to the former parent company under a contract calling for large annual rentals, in order that the parent company might be relieved of an unfavorable showing which would result from consolidation. The federal reserve board, something over a year ago, promulgated a regulation which requires that whenever the borrower is closely affiliated, or controls subsidiary corporations or firms, the borrower's statements shall be accompanied by separate financial statements of such affiliated or subsidiary corporations or firms. This is only a part of the regulation, but the remainder thereof does not apply to the point in question. The point is that interpretation of a balance-sheet representing one of the parties in a group is hazardous and likely to prove unsatisfactory unless the statements of the other parties are subjected to consideration at the same time.

Comparisons, while affording another means of interpretation, have their limitations. Usually, they suggest further investigation in order to ascertain the facts rather than establish significances which are conclusive immediately. The increase in cost during one period over that of a preceding period requires liberal investigation before one may reach a final conclusion as to the cause. Manufacturing costs, involving as they do three distinct factors which are subject to many variations, illustrate one of the serious complications involved in attempted interpretation. The item of materials alone offers plenty of opportunity for consideration. Increased cost of materials may be accounted for by an increase in the purchase price, by a change in the basis of relieving stores or the method of pricing materials charged to the cost of consumption, by an increase in the waste factor, or by adjustments incident to inventory valuation, etc. The same application might be followed through with respect to labor and overhead. Consequently, any possibility of arriving at final conclusions as a result of comparisons appears to be somewhat hopeless, unless the investigation is pursued far enough to establish the facts which are back of the figures. Comparisons, however, do show trends and indicate tendencies which may have a very important bearing on the question of administration in which credit grantors are interested.

Perhaps it is because of the obvious difficulty, in the light of our present state of knowledge, of attempting to utilize comparisons for the purpose of drawing final conclusions that so much attention has been given to the subject of ratios. Ratios are a means of indicating relationships, and relationships frequently are valuable in the work of interpretation. Ratios, however, like other means of interpretation, should be used with discretion. Some of the ratios advocated are sound and dependable. Others are unsound and misleading. The ratios which show the various gradations of profit in relation to sales are dependable and helpful. There is between sales and accounts receivable a relationship full of significance for credit men. There is also between finished-goods inventories and sales a relationship which is of interest to both manufacturing and selling departments. It still remains, after several years' use of a ratio involving the two factors, for someone to demonstrate a relationship between accounts receivable and inventories. There is, however, an opportunity for someone to develop the relationship existing between finished goods and sales in the utilization of working capital, taking into consideration the turnover thereof. One ratio frequently misused is that which results from the division of owned capital by borrowed capital, instead of setting up two ratios: one to show the relationship between borrowed capital and total capital, the other the relationship between owned capital and total capital. But withal ratios have served a very useful purpose in stimulating thought along the lines of interpretation.

Consideration of the subject of interpretation would not be quite complete, it seems, without some reference to financial statements which appear in the reports of certified public accountants, and perhaps to the reports themselves.

A certified general audit report with an unqualified certificate is a representation that the accounts as stated are correct, having been verified by an independent and unbiased reviewer. While the representations may be accepted as a basis for reliance, they may not be regarded as having been guaranteed by the accountant. An accountant is required to be qualified by education and experience for the work which he undertakes, to exercise his best skill and use reasonable care and diligence in the execution of his work. Being human, he is fallible and may not be held for errors of judgment if he can show application of reasonable skill and judgment.

Accountancy practice, being in a formative stage in this country, has made relatively little progress in the matter of standardization. Little has been done to acquaint the general public with the scope and classification of accountancy service. While some individuals who are familiar with the subject realize that a certified public accountant's work is varied, few persons understand that there are many different types of service and that these types must be differentiated. Some of the work which a certified public accountant does may be classified as follows: general audits, balance-sheet audits, cash audits, partial audits, general examinations, limited examinations and investigations. An accountant also prepares and reviews tax returns, contests assessments and prosecutes tax claims, prepares and renders opinions on tax matters, conducts surveys and devises and installs systems in relation to the general accounts, to the work of cost finding and to budgeting. Miscellaneous service embraces preparing and rendering opinions having to do with accounting, financial and business matters, giving testimony in court, acting as arbitrator in accounting controversies, rendering advice in accounting matters, preparing statements from books or records without verification, and so on through a long list.

The variety of service gives rise to a variety of reports. While it is incumbent upon an accountant to set forth clearly in his reports the scope and character of such work, and his conclusions after its completion, it is equally incumbent upon those who use his reports that they read the reports and give consideration to the accountant's representations. Instances are known where financial statements in accountants' reports have been used without the reader having read the accompanying comments which altered entirely the significance of the statement. It seems fair to point out to those who have occasion to consider reports of certified public accountants that some contain certificates while others do not; that some certificates are unqualified while others are qualified for the purpose of excepting certain items which the accountant has not been permitted or able to verify to his satisfaction.

Reports on general audits, balance-sheet audits and general examinations usually should be accompanied by certificates, but the certificates must be read and considered before the report may be accepted as a basis for reliance. The report on a limited examination usually will not contain a certificate, or if it does the certificate will be so highly qualified as to nullify any value which the report may have.

Limited examinations as a type are the bane of an accountant's existence. Taking the position that he may not refuse to serve anyone who seeks his services legitimately, the accountant sometimes undertakes to make a limited examination in which the work is confined to a verification of certain items only or only a partial verification of some of these items. The restrictions are placed upon the accountant by the client, the client's motive usually being to keep down the expense. Cases have been known where reports on limited examinations have been issued for home consumption, as it were, only to be used later in seeking bank or commercial credit or in supporting credits already established.

Certified public accountants need the coöperation of credit men in eliminating engagements which call for service of this type. An experience or two of having such reports rejected as being of no value for credit purposes will help to educate clients to the necessity of procuring for credit purposes general audit reports with unqualified certificates under engagements in which the accountant is permitted to satisfy himself reasonably as to the accuracy of the financial results as well as transactions leading to such results.

Finally, it seems that we are forced to the conclusion that the art of interpretation is in its infancy. Relatively little is known concerning it. The subject is full of possibilities. As it is further developed, it will prove increasingly useful in the matter of credit, investment, management and administration and to the various other purposes which financial statements serve.