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Financial statements: an explanation for investors

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FINANCIAL STATEMENTS
AN EXPLANATION FOR INVESTORS

A THESIS
PRESENTED TO
THE FACULTY OF
THE SCHOOL OF BUSINESS ADMINISTRATION
THE UNIVERSITY OF RICHMOND

IN PARTIAL FULFILLMENT
OF THE REQUIREMENTS FOR THE DEGREE
MASTER OF SCIENCE IN BUSINESS ADMINISTRATION

BY
EDWARD N. ODOM
JUNE, 1962

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To My

WIFE

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Chapter I

The Need for Understanding Financial Statements

Why should an investor understand financial statements? When we ask this question certain other questions immediately come into our minds. The first question is, "What is an investor?"

I believe that the profit motive, the desire to make money, is not only the primary reason for the existence of all American tax-paying business; it is the very foundation of our capitalistic society. When people try to create wealth from capital they do it in one of three ways. They either gamble, speculate or invest. Perhaps we can best define investing by relating it to gambling and speculating.

"Gambling represents the creation of risks not previously existing - e.g. race track betting - whereas speculation applies to the taking of risks that are implicit in a situation and so must be taken by someone."¹ We gamble when we bet that it will rain tomorrow. We have created a risk which did not exist, for the sake of the gamble. On the other hand the farmer is a speculator, according to the definition, even if he only plants a crop for his own family's consumption because he assumes the risks that are implicit in

1. Benjamin Graham and D. L. Dodd, Security Analysis, (New York, London: Whittlesey House, McGraw-Hill Book Company, Incorporated, 1940), p. 67

planting - drought, flood, hail, wind and insects. If any of us are to eat the fruits of the soil someone must plant. So the farmer plants, and tries to minimize the risk as much as possible.

Many definitions have been offered for speculation and a great deal has been written about the essential role the speculator plays in our economy, especially in the securities markets. In the securities markets such as the New York Stock Exchange or the American Stock Exchange, the speculator helps to make a more orderly market by minimizing fluctuations in stock prices either up or down. Sometimes speculators attempt to profit from short term market corrections. If XYZ Corporation stock is falling in price, speculators might buy it, hoping that the price will go up. A prolonged, uninterrupted rise in XYZ Stock may prompt speculators to sell it short. In this way the speculator helps to slow the rise in stock prices by offering stock for sale, and cushions the fall of stock prices by buying stock.

Likewise, many definitions have been given for investing, but the basic difference between speculation and investment lies in the motive for the action, rather than the action itself.² As a general rule, we might say that investors in common stocks, for example, would be more interested in dividend income and long-term capital gains, whereas speculators would be more concerned with day to day market fluctuations and short-term capital gains.

2. Birl E. Schultz, The Securities Market and How It Works, (New York and London: Harper and Brothers, 1946), p. 28.

I do not mean to imply that a person who holds a stock for five months and then sells it is a speculator, whereas a person who sells a stock after holding it for six months (thereby meeting the long-term definition of the Internal Revenue Code) is an investor. Rather, the investor is more interested in the income that any property may produce, and the speculator is more interested in the fluctuations in the value of the property.

The second question which comes to mind when we ask the question "Why should an investor understand financial statements?", is "Why should I invest?" More specifically - "Why should I invest in the securities of corporations which tell the story of their financial progress with financial statements?"

A person who has provided for, and can continue to provide for the necessities of life for those who are dependent upon him for support, who has adequate life insurance protection, and has provided for emergency expenses, is in a good position to invest in common stocks. Such a person, presumably, can afford to lose his investment, although none of us would invest with the thought of losing our investment. Moreover, such a person probably would not be inclined to take the kind of speculative risks involved in going into a new business or financing a new business. Such a person might have a moderate income, which would make it practically impossible for him to go into a

substantial business for himself. This person might have many personal reasons for investing.

This person might want to build a nest-egg and receive regular income on his investment. In such a case he might put his money into an insurance endowment, or into a bank savings account, but the return on his investment, that is the income on the investment, would be small because the risk would be slight.

He might want to provide himself with a hedge against inflation, in view of the fact that the United States has been in a period of rising prices for many years. In other words, he would want an investment which would rise in value as consumer prices rose. In this case, he might invest in land, other real property, or common stocks.

He might want a very secure investment which would accumulate regularly, in small amounts, to provide additional security for retirement, or to provide for the education of his children. In this case the prospective investor could choose Series E United States Government Savings Bonds. Here again the return on investment would be small. The obligations of the United States Government are the most secure investments in the world. Consequently, the United States does not have to offer a high return in order to sell these obligations. On the other hand, the fact that government bonds pay a fixed number of dollars in a period of rising prices, makes them unattractive to many investors.

By investing in corporate securities a person can

work toward any of the objectives which investors have. Some of the advantages of stocks and bonds as an investment are as follows:

1. Investment in corporate securities can involve a minimum of risk. Many corporate bonds which are rated AAA in Moody's Investment Manuals are almost as secure as to principle and interest, as government bonds. Also many high quality, so-called "blue chip" common stocks provide a secure investment and regular income over a period of years.
2. Investment in common stock can provide a hedge against inflation because stock prices generally rise in anticipation of, or as, consumer prices rise.
3. A sound systematic investment program in stocks can appreciate in value. Some businesses grow faster than others. Likewise, some stocks grow in value faster than others.
4. Among the 1,200 stocks and bonds traded on the New York Stock Exchange and the thousands of other securities listed on the twelve³ other exchanges and traded over the

3. Lyman Bryan, "Washington Background," The Journal of Accountancy, Volume 111-112, August, 1961, p. 18.

counter, a person can find a security offering almost any degree of risk and hence a wide range of yields. (Ordinarily, an investor who was asked to assume a great risk would expect a high return on his investment. If the risk of loss was slight, he could not expect so high a return.)

In 1945 the average yield of all dividend paying common stocks on the New York Stock Exchange was 3.6%. In 1948 the average was 7.8%.⁴ In February 1956, the common stock of Superior Oil Company of California was selling for \$1,070 a share and offering a return of less than 1% or 0.28%. At the same time U. S. and Foreign Securities, a closed end investment trust, (one with a fixed number of authorized shares) was selling for \$31.75 per share and offering buyers a return of 13.76%.⁵ The long term trend of stock prices has been up since the Great Bull (rising) Market began in 1946. Earnings and dividends have not increased

4. A pamphlet distributed by Abbott, Proctor, and Paine, Members of the New York and American Stock Exchanges, Monthly Investment Plan, (December, 1953), p. 10.

5. "Wall Street Talks," Business Week, March 10, 1956, p. 156.

as much as some stock prices. Consequently stock yields (the dividend divided by the market or purchase price) have declined. In 1955 the average yield of all dividend paying common stocks listed on the New York Stock Exchange was 4.6%.⁶ These average yields which have been quoted are median averages. In other words, if all of the yields of all dividend paying common stocks were listed in order, from lowest to highest, in April, 1955, 4.6% would have been the mid point, with an equal number of stocks having lower and higher yields.

Exhibit A, at the end of this chapter, is a table showing 214 common stocks listed on the New York Stock Exchange. These stocks are among 400 stocks which have paid a cash dividend in every year for over 25 years. The total dividends listed in the table amount to \$372.58. All prices add to \$12,979.375 for an average yield of 2.9%. ($\$372.58 \div \$12,979.375 = 2.9\%$). Even though the annual dividends shown do not include extra dividends, which usually come at the end of the year, we can see that yields have further declined. And yet there are many stocks that offer fair returns and prospects of increase in value.

6. A pamphlet published by the Members and Member Firms of the New York Stock Exchange, Investment Facts About Common Stocks and Cash Dividends, (1955), p. 1.

By investing in corporate securities, a person of moderate means can express his faith in the capitalistic system which has made possible the unparalleled growth and the high standard of living in the United States. (For stocks listed on the New York Stock Exchange, monthly investment plans can be started with an investment of \$40 every three months.) I am afraid that we have become too much concerned with financial security, social security and welfare programs. As a result we are reluctant to take the risks of the entrepreneur, even if we know the extent of the risk, "The bondholder is purely a capitalist in the economic sense, and is in no way an entrepreneur. His essential function consists of committing capital to the management of others. As a practical matter the same situation applies, as a rule, to the preferred stockholder, although there are exceptions. The investor who seeks control ordinarily does so by the purchase of common stock."⁷

Today, there is a great deal of interest in corporate securities and in financial statements. This has not always been the case.

In the latter part of the 18th century there was a buttonwood tree located at what is now 68 Wall Street in New York City. On May 17, 1792 twenty-four brokers met and signed "The Buttonwood Tree Agreement" which set forth buying and selling commissions to be charged by the signatories.

7. Ralph E. Badger, and Harry G. Guthmann, Investment Principles and Practices, (Third Edition, New York: Prentice-Hall, Incorporated, 1942), p. 124.

Since that time many regulations regarding trading on the stock exchanges, and disclosure of financial information to the public, have developed. However, as late as 1866 the chairman of the Committee on Securities of the New York Stock Exchange wrote to the secretary of the Delaware Lackawana and Western Railroad Company "to request you will direct, that from time to time as they may be issued, the Reports of your Company be sent to the Secretary of the New York Stock Exchange....." The answer to this letter, signed by the Treasurer of the Railroad stated we "make no Reports and publish no statements and have not done anything of the kind for the last five years."⁸

Since the 16th Amendment to the Federal Constitution made the Federal Income Tax legal in 1913, businessmen have become keenly interested in financial statements. This interest goes much farther than merely seeing whether statements prepared from accounting records indicate that the records meet the requirements of the Internal Revenue Code. As modern businesses have become larger, more complicated and more competitive, managers have wanted statements showing the financial position and the results of operations quicker and more frequently.

The need for credit has required nearly all businesses to give careful attention to financial statements. Banks,

8. Birl E. Schultz, The Securities Market and How It Works, p. 9.

Insurance Companies and others who extend credit to business organizations require financial statements from companies borrowing from them.

The New York Stock Exchange has fostered full disclosure of financial information to the public. In order to have its securities approved for listing on this Exchange, a company must be owned by at least 1,500 people who own 100 or more shares. The company must have 400,000 shares of stock in the hands of the public, must also agree to report its financial position and results of operations to stockholders regularly.⁹

The Federal Government has greatly increased our concern with financial statements. An investigation of stock exchange practices was conducted by the Senate Committee on Banking and Currency in 1932 and 1933. Out of the committee hearings came the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act of 1933 was intended to prevent fraud in the issuance of new securities. The Securities Exchange Act of 1934 regulates national stock exchanges to limit speculation, to prevent unfair practices and to require dissemination of information pertaining to securities traded on the exchanges. The Securities and Exchange Commission principally administers and polices four laws. They are:

1. The Securities Act of 1933

9. An advertisement by the New York Stock Exchange, "How to Invest For Growing Income and Family Security," Readers Digest, Volume 77, Number 462, October, 1960, p. 185.

2. The Securities Exchange Act of 1934
3. The Public Utility Holding Company Act of 1935
4. The Investment Company Act of 1940.

To implement these laws the Securities and Exchange Commission has issued Regulation S-X which prescribes "the form and content of all financial statements required to be filed as part of:

1. Registration statements under the Securities Act of 1933....
2. Applications for registration of Securities under the Securities Exchange Act of 1934....
3. Supplemental or periodic reports under section 13...(and) 15 of the Securities Exchange Act of 1934...."¹⁰

As more people have become involved in preparing and in analyzing financial statements, more people have become interested in corporate securities. During the rapid rise of the stock market in 1929, uninformed stock buying reached a fever pitch. I am told that many people bought Seaboard Air Line stock, thinking that they were investing in the promising air transportation industry. The problem of uninformed stock buying has continued to exist. In 1955, the Senate Committee on Banking and Currency conducted a Stock

10. United States Securities and Exchange Commission, Regulation S-X, Form and Content of Financial Statements, as amended to and including November 3, 1953, (Washington, D. C., 1954), p. 1.

Market study. Several witnesses stated that tips and rumors and touting of stocks were more prevalent than had been the case for many years. "Mr. Edward T. McCormick, President of the American Stock Exchange stated that the tipster is 'one of the biggest headaches I have had'."¹¹ In April and again in May of 1961, Mr. Keith Funston, President of the New York Stock Exchange, found it necessary to issue warnings to discourage people from buying stocks of dubious value, recklessly, on tips and rumors. The reckless, uninformed interest in corporate securities is interest we can do without.

Many people, on the other hand, take a prudent approach toward the stock market. Financial sections of the daily newspapers have become almost as popular as the comics and sports sections. Stock ownership has become more widespread. A survey by the New York Stock Exchange in 1955 revealed the following facts about the distribution of share owners of publicly held corporations:

<u>Company</u> ¹²	<u>Number of Owners</u>
American Telephone & Telegraph Co.	1,307,215
General Motors	459,099
Standard Oil of New Jersey	296,782
General Electric Co.	294,995
United States Steel Co.	224,423
Cities Service Co.	191,152

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11. United States Congress, Senate Stock Market Study, Report together with Individual Views and Minority Views of the Committee on Banking and Currency, (Eighty-Fourth Congress; First Session, Report Number 376), p. 11.
 12. An advertisement by the New York Stock Exchange "The Stock Exchange Reports to You and You," Life, Volume 38, Number 10, March 7, 1955, pp. 8-9.

American Share Owners¹³

Men	36.3%
Women	26.9%
Joint Account	7.5%
Trustees, Institutions & Others	29.3%
	<u>100.0%</u>

Share Owners by Income Groups¹⁴

<u>Income Group</u>	<u>%</u>	<u>Number of People</u>
Under \$5,000	31.6	2,370,000
\$5,000 to \$10,000	44.4	3,330,000
\$10,000 and over	24.0	1,800,000
Total	<u>100.0%</u>	<u>7,500,000</u>

In July, 1961 the American Telephone and Telegraph Company invited a family from Wichita, Kansas to New York City to receive the Company's stock certificate No. 2,000,000.¹⁵ This Company whose stock is sometimes referred to as "Mother Bell" or the stock for widows and orphans, has been a leader in stockholder relations. This world's largest corporation, in 1960, printed 700 copies of its annual report in Braille, including 200 copies for library use.¹⁶

The most recent survey of stockholders indicates that there are now over 15,000,000 people in the United States who own corporate securities. The number of people who own

13. Ibid., pp. 8-9.

14. New York Stock Exchange pamphlet, Investment Facts About Common Stocks and Cash Dividends, p. 7.

15. Richmond News Leader, (Wednesday, July 26, 1961), p. 30.

16. The New York Times, (Section 3; Sunday, July 30, 1961), p. 1.

a share of American business is growing at a rate of 1,300,000 per year. Today, almost half of the 15,000,000 shareholders have incomes from \$5,000 to \$10,000 per year, and another 29% earn less than \$5,000. All of these facts show the tremendous amount of interest in stocks and bring us finally to our original question - "Why Should an Investor Understand Financial Statements?"

For our own enlightened self-interest we should always remember the admonition of one of the largest brokerage houses in the United States - "Investigate, then Invest". There are those who overlook the fact that the investor has a responsibility for protecting his own investment. A thesis submitted to the Graduate Faculty of the University of Richmond in June, 1957 stated; "Since ownership in the equity of American corporations appears to be constantly increasing, and a greater part of this increase represents the untrained investor, serving his apprenticeship in the fine art of investment....., it is necessary for the corporate management to do all in its power to see that stockholders obtain the information they desire. Many stockholders have neither the time nor the training to properly analyze financial statements."¹⁷ Of course this statement is true, but my thesis is that the moderate income investor, who cannot afford to pay for investment advice which will tell him whether to buy, sell or

17. Donald Eugene Furr, Ratio Analysis of Financial Statements, (a thesis submitted to the University of Richmond, June, 1957), p. 68.

hold each particular stock in his portfolio, had better take the time to investigate prospective investment action. Furthermore, the prospective investor should know how to investigate a company that he is interested in. Mr. Edward McCormick (previously quoted) is also a C.P.A. and a former Commissioner of the Securities and Exchange Commission. In speaking at the annual meeting of the American Accounting Association on August 26, 1959, he said, "It is startling to realize how very little the ordinary run-of-the-mill stockholder knows about the financial affairs of the company he partly owns."¹⁸

The purpose of this paper is to alleviate this situation to some extent.

If America is to continue to grow, more and more equity (ownership) capital must continue to come from persons with incomes from \$5,000 to \$10,000 a year. Insofar as laymen, and not just accountants, are able to understand financial statements, they will be in a better position to share the fruits of this growth and to minimize the risks which are inherent in common stock ownership.

This does not mean that having read this thesis, we will be qualified financial analysts. Neither does it mean that an understanding of financial statements will eliminate investment losses. Financial statements are far from infallible. It is impossible to analyze the financial strength,

18. Edward T. McCormick, "Reporting to Stockholders," The Accounting Review, Volume XXXV, Number 2, April, 1960, p. 224.

and operating performance of a business by mechanical methods alone. There is no formula for running a statement through a series of tests or ratios to determine whether it is good or bad. In investing and in studying financial statements, let us remember that there is no substitute for intelligence and good judgment.

EXHIBIT A*
Selling Below \$30 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend**</u>	<u>Closing Price 7/28/61**</u>	<u>Yield***</u>
Acme Steel Co. Steel Specialties	1901	\$.30	22 3/8	1.3
American Molasses Co. Molasses, sugar, related products	1927	.80	15 3/4	5.1
American Shipbuilding Co. Shipbuilding and Repairing	1917	1.12	20	5.6
Arvin Industries, Inc. Auto parts, household appliances	1925	1.00	24 3/8	4.1
Bohn Aluminum & Brass Corp.	1925	1.00	24 1/2	4.1

* Stocks, Principal line of business and year payment began are from Investment Facts
- About Common Stocks and Cash Dividends, p. 8-17.

** Annual Dividends and Closing Prices are from The New York Times, Section 3, Sunday,
-- July 30, 1961, pp. 2, 4, 9. Annual dividends are based on the latest quarterly or
semi-annual declaration and do not include extra dividends.

*** Yield is based on Annual Dividend and 7/28/61 price.

EXHIBIT A CONTINUED
Selling Below \$30 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Book-of-the-Month Club Book sales by mail	1927	\$1.20	25	4.8
Chicago Yellow Cab Co. Taxi Operator	1917	.50	19 1/4	2.6
Central Aguirre Sugar Co. Cane Sugar	1915	1.60	25 5/8	6.2
City Products Corp. Fuel & Ice Distributor	1896	1.30	28 5/8	4.5
Cone Mills Denims & Cotton Flannels	1914	.80	13 5/8	5.9
Dr. Pepper Co. Soft Beverage	1930	.60	18	3.3
Dome Mines, Ltd. Canadian gold mining	1920	.70	23 7/8	2.9
Duquesne Light Co. Operating public utility	1913	1.18	28 1/4	4.1

EXHIBIT A CONTINUED
Selling Below \$30 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Gamble-Skogmo, Inc. Auto supplies, TV, Appliance Stores	1929	\$1.20	26 1/2	4.5
General Cigar Co. Tobacco products	1909	1.20	29 1/2	4.1
Howe Sound Co. Copper, Silver, Gold mining	1923	.62	18 1/8	3.4
Island Creek Coal Co. Bituminous coal	1912	1.50	27 1/2	5.5
Lone-Star Gas Co. Natural gas pipe lines	1926	1.00	25 5/8	3.9
Marine Midland Corp. Commercial Bank	1929	1.00	28 1/2	3.5
McQuay-Norris Mfg. Co. Auto engine and chassis parts	1927	1.00	18 3/8	5.4
Monarch Machine Tool Co. Machine tools	1913	.40	17 1/2	2.3

EXHIBIT A CONTINUED
Selling Below \$30 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Outlet Co. Department Store	1926	\$.95	19 3/4	4.8
Parker Rust Proof Co. Rust-proofing chemicals	1924	1.50	26 1/2	5.7
Plymouth Oil Co. Petroleum products	1925	.50	25 3/4	1.9
Scovill Manufacturing Co. Brass Mill Products	1856	1.00	23 3/4	4.2
Frank G. Shattuck Co. Candy, chain restaurants	1925	.40	22 1/2	1.8
Smith-Douglass Co. Fertilizers	1922	1.20	28 1/2	4.2
South Puerto Rico Sugar Co. Cane Sugar	1924	.60	22 3/8	2.7
Spencer Kellogg & Sons, Inc. Vegetable Oils	1913	.80	21 1/2	3.7

EXHIBIT A CONTINUED
Selling Below \$30 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Sun Chemical Co. Industrial Chemicals	1929	\$.60	17 5/8	3.4
Sunshine Mining Co. Silver mining	1927	.20	10 3/4	1.9
Texas Gulf Sulphur Co. Sulphur mining	1921	1.00	25 5/8	3.9
Toledo Edison Co. Operating public utility	1922	.70	23 5/8	3.0
United Engineering & Foundry Co. Steel mill equipment	1902	1.00	20 1/8	5.0
U. S. Pipe & Foundry Co. Cast iron pipe castings	1926	1.20	23 1/2	5.1
U. S. Playing Card Co. Playing cards, novelties	1896	1.10	28 1/8	3.9
Waldorf System, Inc. Chain cafeterias	1919	.60	11 3/4	5.1
Westinghouse Air Brake Co. R.R. Air brakes & signal equipment	1875	1.20	26 3/8	4.5

EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Adams Millis Corp. Cotton and Rayon Hosiery	1928	\$.72	30 1/2	2.4
American Bakeries Corp. Wholesale Bakery Products	1927	2.40	43	5.6
American Brake Shoe Railroad & auto brakes	1902	2.40	48 3/8	5.0
American Can Co. Cans & containers	1923	2.00	44 1/2	4.5
American Machine & Foundry Co. Bowling equipment & Tobacco machinery	1927	.90	46 3/8	1.9
American Natural Gas Gas Utility Holding Co.	1904	1.20	39 5/8	3.0
American News Co. Magazine & Newspaper Distributors	1864	1.00	43 1/2	2.3
Anchor Hocking Glass Corp. Glassware & Glass Containers	1914	1.40	39	3.6

EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Archer-Daniels Midland Co. Linseed Oil	1927	\$2.00	41 3/8	4.8
Atlantic City Electric Co. Operating public utility	1918	1.20	46	2.6
Baltimore Gas & Electric Co. Operating public utility	1910	1.00	32	3.1
Beech Creek Railroad Co.	1891	2.00	31 5/8	6.3
Best & Co. Retail Specialty Stores	1924	2.00	37 3/8	5.4
Canada Southern Railway Co.	1887	3.00	43 1/2	6.9
Carpenter Steel Co. Alloy steel and specialties	1907	1.20	44 3/4	2.7
Caterpillar Tractor Co. Farm Machinery	1914	1.00	39	2.6
Central Illinois Light Co. Operating public utility	1921	1.52	41 1/8	3.7

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EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Continental Can Co. Cans and containers	1923	\$1.80	44 1/8	4.1
Cream of Wheat Corp. Cereals	1900	1.60	45 3/8	3.5
DeVilbiss Co. Compressors, spray guns	1918	1.60	31 1/8	5.1
Eaton Manufacturing Co. Auto and aircraft parts	1923	1.80	36 7/8	4.9
Firestone Tire & Rubber Co. Tires, Tubes, Rubber products	1924	1.00	46 1/4	2.2
Freeport Sulphur Co. Sulphur mining	1927	1.20	30 7/8	3.9
General Mills, Inc. Flour, Cereals, Feeds	1898	1.20	34 3/4	3.5
General Motors Corporation Auto manufacturers	1915	2.00	46 3/4	4.3

EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
W. T. Grant Chain department stores	1907	\$1.20	31	3.9
G. W. Helme Co. Snuff	1912	1.60	37 1/2	4.3
Household Finance Corp. Installment Loans	1917	1.20	48	2.5
Idaho Power Co. Operating public utility	1917	1.00	33 7/8	3.0
International Shoe Co. Shoe Manufacturer	1913	1.80	36	5.0
Joy Manufacturing Co. Mining Machinery	1929	2.00	41 1/2	4.8
Kansas Power & Light Co. Operating public utility	1915	1.48	46 1/2	3.2
S. S. Kresge Co. Chain variety stores	1913	1.60	32 7/8	4.9

EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Kroger Co. Groceries, chain food stores	1902	\$1.10	30	3.7
The Lehman Corporation Investment Company	1930	1.58	30	5.3
Lehn & Fink Products Corp. Drugs & Toiletries	1925	.80	38 7/8	2.1
McCall Corporation Printers, publishers, dress patterns	1926	.50	30	1.7
McIntyre Porcupine Mines Canadian gold mining	1917	1.00	36 3/4	2.7
Melville Shoe Corp. Shoe manufacturer & distributor	1916	1.60	34 7/8	4.6
Midwest Oil Corp. Crude petroleum	1921	.70	44 1/2	1.6
John Morrell & Co. Meat packing	1916	.80	31 1/4	2.6

EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
G. C. Murphy Chain variety stores	1913	\$2.20	47 7/8	4.6
J. J. Newberry Co. Chain variety stores	1928	2.00	44 1/8	4.5
New York State Electric & Gas Co. Operating public utility	1910	1.30	37 1/4	3.5
Nopco Chemical Co. Industrial Chemicals	1927	1.00	47 3/4	2.1
Ohio Edison Company Operating public utility	1930	1.48	42 1/8	3.5
Olin Mathierson Chemical Corp. Industrial Chemicals, rocket fuels	1926	1.00	49 5/8	2.0
Pacific Telephone & Telegraph Co. Operating public utility	1925	1.14	42	2.7
Parke, Davis & Co. Pharmaceuticals	1878	1.00	33 3/8	3.0

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EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
J. C. Penney Co. Chain variety stores	1922	\$1.20	47 1/2	2.5
Peoples Drug Stores, Inc. Chain drug stores	1927	2.00	42 3/4	4.7
Chas. Pfizer & Co. Pharmaceuticals	1901	.60	41 3/8	1.5
Philadelphia Electric Co. Operating public utility	1902	1.20	32 1/8	3.7
Potomac Electric Power Co. Operating public utility	1904	1.44	40 3/4	3.5
Pullman, Inc. Railroad cars and equipment	1867	2.00	36 1/8	5.5
Ruberoid Co. Asphalt and Asbestos products	1899	2.00	42 3/4	4.7
San Diego Gas and Electric Co. Operating public utility	1909	1.20	32 1/4	3.7

EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Socony-Mobil Oil Co. Petroleum Products	1902	\$2.00	46 1/2	4.3
Standard Oil Co. of N. J., Inc. Petroleum products	1882	1.10	45 5/8	2.4
James Talcott, Inc. Commercial loans	1924	.90	42 7/8	2.1
Union Electric Co. of Mo. Operating public utility	1906	1.80	46 1/4	3.9
Union Pacific Railroad Co.	1900	1.20	34 7/8	3.4
Union Tank Car Co. Leases Railroad tank cars	1914	1.60	36 3/4	4.4
United Biscuit Co. Biscuits, crackers, cookies	1928	1.00	35	2.9
United-Carr Fastener Corp. Snap fasteners	1923	1.20	35 1/4	3.4
United States Tobacco Co. Tobacco products	1912	1.20	31	3.9

EXHIBIT A CONTINUED
\$30 to \$50 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Universal Leaf Tobacco Co. Leaf tobacco processors	1927	\$1.20	41 1/2	2.9
Waukesha Motor Co. Diesel & gasoline engines	1922	2.00	36 1/4	5.5
West Virginia Pulp & Paper Co. Pulp & paper products	1899	1.20	34 1/2	3.5
Western Auto Supply Co. Auto parts, home appliance stores	1928	1.40	45 1/2	3.1
S. S. White Dental Mfg. Co. Dental instruments and equipment	1881	1.80	47 1/2	3.8
Yale & Towne Mfg. Co. Lift-trucks, building hardware	1899	1.50	33 7/8	4.4

EXHIBIT A CONTINUED
\$50 to \$75 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Abbott Laboratories Pharmaceuticals	1926	\$1.80	69 3/4	2.6
Air Reduction Co. Welding gas and equipment	1917	2.50	74 1/4	3.4
Allied Chemical & Dye Corp. Industrial chemicals	1921	1.80	64	2.8
American Snuff Co. Snuff	1903	2.80	73	3.8
Associates Investment Co. Installment loans	1918	2.60	71 1/2	3.6
Atlantic Refining Co. Petroleum products	1927	2.40	56 1/4	4.3
Borden Co. Dairy products	1899	1.50	64 1/8	2.3
Briggs & Stratton Auto parts, small engines	1929	2.00	54	3.7

EXHIBIT A CONTINUED
\$50 to \$75 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Cannon Mills Co. Towels and sheets	1890	\$3.00	69	4.3
Carborundum Co. Abrasives, refractories	1922	1.60	56	2.9
Chesapeake & Ohio R.R. Co.	1922	4.00	58 3/4	6.8
Cleveland Electric Illum. Co. Operating public utility	1900	2.00	57 1/8	3.5
Columbian Carbon Carbon blacks	1916	2.40	65 1/2	3.7
Columbus & So. Ohio Electric Co. Operating public utility	1927	2.00	62	3.2
Continental Insurance All insurance except life	1854	2.20	59 1/8	3.7
Corn Products Refining Co. Corn starch, syrup products	1920	1.20	52 7/8	2.3
Detroit Edison Co. Operating public utility	1909	2.20	58 1/4	3.8

EXHIBIT A CONTINUED
\$50 to \$75 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Electric Storage Battery Co. Batteries and accessories	1901	\$2.00	57 3/4	3.5
Family Finance Corp. Installment loans	1929	1.60	54 1/4	2.9
First National Stores Grocery chain stores	1914	2.00	66	3.0
Georgia Pacific Plywood Co. Lumber products	1927	1.00	66 1/4	1.5
Great Northern Paper Co. Paper and paper products	1910	1.00	55 1/2	1.8
Hackensack Water Company Operating public utility	1886	2.40	57 1/2	4.2
H. J. Heinz Co. Groceries, canned foods	1911	1.00	62 1/2	1.5
Jewel Tea Co. Tea, groceries	1928	1.40	64 1/2	2.2

EXHIBIT A CONTINUED
\$50 to \$75 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Kansas City Power & Light Co. Operating public utility	1921	\$2.32	70	3.3
Lily-Tulip Cup Corp. Paper cups	1929	1.00	50 3/4	2.0
Link-Belt Co. Industrial conveyor belts	1906	2.40	53	4.5
R. H. Macy & Co. Department stores	1927	2.00	58 1/2	3.4
May Department Stores Co. Chain department stores	1911	2.20	52 1/2	4.2
Mesta Machine Co. Steel mill machinery	1914	2.50	52 1/2	4.8
Monsanto Chemical Co. Industrial Chemicals	1925	1.00	53 5/8	1.9
National Dairy Products, Corp. Dairy products	1924	2.00	69 7/8	2.9

EXHIBIT A CONTINUED
\$50. to \$75 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Northern Central R. R. Co.	1881	\$4.00	64 1/7	6.2
Norwich Pharmacal Co. Drugs and Toiletries	1925	1.00	59 1/2	1.7
Pacific Lighting Co. Operating public utility	1909	2.40	56 1/2	4.2
Penick & Ford, Ltd. Corn, sugar, maple products	1929	.80	53 5/8	1.5
Pet Milk Co. Dairy products	1922	1.00	57	1.8
Pillsbury Mills, Inc. Flour, feeds	1924	1.50	56 1/2	2.7
Pittsburg Plate Glass Co. Glass, paint, chemicals	1899	2.20	64 3/4	3.4
Public Service Electric & Gas Operating public utility	1907	2.00	57 1/2	3.5
Quaker Oats Co. Cereals, food products	1906	2.00	72	2.8

EXHIBIT A CONTINUED
\$50. to \$75 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Raybesto-Manhattan, Inc. Asbestos and rubber products	1895	\$3.40	71	4.8
Safeway Stores, Inc. Chain grocery stores	1927	1.50	51 1/2	2.9
Southern California Edison Co. Operating public utility	1907	2.60	71 1/2	3.6
Standard Brands, Inc. Food processors & distributors	1899	1.80	63 1/8	2.9
Standard Oil of California, Inc. Petroleum products	1912	2.00	52	3.8
Stauffer Chemical Co. Industrial Chemicals	1915	1.20	55 5/8	2.2
Sun Oil Co. Petroleum products	1904	1.00	53 1/8	1.9
Timkin Roller Bearing Co. Roller bearings, steel tubes	1921	2.40	56 1/8	4.3

EXHIBIT A CONTINUED
\$50 to \$75 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Union Oil Co. of California Petroleum products	1916	\$2.00	53 3/4	3.7
United Gas Improvement Co. Operating public utility	1885	2.40	64 3/4	3.7
Virginia Electric & Power Co. Operating public utility	1925	1.30	60 1/2	2.1

EXHIBIT A CONTINUED
\$75 to \$100 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Allegheny & Western R. R. Co.	1899	\$6.00	92	6.5
Amerada Petroleum Corp. Crude petroleum	1922	2.60	84	3.1
American Chicle Co. Chewing gum	1926	1.60	85 1/2	1.9
American Tobacco Co. Cigaretts, tobacco products	1905	2.80	93	3.0
Boston Edison Operating public utility	1890	3.00	78 3/4	3.8
Bristol Myers Drugs and toiletries	1900	.50	85 1/4	.6
Brown Shoe Co. Shoe manufacturer	1923	2.80	81 1/2	3.4
Carolina, Clinton & Ohio Railway	1925	5.00	94 1/2	5.3
C I T Financial Corp. Installment loans	1921	2.80	77	3.6

EXHIBIT A CONTINUED
\$75 to \$100 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Coca-Cola Co. Mfgs. & Distributors of Coca-Cola Syrup	1893	\$2.40	88 3/4	2.7
Commonwealth Edison Co. Operating Public Utility	1890	2.00	86 5/8	2.3
Consolidated Edison Co. Operating Public Utility	1885	3.00	75 5/8	4.0
Dow Chemical Co. Industrial chemicals	1911	1.40	77 3/4	1.8
General American Trans. Corp. Railroad car & terminal lessors	1919	2.25	84 3/4	2.7
General Foods Corp. Food processors & distributors	1922	1.60	83 7/8	1.9
Hercules Powder Co. Chemicals, explosives	1913	.75	92 7/8	.8
Ingersoll-Rand Co. Air and gas compressors	1910	3.00	89	3.4

EXHIBIT A CONTINUED
\$75 to \$100 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Johnson & Johnson Surgical products and dressings	1905	\$1.00	89 1/2	1.1
Liggett & Myers Tobacco Co. Cigarettes, tobacco products	1912	5.00	94 7/8	5.3
Minnesota Mining & Manufacturing Co. Adhesives, abrasives	1916	.60	76 1/4	.8
National Biscuit Co. Biscuits, crackers, cereals	1899	2.80	79	3.5
National Lead Co. Lead products, paint	1906	2.25	89 3/8	2.5
National Steel Corp. Steel and steel products	1907	3.00	95 1/2	3.1
Otis Elevator Co. Elevators and escalators	1903	1.50	78 3/8	1.9
Pacific Gas & Electric Co. Operating public utility	1919	2.80	76 1/2	3.7

EXHIBIT A CONTINUED
\$75 to \$100 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Philip Morris, Inc. Cigarettes, tobacco products	1928	\$3.60	95 1/4	3.8
Proctor & Gamble Co. Soap and toiletries	1891	1.40	87 1/4	1.6
Public Service Co. of Colorado Operating public utility	1907	2.10	79 3/4	2.6
Sterling Drug Inc. Pharmaceuticals	1902	1.80	83 3/4	2.1
F.W. Woolworth Co. Chain variety stores	1912	2.50	76 1/8	3.3

EXHIBIT A CONTINUED
Over \$100 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
American Home Products Corp. Drugs, cosmetics, food products	1919	\$3.60	228 1/2	1.6
American Telephone & Telegraph Co. Bell Telephone System	1881	3.60	124 3/4	2.9
Campbell Soup Co. Soup and other food products	1902	2.00	108 7/8	1.8
Corning Glass Works Glassware and glass products	1881	1.50	166	.9
DuPont Nylon, Chemicals	1904	3.00	226 1/4	1.3
Eastman Kodak Co. Photo and optical products	1902	2.00	105	1.9
Gillette Co. Razors, blades & permanent wave sets	1906	2.50	116	2.2
Hershey Chocolate Corp. Chocolate & cocoa products	1930	3.00	146	2.1

EXHIBIT A CONTINUED
Over \$100 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Houston Light & Power Co. Operating public utility	1922	\$1.60	107 3/4	1.5
International Business Machines Manufactures, sells & leases business machines	1916	2.40	487	.5
International Salt Co. Salt for industry and home use	1915	2.00	101 1/2	2.0
Minn. Honeywell Regulator Co. Thermostats, Computers	1928	2.00	145 3/4	1.4
Norfolk & Western Railroad Co.	1901	4.00	101	4.0
R. J. Reynolds Tobacco Co. Cigarettes, tobacco products	1901	3.00	133 3/4	2.2
Rohm & Haas Co. Industrial Chemicals & Plastics	1927	3.00	547	.5
Scott Paper Co. Paper towels and tissues	1915	2.20	107 1/8	2.1

EXHIBIT A CONCLUDED
Over \$100 Per Share

	<u>Year Payment Began</u>	<u>Annual Dividend</u>	<u>Closing Price 7/28/61</u>	<u>Yield</u>
Sunshine Biscuits, Inc. Biscuits, crackers, cereals	1927	\$4.40	107	4.1
Texas Utilities Co. Utility holding company	1917	2.08	104	2.0
Union Carbide & Carbon Corp. Industrial chemicals	1918	3.60	135 1/2	2.7
U. S. Gypsum Co. Gypsum, lime, paints	1919	2.40	104 3/4	2.3
Wm. Wrigley, Jr. Co. Chewing gum.	1913	3.00	114 5/8	2.3

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CHAPTER II

Statement of Financial Position (Balance Sheet)

Repeated use has been made of the term "financial statements" in the preceding chapter. In a very general sense, financial statements are any statements or schedules that contain financial data. However, the term "financial statements", as used in this paper, refers to the Balance Sheet and the Statement of Earnings. This chapter is concerned with the Balance Sheet.

Some people would throw up their hands and plead ignorance if they became engaged in conversation about corporation financial reports. Others find very little value in financial statements, saying that the balance sheet and statement of earnings do not tell what the future of a business will be, or perhaps saying that accounting terminology is more confusing than helpful. It is true that accountants are basically historians, recording for the most part, transactions which have taken place in the past. But what is wrong with historical financial data as a basis for forecasting the future? History may well be the most accurate basis available. Nearly all trends, comparisons and analyses are based on the past. It is also true that some accounting terms are confusing. Accountants, like other professional people, use a specialized vocabulary, but there

are very few terms that are completely new to the average layman.

Actually, accountants have done a tremendous job in developing record keeping systems and reports which condense hundreds of thousands of transactions completed by a business, into thirty or forty items on a balance sheet. Furthermore, understanding financial statements is not an impossible chore. Preparation of the Balance Sheet and the Statement of Earnings is difficult but the mathematics employed is elementary.

One thing that we should bear in mind constantly, as we approach a financial statement, is that figures are cold statistics if they are thought of only as figures, but they are vital forces which have significance if they are thought of as representing things. For example, in looking at the inventory item in the balance sheet of a retail department store, think of the items which the figures represent; men, women's and children's clothing of all kinds, housewares, appliances, toys and hardware with thousands of items. When this is our approach, we take an intelligent approach because questions arise naturally. We wonder if any of it is obsolete or out of style.

Sometimes balance sheets are called statements of financial position. Banks call their balance sheets Statements of Condition. It is true that the balance sheet must balance, with the assets on the left side equalling the liabilities on the right, in the account form of balance sheet. However, the title Statement of Financial Position is

much more descriptive. The financial position at the close of business on a particular day is what this statement purports to show. It is as if a snapshot had been taken of the condition of the business. Of course, by the time the snapshot is developed, or the statement has been printed, the condition of the business has changed.

The first thing, therefore, that should be noted about the Statement of Financial Position is the date, which ordinarily appears at the top of the statement just under the company name. Having noted the date of the statement, we should find out what relation the date of the statement bears to the natural flow of the business.¹

On December 31, for example, we would not expect a toy manufacturer's finished goods inventory to be at its peak. By the time Christmas arrives his accounts receivable should be declining. On the other hand, a cigarette manufacturer, on December 31, would be near a peak inventory and debt position. At this time of the year, the cigarette manufacturer would probably have just completed the purchase of large quantities of bright tobacco. Indeed, he may be well into the purchase of burley tobaccos. Tobacco products manufacturers age their leaf tobacco inventory for over two years. Leaf purchases require great amounts of money. Consequently, cigarette manufacturers usually borrow from banks on short term notes to finance leaf purchases. Both inventory and debt are likely to be high on December 31, in this industry.

1. Herbert G. Stockwell, How to Read A Financial Statement, (New York: The Ronald Press Company, 1925), p. 158.

It has been stated that the Statement of Financial Position employs elementary mathematics. However, the principle on which this statement is based is a very simple equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}.$$

"The function of a balance sheet is to show what the company owns and what it owes,"² and what part of the capital is supplied by the owners.

Assets are what the company owns, including claims on the assets of others. (Accounts Receivable are claims on the assets of others.) Wherever property (or assets) are owned, someone has a financial interest in the property. If there are debts on the property, the creditor has an interest. If there are no debts, the owner has the sole interest and the equation is as follows:

$$\begin{aligned} \text{Assets} &= \text{Liabilities (none)} + \text{Owners' Equity or} \\ &\text{Assets} = \text{Owners' Equity}. \end{aligned}$$

The interest in the assets is made up of the creditors' equity (liabilities), and the owners' equity which is called Capital on most corporation statements of financial position.

Although it is not intended here to provide a course in accounting, it is well that the prospective investor understand the basic theory of double entry accounting. One cannot understand financial statements without some appreciation of the way they come about and how they change from one year to the next. Double entry accounting means that every transaction has two sides - a debit (or charge) and a

2. Benjamin Graham and Charles McGoldrick, The Interpretation of Financial Statements, (New York: Harpers and Brothers, 1955), p. 2.

credit. The total of the debits equals the total of the credits. This is why the Statement of Financial Position balances. Normally asset accounts have debit balances. (The debits to a particular asset account exceed the credits to the account, leaving a debit balance.) Liability and Capital Accounts usually have credit balances. Income accounts have credit balances and expense accounts have debit balances; when all of the income and expense accounts are closed at the end of an accounting period, an excess of income over expense would be a credit which would be an addition to the capital section of the Statement of Financial Position. The principles of debit and credit are as follows:

A debit

1. Increases any asset account,
2. Decreases any liability account,
3. Decreases any capital account,
4. Decreases any income account,
5. Increases any expense account.

A credit

1. Decreases any asset account,
2. Increases any liability account,
3. Increases any capital account,
4. Increases any income account,
5. Decreases any expense account.

Let us illustrate these principles. Suppose that you and two of your friends decide to incorporate a business to sell widgets as a wholesaler. Each of you has \$10,000 and so you decide to have 30,000 shares of common stock at \$1.00 par value. As each of you paid for his ten thousand shares of stock, the entry in the accounts would be a debit to cash

3. Howard S. Noble, Accounting Principles, (Fourth Edition; Cincinnati, Ohio: South-Western Publishing Company, 1945), p. 63.

for \$10,000 and a credit to common stock for \$10,000. After these three transactions, the Statement of Financial Position would show:

<u>Assets</u>		<u>Capital</u>
Cash	\$30,000	Common Stock \$30,000

Together, you decide that each of the three owner-managers shall receive a salary of \$300 per month. You rent a building for \$100 per month. You purchase a delivery truck for \$3,600 cash. You buy 2,000 widgets from the manufacturer for \$.70 each. During the month the corporation sells 1,400 widgets at \$1.00 each. The monthly expense for the operation of the truck is \$50. Each of these transactions would be recorded in accounts which would group similar transactions. A Statement of Earnings and a Statement of Financial Position could be prepared after each transaction, but even in this small business the owner-managers would not have time to observe the effect of each transaction on the financial position of the company. They would, however, watch the cash balances daily and probably want a statement of earnings every month. A separate account for each type of asset, liability, income, expense, and capital would be maintained. The accounts would reflect the increases and decreases in each of these items.⁴ The transactions for the month for your company would be recorded as follows: (see Exhibit B where the entries bear the same letters as the descriptions below.)

- A. Balances in the accounts at the beginning of the month.

4. Ibid., p. 58.

EXHIBIT B

ASSET ACCOUNTS		LIABILITY ACCOUNTS		EXPENSE ACCOUNTS		INCOME ACCOUNTS	
Cash		Accounts Payable		Cost of Goods Sold		Sales	
Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
(A) 30,000	(D) 3,600		(E) 1,400	(G) 980	(J) 980	(J) 1,400	(F) 1,400
(H) 900			(I) 50				
Accounts Receivable		Rent Payable		Salary Expense		Income Summary	
Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
(F) 1,400	(H) 900		(C) 100	(B) 900	(J) 980	(J) 980	(J) 1,400
Widget Inventory		Salaries Payable		Rent Expense		(J) 900	
Debit	Credit	Debit	Credit	Debit	Credit	(J) 100	
(E) 1,400	(G) 980		(B) 900	(C) 100	(J) 100	(J) 50	
Truck				Truck Expense		2,030	1,400
Debit	Credit			Debit	Credit		
(D) 3,600				(I) 50	(J) 50		
CAPITAL ACCOUNTS						Loss	(K) 630
Common Stock							
Debit	Credit						
	(A) 30,000						
Retained Earnings							
Debit	Credit						
(K) 630							

- B. Salaries have not been paid at the end of the month, but they are due.
- C. Rent is due for one month.
- D. The truck is acquired for cash.
- E. The corporation buys 2,000 widgets at \$.70 each, owing \$1,400 to the manufacturer.
- F. Sales during the month totaled \$1,400. (1,400 widgets at \$1.00 each.) All of the sales were credit sales.
- G. An inventory is taken at the end of the month, revealing that there are 600 widgets on hand. The inventory is relieved of the cost of the sales. (1,400 widgets at \$.70 each = \$980.)
- H. Payment is received for 900 widgets.
- I. Truck expense is payable.
- J. Sales, Cost of Goods Sold and all expenses are transferred to an Income Summary Account to determine the results of operations for the month.
- K. Loss is transferred to Retained Earnings account where it appears as a deficit.

At this point a Statement of Earnings could be prepared from the accounts as follows:

WIDGET SALES CORPORATION
Statement of Earnings
Month Ended October 31, 19X5

Sales		\$1,400
Less Cost of Goods Sold		<u>980</u>
Gross Profit		\$ 420
Operating Expenses		
Salaries	\$900	
Rent	100	
Truck	<u>50</u>	<u>\$1,050</u>
Net Loss		\$ 630

A Statement of Financial Position might also be prepared by using the balances in the various asset, liability

and capital accounts. In Exhibit B we note that the debits to the cash account total \$30,900 and the credits total \$3,600, giving the company a net debit cash balance of \$27,300 (\$30,900 less \$3,600). Accounts Receivable has a \$500 debit balance, and the Inventory account has a \$420 debit balance. The Statement of Financial Position might look as follows:

WIDGET SALES CORPORATION
Statement of Financial Position
October 31, 19X5

Assets

Current Assets:

Cash	\$27,300
Accounts Receivable	500
Inventory	420
Total Current Assets	<u>\$28,220</u>

Truck

Total Assets	<u>3,600</u> <u><u>\$31,820</u></u>
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Liabilities

Current Liabilities:

Salaries Payable	\$ 900
Accounts Payable	1,550
Total Current Liabilities	<u>\$ 2,450</u>

Capital and Retained Earnings:

Common Stock - Par \$1.00	
Issued 30,000 shares	\$30,000

Deficit	<u>630</u>
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Total Capital and Deficit	<u>\$29,370</u>
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Total Liabilities and Capital	<u><u>\$31,820</u></u>
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When a Statement of Financial Position shows the Liabilities listed below the Assets, it is known as a "report form" of statement. Small businesses frequently use the report form. Many corporations' statements follow the

"account form" showing the assets on the left and the liabilities and capital on the right side.

These two statements summarize the transactions recorded in the accounts using the double entry system, but they are greatly oversimplified. The accountant member of the owner-manager team of the Widget Sales Corporation, at the meeting of the Board of Directors, would probably point out that the value of the truck was declining even though no depreciation was recorded. Also, he might suggest that some provision should be made for possible bad debts included in the Accounts Receivable. These would be two additional items of expense which would make the Loss something in excess of the \$630 reported on the Statement of Earnings. All of the directors would probably agree that since they had proven that there was a ready market for widgets, they should substantially increase their inventory and their sales efforts.

It should be noted that the Statement of Financial Position of The Widget Sales Corporation was divided into sections. The first of these sections included assets which are classified as current assets. Sometimes current assets are called working assets since they are the assets that reflect the conversion of raw materials into work in process, then into finished product, to accounts receivable as sales are made, and finally into cash as accounts receivable are collected. Adam Smith defined current assets many years ago. He wrote, "The goods of the merchant yield him

no revenue or profit till he sells them for money, and the money yields him as little till it is again exchanged for goods. His capital is continuously going from him in one shape, and returning to him in another, and it is only by means of such circulation or successive exchanges, that it can yield him any profit."⁵ Current assets include cash and other assets which in the normal course of business will be turned into cash in the near future, usually within a year. The one year rule is arbitrary, of course, but most companies complete a full cycle of their operations in one year. Some companies, however, such as distillers and tobacco manufacturers include their inventories in current assets even though they may not completely turn over and be converted into cash for several years. These businesses follow the normal operating cycle concept of current assets.

Rule 3-13 of Regulation S-X states, "Items classed as current assets shall be generally realizable within one year. However, generally recognized trade practices may be followed with respect to the inclusions of items such as installment receivables or inventories long in process, provided an appropriate explanation of the circumstances is made and, if practicable, an estimate is given of the amount not realizable within one year."⁶

5. Adam Smith, An Inquiry Into The Nature and Causes of The Wealth of Nations, Edwin Cannan, Editor, (Modern Library Edition; New York: Random House, Incorporated, 1937), pp. 262-263.

6. United States, Securities and Exchange Commission, Regulation S-X, Form and Content of Financial Statements, Article 3, Rule 3-13, p. 7.

Normally current assets are shown in the order of their liquidity. Cash is the most liquid of all assets and is shown first. Most laymen would be familiar with the term "cash", because it is just what he would expect it to be - bills and silver and checks for deposit in the till and money in the bank. The layman should avoid the tendency to think of cash as being synonymous with profit. Profit is merely the excess of income (sales or revenue) over expenses. Some expenses, such as depreciation and bad debts do not involve an outlay of cash. As for sales, in this country the greatest percentage of the dollar amount is on credit. This fact suggests one reason why we should not pass over the cash item in the Statement of Financial Position too hurriedly.

It is almost as bad for a company to have too much cash as it is to have too little. If a company has too much cash continually, chances are that the excess cash is idle much of the time. Immediately after World War II, the Statements of Financial Position issued by Montgomery Ward showed large amounts of cash and marketable securities. This was in keeping with the belief of Mr. Sewell Avery, Board Chairman, who felt that the Company should be in a very liquid position to meet the depression which he expected. Montgomery Ward became a target for Mr. Louis Wolfson, who could have used the cash to expand his industrial empire. In the second place, Sears Roebuck far outstripped Montgomery Ward, its closest competitor. When a working asset is not working, or circulating, it is not contributing anything to

the profits or financial progress of the company. We should remember that all assets have greater value when they are used in a going concern than they have as individual pieces of property.

Even though cash might be stated as a definite amount of dollars and cents on the Statement of Financial Position, we should not assume that it warrants no scrutiny. Cash on hand, demand deposits and time deposits in bank, if any, should be stated separately from any bank deposits subject to withdrawal restrictions.⁷ If the company has foreign subsidiaries and has consolidated foreign currency with United States currency in a consolidated Statement of Financial Position, the basis for the conversion of the foreign currency should be shown.⁸

While too much cash, over a period of years might indicate a failure to keep this working asset adequately employed, it is obvious that a company should have enough cash to meet its current obligations as they mature, and to take advantage of all cash discounts allowed by suppliers. Sometimes banks are reluctant about supplying working capital for business, especially on a continuing basis, feeling that a business should generate its own working capital through the conversion of its assets. However, it would profit a business to borrow short term money at 6% interest per annum ($\frac{1}{2}\%$ per month), if necessary in order to pay for goods

7. Ibid., Article 5, Rule 5-02, p. 13.

8. Ibid., Article 3, Rule 3-09, p. 6.

and services it purchases, soon enough to take all cash discounts which are allowed.

Cash is the most definite of all assets in terms of dollars. It can be counted, and that part that is in the bank can be verified and reconciled to the company's books. As long as non-cash items, such as I.O.U's in the petty cash fund, are not included in the total, we can depend on the dollar amount in the Statement of Financial Position. All other assets are subject to question, since their stated values are somewhat more subject to the judgment of the company management. Most asset values are based on historical cost, but later we shall see that there are different methods of determining historical cost.

Following the Cash item in the Statement of Financial Position we usually find Accounts Receivable. Sometimes they are described as Accounts Receivable - Trade or as Accounts Receivable from Customers. In other words, this account should not include amounts owing from officers or employees of the company or advances to subsidiaries or worthless accounts. Accounts Receivable represent a definite dollar claim on the assets of customers. If you were looking at the statement of a local department store, what you owed on your charge account would be included in this classification. Because some people and some companies fail to pay their bills, many conservative businesses, at the end of each accounting period follow the practice of setting up an adequate reserve for doubtful accounts or bad debts.

This reserve is deducted from the accounts receivable total and the net figure is shown on the Statement of Financial Position. Other companies anticipate the cash discounts which will be taken by their customers and deduct this allowance from the accounts receivable total.

There are many different business and trade practices regarding terms of payment of sales invoices. Nearly all companies state the terms of payment on their sales invoices, which are the documents representing a debit to the customers' accounts receivable and credit to sales on the sellers' books. Some companies state that the mode of payment is net cash. This means that no discount is allowed for prompt payment but that the amount of the invoice is due when billed. More frequently cash discounts are allowed for prompt payment, and the most common is 2% for payment within ten days from the date of the invoice, or payment of the full amount within thirty days from the date of the invoice. These terms are written "2/10/30" or "2%-10 days, 30 days net."⁹

We have mentioned the fact that some people, and some companies do not pay their bills promptly. Obviously, the older an account receivable is, the more doubtful its collection becomes. Therefore, one of the most important questions regarding accounts receivable is, "How old are the accounts?" In order to answer this question completely it would be

9. Thomas W. Byrnes, K. L. Baker, and C. A. Smith, Auditing, (New York: The Ronald Press Company, 1948), p. 177.

necessary to have access to the accounts receivable ledgers containing every individual customer's account. If we had access to these records we could determine the dollar amount of accounts receivable outstanding which were:

1. Billed this month
2. Billed last month
3. Billed month before last
4. Billed prior to month before last.

If the terms of sale specified that payment was to be made within thirty days of the invoice date, we would certainly think that the collection of those sales billed prior to month before last would be doubtful. However, since the investor ordinarily would not have access to such information, it would be natural for him to relate the accounts receivable balance in the Statement of Financial Position to the sales figure in the Statement of Earnings. This relationship is a natural one, since trade receivables are unpaid sales.

Another important consideration is whether the accounts receivable are made up of amounts owing from many small customers or from a few large customers. All things being equal, it would be more risky to have a few large customers, just as it would be risky to invest all of one's money in one company.

The final current asset which we shall consider is the inventory item. "Inventories comprise goods held for sale or in the process of manufacture and materials and

supplies used up in operating the business."¹⁰ "Merchandise is the largest and most important item in many balance sheets of both large and small concerns. Unlike accounts and notes receivable, merchandise (inventory) does not represent a definite claim to dollars. Merchandise must first pass through the sales process before it reaches the stage of representing an absolute monetary claim."¹¹ The valuation of this asset is frequently subject to honest differences of opinion. This honest difference of opinion can be reflected in the stated profit of a business, with an overvaluation of the closing inventory causing an overstatement of profits and an understatement in inventory resulting in an understatement of profits.

Normally the cost of goods sold is determined by deducting the closing inventory from the total of the beginning inventory plus the purchases or additions to the inventory during the accounting period. Let us refer again to the Widget Sales Corporation. You will recall that there was no inventory at the beginning of the month. During the month 2,000 widgets were purchased for \$1,400. These were additions to the inventory. At the end of the month a physical inventory was taken and 600 units were found to be on hand. These 600 units are a part of the 2,000 purchased

10. Benjamin Graham and Charles McGoldrick, The Interpretation of Financial Statements, p. 23.

11. Roy A. Foulke, Practical Financial Statement Analysis, (Second Edition; New York: McGraw-Hill Book Company, Incorporated, 1950), p. 80.

at \$.70 each and so they have a cost of \$420. By deducting the \$420 from the \$1,400 we find that the cost of goods sold for the period is \$980. Suppose, however, that an error had been made in taking the ending inventory count or that the inventory had been deliberately misstated as 700 units. Such an error would result in a cost of sales figure of \$910 instead of \$980 and a loss of \$560 instead of the \$630 reported in the Statement of Earnings. We can see that an overstatement of the closing inventory would result in an understatement of the cost of goods sold and an overstatement of profits.

Manufacturers normally have several different types of inventories. They are raw materials, goods in process of manufacture, finished stock and supplies. Raw materials are those materials which are purchased to be converted eventually into finished products in the manufacturing process. Of course, a raw material to one manufacturer is a finished product to another. Sheet steel, a finished product to the U. S. Steel Company, is a raw material to General Motors. Finished stock, then, is a product ready for sale. In between raw materials and finished goods, we find goods or work in process. Goods in process represent the cost of the raw materials put into process plus the labor and overhead which has been expended in converting these raw materials. Supply inventories normally are those items which are needed to make the finished product but which are not directly a part of the finished product. An

inventory of small tools or machine parts may fall into this category. Or the supplies may be general factory operating supplies such as fuel oil.

There are several ways of determining the cost of this current asset. One method is called average cost. The average cost method is presently used by most cigarette manufacturers to value their large leaf tobacco inventories. A footnote to the American Tobacco Company Consolidated Balance Sheets at December 31, 1959 states, "inventories used in the computation of cost of sales are priced at costs which result from the averaging monthly of transactions reflected in the inventory accounts except that revenue stamp inventories were priced at actual cost."¹² What they mean by averaging is that all of the piles of tobacco of a particular grade that are "sold American" on the auction floor are averaged together. For example, if they bought 100 pounds at \$68 per hundred, 100 pounds at \$70, and 100 pounds at \$72 and these constituted the monthly transactions, the average cost of this grade would be \$.70 per pound (300 pounds totaling \$210). This tobacco would be charged into work in process at \$.70 per pound.

There are two other major methods of cost determination for inventories. One is called the first in - first out or "fifo" method and the other is called the last in - first out or "lifo" method. Under the "fifo" method, the

12. American Tobacco Company, Incorporated, 1959 Annual Report, p. 19.

inventory at the end of the year is treated as being derived from the latest acquired goods. Under the "lifo" method, the inventory at the end of the year is treated as being derived from the earliest acquired goods. In other words the last acquired goods are considered to be the first sold. One of the generally accepted accounting principles is that inventories should be stated at the lower of cost or market; however, where the "lifo" method is used, the inventory is taken at cost, regardless of market values.¹³ "Lifo" is a method of freezing the price of that portion of one's inventory which does not decline in size, at the price of the opening inventory in the year "lifo" is adopted. On a period of rising prices, a company is able to charge a greater portion of the inventory price rise into cost of sales, thus reducing their reported profit and their tax liability. "If the inventory is priced under the 'lifo' method for tax purposes, the same prices must be applied to the inventory used to determine the net income reported in published financial statements."¹⁴

Let us examine the difference that the "fifo" and the "lifo" pricing methods can make in gross profit. (See Exhibit C) Notice that in these two examples, the sales

13. Prentice-Hall, 1951 Federal Tax Course, J. R. B. Byers, F. A. Dunn and R. B. Mitchell, Consulting Editors, (Students Edition; New York: Prentice-Hall, Incorporated, 1951), p. 2607.

14. R. G. Rankin, What's Behind A Financial Statement, (First Edition; Garden City, New York: Doubleday and Company, Incorporated, 1949), p. 93.

EXHIBIT C

FIRST IN - FIRST OUT¹⁵

Sales, (5,000 units at \$4.00 each)	\$20,000
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Cost of Sales

Opening Inventory (2,000 units at \$1.00)	\$ 2,000
Purchases (5,000 units at \$3.00)	<u>15,000</u>
Total Available for Sale	\$17,000
Less Closing Inventory (2,000 at \$3.00)	<u>6,000</u>
Cost of Sales	<u>11,000</u>
Gross Profit on Sales	<u>\$ 9,000</u>

LAST IN - FIRST OUT

Sales (5,000 units at \$4.00)	\$20,000
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Cost of Sales

Opening Inventory (2,000 units at \$1.00)	\$ 2,000
Purchases (5,000 units at \$3.00)	<u>15,000</u>
Total Available for Sale	\$17,000
Less Closing Inventory (2,000 at 1.00)	<u>2,000</u>
Cost of Sales	<u>15,000</u>
Gross Profit on Sales	<u>\$ 5,000</u>

15. Prentice-Hall, 1951 Federal Tax Course, p. 2605.

opening inventory and purchases are identical. Under the "fifo" method, the closing inventory is treated as being derived from the latest acquired goods and under the "lifo" method the closing inventory is treated as being derived from the earliest acquired goods. The two methods result in a \$4,000 difference in the closing inventories, and therefore in the cost of sales and gross profit. Under the "lifo" method, if 3,000 units had been on hand at the end of the period, 2,000 would have had a unit cost of \$1.00 and 1,000 would have been at \$3.00, for a total ending inventory of \$5,000.

Most asset values are stated at historical cost. In the case of inventories, the investor should take into account the method of determining the cost, whether average cost, first-in, first-out, or last-in, first-out. The other major exception to the cost principle for assets is marketable securities which may appear in the statement of financial position at the lower of cost or market. Assets frequently shrink but liabilities never do in case of liquidation. Market values and the replacement cost of assets in excess of stated book values are usually ignored in accounting for assets. On the other hand, all known liabilities are recorded and estimated amounts are set up for all anticipated liabilities. Obviously, generally accepted accounting principles require that the statement of financial position should be a conservative one.

On the liability side of the statement of financial

position, those items which are most closely related to the current assets are the current liabilities. Current assets have been described as working assets because they are constantly revolving in the normal course of business. It is this conversion of current assets from inventory, to receivables, to cash that enables a business to meet the current obligations or liabilities in an orderly manner as they mature. Furthermore, we have seen that it is not enough to meet current liabilities as they mature. A company should be in a position to take all discounts which are allowed for prompt payment. A current liability is an obligation that is payable on demand or within one year from the statement date. Some authorities state that current liabilities are "those liabilities which will be liquidated within the ensuing year."¹⁶ However the determining factor is the due date of the obligation and not the probable payment date. Some types of current liabilities are notes payable, accounts payable, wages and salaries accrued, other accruals such as commissions, bonuses, royalties, taxes, interest, rent, and storage, and current maturities of long term debt.

The amounts of Notes Payable to banks, to the trade and to others should be stated separately.¹⁷ Many companies

16. R. G. Rankin, What's Behind A Financial Statement, p. 139.

17. United States, Securities and Exchange Commission, Regulation S-X, Form and Content of Financial Statements, Article 5, Rule 5-02, p. 15.

do not do this and yet it seems that it would be to their advantage. Few lines of business still deal in trade notes payable, and so any notes payable - trade, in a line of business that ordinarily sold on account, would be suspect. Notes payable - trade, in such a case, would indicate that the purchaser had to give a note in settlement of, or as a promise, to pay a past due account. Ordinarily the prospective investor should be suspicious of large notes payable to banks which might indicate that the business is not able to supply its own working capital. We should look beyond the figures, however and realize that some lines of business such as cigarette manufacturers and distillers finance large inventories with notes payable to banks. The investor would like to have this separation of the notes payable and he would certainly want to know if any notes were payable to officers of the company. If notes payable are shown on the Statement of Financial Position as one figure, an odd amount of dollars, rather than round figures, might indicate that the notes are not exclusively payable to banks.

In connection with the cash account, we considered the importance of paying trade accounts payable promptly in order to obtain all cash discounts allowed. Indeed, we found it is so important that it pays a business to borrow money, if necessary, to follow this policy. Let us assume that the R. J. Reynolds Tobacco Company purchases \$240,000,000 worth of goods and services during a year and that they receive

a 1% cash discount on those purchases. Discount for the year would amount to 1% of \$240,000,000 or \$2,400,000.

Suppose further, that these purchases for advertising, sales promotion, cigarette distribution, for leaf, flavorings, cigarette wrapping and shipping materials, machinery and machine parts and thousands of other operating and factory supply items are purchased at a rate of \$20,000,000 per month. If, somehow, it became necessary for the company to borrow \$20,000,000 every month at 6% interest, the interest would amount to \$1,200,000 (6% per annum = $\frac{1}{2}\%$ per month times \$240,000,000). The savings resulting from taking cash discounts in this instance would be \$1,200,000.

Many statements of financial position contain an amount described as accrued liabilities, accrued expenses or sundry accruals. Sundry accruals can be a varied mixture of liabilities. It has been noted that assets rarely ever bring their stated book values in liquidation. On the other hand, the conservative business attempts to accrue real and potential liabilities even though payment may not be due on the statement date. For example, if the date of the Statement of Financial Position falls on a Wednesday and the company had paid its employees for work through the previous Friday, wages and salaries should be accrued from Saturday through Wednesday. Many companies rent property or equipment on a long term basis. At the statement date, six month rental expense may have accrued although the actual payment of the rent may not be due for another six months.

Some tobacco companies store thousands of hogsheads of tobacco in public storage warehouses. At the end of every accounting period, those companies multiply the storage rate by the number of hogsheads on storage to determine what their accrued storage liability should be at the statement date. When accrued rent or rent payable is credited in the accounts, rent expense is debited. These entries are made in an effort to charge expenses to the proper accounting period, and to reflect net profit more accurately and evenly.

We have considered current assets first and then current liabilities because of the importance of the relationship between these two groups of accounts in the Statement of Financial Position. By deducting the sum total of the current liabilities from the sum total of the current assets we arrive at a dollar difference known as working capital. Working capital is something that business management is constantly concerned with, and the investor is not so interested in the dollar amount of the working capital as he is in the proportion of working capital to current assets and current liabilities. Companies X and Y below, illustrate this principle:

	<u>Company X</u>	<u>Company Y</u>
Current Assets	\$600,000	\$3,000,000
Current Liabilities	300,000	2,700,000
Working Capital	300,000	300,000

Notice that both companies have \$300,00 working capital. In the case of Company X, current assets could shrink 50% and

still current liabilities could be paid. A 50% shrinkage in Company Y's current assets would leave current assets of \$1,500,000 and current liabilities of \$2,700,000. When viewing the current section of the Statement of Financial Position, the working capital represents the equity of the owners in the current assets when there is no long term debt. The dollar amount of working capital has little significance, but is important only in its relationship to other items or groups of items. We shall study these relationships when we analyze two actual financial statements in a subsequent chapter.

CHAPTER III

The Statement of Financial Position (Concluded)

Now we come to the fixed sections of the Statement of Financial Position. In the account form of the Statement of Financial Position, we find a group of assets on the left side just below the current assets, which are usually referred to as fixed assets. These assets include real property and equipment used in the business. They are called fixed assets because they are of a permanent nature and are not intended for sale so long as they serve the needs of the business.¹ In other words, fixed assets are not normally converted into cash as current assets are. They are necessary to facilitate the conversion that takes place in the current assets. Adam Smith defined fixed assets just as clearly as he did current assets.

Some part of the capital of every master artificer or manufacturer must be fixed in the instruments of his trade. This part, however, is very small in some and very great in others. A master tailor requires no other instruments of trade but a parcel of needles. Those of the master shoemaker a little, though but a very little, more expensive. Those of the weaver rise a good deal above those of the shoemaker....in other words, a much greater fixed capital is required. In a great ironworks, for example, the furnace for melting the ore

1. Howard S. Noble, Accounting Principles, p. 25.

the forge, the slit mill, are instruments of trade which cannot be erected without a very great expense.²

This foregoing description of fixed assets, written in the seventeenth century, indicates how important these assets are. They are so important to public utilities, for example, that they show fixed assets ahead of current assets in the Statement of Financial Position.

Fixed assets are shown on the Statement of Financial Position at cost which is the amount paid or expended for the assets. From this cost is deducted the accumulated depreciation on these assets which wear out. From an accounting standpoint, improved land does not wear out, but all other fixed assets are gradually used up or worn out in the operation of the business. There can be many fixed asset accounts making up one total on the Statement of Financial Position. Many manufacturers own the land on which their factories are located. They have land, possibly land improvements (which do depreciate), railroad sidings, buildings, building equipment, autos and hauling equipment, office equipment and machinery. Some factories maintain company cafeterias and hospitals for employees and have separate fixed asset accounts for cafeteria equipment and hospital equipment.

Businesses which rent facilities on long term leases often improve these facilities and capitalize the cost as a fixed asset called leasehold improvements. The cost of

2. Adam Smith, An Inquiry Into The Nature and Causes of The Wealth of Nations, p. 263.

such improvements would be charged as an expense of the business, over the remaining life of the lease. To illustrate, let us assume that a business had a ten year lease on its office space. When the lease was five years old, the company made improvements in the property costing \$100,000. This \$100,000 would be amortized over the remaining five year life of the lease at a rate of \$20,000 per year.

Other fixed assets are often accounted for in the same manner. However, many problems arise in connection with accounting for fixed assets, such as buildings and machinery. Possibly, the greatest problem is that of determining whether a particular alteration or improvement of an existing fixed asset should be capitalized or not. "The general rule is that such expenditures are properly chargeable to the fixed asset accounts if they enhance the intrinsic value of the property; otherwise the expenditure should be charged against current income. The rule is easy to state, but difficult to apply, especially when the disposition of the expenditure may be influenced by income tax considerations."³ Of course, if an expenditure were charged against current income in the period of the expenditure, net income subject to income taxes would thereby be reduced. On the other hand, if an expenditure were capitalized as a fixed asset, only the depreciation for the accounting period would be charged against current income.

3. R. G. Rankin, What's Behind A Financial Statement, p. 96.

How much of the cost of a fixed asset should be charged against current income? This is another problem in accounting for machinery and equipment. These charges may be called depreciation, obsolescence, depletion or amortization.

Depreciation applies to the ordinary wearing out of buildings and equipment. Obsolescence refers to an extra-rapid loss of value due to technological and similar changes. Depletion applies to the gradual removal of universal and timber resources by turning them into products for sale....Amortization is a general term applied to all deductions of the depreciation type, but it also connotes special kinds of charge offs, e.g. "accelerated amortization" of defense facilities.⁴

Determining the amount of these charges is a problem because it is difficult to be precise about the useful life of a machine. Frequently engineers take one view, production men another, accountants another and the Internal Revenue Service, still another view. The Internal Revenue Service has published a bulletin called Bulletin F which suggests acceptable useful lives for many types of equipment. This bulletin serves as a guide to many industries.

Most businesses use the straight line depreciation method. This means that the periodic depreciation charge against income remains the same throughout the life of the equipment. Under this method, if a machine is estimated to have a 15 year life, the original cost of the machine is

4. Benjamin Graham and Charles McGoldrick, The Interpretation of Financial Statements, p. 31.

divided by 180 months to determine the monthly depreciation. The same procedure would be followed with a building with a fifty year estimated life, or with a truck with a four year estimated life. One can see the problems which arise, especially in the minds of industrial engineers when they find that two machines have the same depreciation rate even though one is in operation eight hours a day while the other operates twenty-four hours a day. As a nation of automobile owners, most Americans realize that the depreciation on a new car, as measured by trade-in value, is heaviest in the first two years of ownership.

What does all of this mean? It means that when an investor looks at a Statement of Financial Position, he cannot assume that the stated net value (gross value less reserve for depreciation) of the real estate and equipment is worth the exact amount of dollars so stated: certainly not from everyone's viewpoint. Furthermore, if the fixed assets are misstated from anyone's viewpoint, then the net profit shown on the Statement of Earnings is misstated from someone's viewpoint. This does not mean that the Statement of Financial Position and the Statement of Earnings have no value for the investor. On the contrary, when the figures are understood, they can tell a revealing story. Accountants generally are conservative people. The Statement of Financial Position and the Statement of Earnings present a conservative picture of a business. Accountants are inclined to overstate liabilities

and understate assets, where estimates are involved in the Statement of Financial Position. They are inclined to overstate expenses and understate income where estimates are involved in the Statement of Earnings. Where differences of opinion are involved, I believe that most errors in estimation would be in the direction of conservatism, especially on statements which are audited by independent public accountants.

There are some people who would not agree that the Balance Sheet should be called a "Statement of Financial Position." These people apparently feel that this statement does not indicate the financial position of the business because the asset values (stated at cost in most cases according to generally accepted accounting practices) do not conform to their viewpoint. We must remember that different groups of people have different viewpoints. Indeed, there are differences within groups. The accountants want a conservative statement of assets, liabilities and profit and most company managers agree with this position, even though they might like to make a good profit showing. Perhaps some investors would want the assets to be valued at their "fair market value" rather than cost so that the book value of the common stock would be a more accurate measure of market value of the stock. Mr. Roy A. Foulke, a Vice President of Dun and Bradstreet and author of the authoritative book, Practical Financial Statement Analysis, takes the position

that balance sheets should be based on "current economic values."⁵ Presumably, by current economic values he means fair market values. He cites an example of a piece of land, a building or a plant that cost \$100,000 ten years ago, and may have a "current economic value" of only \$25,000 due to a depression, purchase at an inflated price or change in the neighborhood. He says that this same asset could have a net value (cost less depreciation) on the Statement of Financial Position of \$80,000. This is an unlikely situation. It seems more likely to me, considering the rise in prices since World War II, that the property might have a "current economic value" of approximately \$104,000.⁶ Mr. Foulke completely ignores this possibility.

I believe that there are many valid reasons why balance sheets should not reflect "current economic values." Some of these reasons follow:

1. "Current economic values" was defined above as fair market value, but what is fair market value? "Fair market value has been defined as the price which would

5. Roy A. Foulke, Practical Financial Statement Analysis, pp. 85-86.

6. National Industrial Conference Board, Incorporated, "Consumer Prices", Chartbook of Current Business Trends, (1961 Edition, Revised; New York, 1961), p. 5. From 1950 to 1960, the Bureau of Labor Statistics Consumer Price Index rose from 102.8 to 126.5. 124% of \$100,000 - \$20,000 = \$104,000.

probably be agreed upon by a seller willing, but under no compulsion to sell, and a buyer willing, but under no compulsion to buy, where both have reasonable knowledge of the facts.

The definition has been criticized on the ground that the term 'market' presupposes actual competition."⁷ Notice the word probably in the definition.

Note also that the authors state that the definition has been criticized.

But let us make the very unlikely assumption that those individuals who would be responsible for valuing corporate assets could agree on a definition of "current economic value" or a basis for valuation. Even in such a case, I believe we would find situations similar to the case of the homeowner, who tells the tax assessor his home is worth X dollars and tells a prospective buyer his home is worth Y dollars. Rudolph Walter Schattke, in his dissertation, The Implications of Economic Concepts of Income and Profit for Accounting wrote, "one cannot find

7. Prentice-Hall, 1951 Federal Tax Course, p. 1506.

any single authoritative and comprehensive economic concept; nor is there any single source of pertinent economic concepts"⁸ (of income and profit).

Surely, it seems to me, there would be almost as many concepts of "current economic values" as there would be appraisers.

2. Some writers have suggested that the "economic value" concept for Statements of Financial Position is so important that all business assets, and especially fixed assets, should be appraised every year. If we assume that competent appraisers could arrive at fairly uniform values for identical assets, such a procedure would be a practical absurdity. The scope of the job and the cost to the business enterprises would make this procedure prohibitive.
3. Some credit men are really thinking of liquidating value when they say "current economic value." They want to be sure that their loan is protected if the

8. Rudolph Walter Schattke, The Implications of Economic Concepts of Income and Profit For Accounting, "Abstracts of Dissertations in Accounting," The Accounting Review, Volume XXV, Number 4, October 1960, p. 698.

business is liquidated and the assets are sold to meet outstanding liabilities. When a business is forced into bankruptcy, the sale of the assets can be in the nature of a distress sale. Whether this be the case or not, investors should remember that an asset always has more value when it is being used by a going concern, than it has as an item available for sale. For example, a cigarette making machine may be twenty years old, and fully depreciated on the manufacturer's books and still have considerable value, if the machine is in use.

4. Finally, if we followed Mr. Foulke's suggestion, we would begin to return to the days of watered stock, in my opinion. Watered stock is a term that has been applied to common stock which has been inflated in value, by fictitiously increasing the value of assets. The term watered stock was first applied to the cattle which were brought into Chicago in the days of "Commodore" Vanderbilt, full of water after having been fed salt to make them thirsty. Suppose that manufacturers' inventories could be

valued at market values. Then it would be possible for the manufacturer to produce goods at cost, value them at market, and show a book profit without selling \$1 worth of goods. The "generally accepted accounting principle" of valuing most assets at cost is not perfect. However, the cost concept is exceedingly more precise than "current economic value."

The final group of items on the asset side of the Statement of Financial Position is frequently called, "Other Assets" since it consists of neither current nor fixed assets.

This group of assets may include investments in and advances to subsidiaries (companies over which the parent company has control), brands, trademarks and goodwill, prepaid expenses and sundry receivables. Frequently, published Statements of Financial Position tell the investor very little about the nature of these assets. Fortunately, the total amount of these assets is usually a small percentage of the total assets of the company.⁹

There is a tendency toward diversification by large business enterprises today and this tendency has been responsible for the merger of a number of companies. Very

9. In registration statements to the Securities and Exchange Commission, registrants are required to state separately investments or other assets in excess of ten percent of the amount of all assets other than fixed and intangible.

often these mergers are affected by an exchange of stock, with the larger company ending up with over 50% of the smaller company's voting stock. The smaller company then becomes a subsidiary of the parent company. Sometimes the subsidiary company accounts are consolidated with the parent company's at the time the financial statements are prepared. The cash accounts are combined, the inventories and fixed assets and all other accounts are combined. Inter-company items such as an advance from the parent company to the subsidiary company would be eliminated from the totals. The result would be a consolidated Statement of Financial Position for the parent company and its consolidated subsidiaries, as if they were a single corporate entity. Some companies do not consolidate foreign subsidiaries into their financial statements. Instead, they show in their own Statement of Financial Position an investment in non-consolidated foreign subsidiaries.

"Investments" can be a mysterious item in the Statement of Financial Position. It should not be passed over lightly by the prospective investor. Many questions should arise in the investor's mind. Is the investment carried at cost? The statement should give the answer. Is the investment in stock or bonds which have a market value? If so, the statement should give the market value parenthetically or in a footnote. Does the investment have anything to do with the conduct of the main enterprise? In short, the prospective investor should find out all he can

about the item of investments. He should be especially interested in investments in subsidiaries, finding out who the subsidiaries are and what their financial condition is. The old adage, "A chain is as strong as its weakest link" might well be applied to subsidiaries.

Brands, trademarks, copyrights, formulas, franchises, patents and good will are called intangible assets. There may be pieces of paper or legal documents which substantiate the presence of trademarks, copyrights, formulas, franchises and patents, but it is almost impossible to determine the real worth of these assets. Good will is even more illusive. It is entirely proper to include these items in the Statement of Financial Position as assets, if they have been bought. For example, cash is spent in perfecting and recording a patent, or in obtaining a copyright or in purchasing a franchise. Company "X" may purchase Company "Y", paying an amount in excess of the book value of the "Y" company stock. This excess payment would presumably be good will of the "Y" company, which would become an asset of Company "X". However, all intangible assets should be amortized over a period of years. Patents have a seventeen year life. Copyrights have a twenty-eight year life. Some intangible assets, such as patents and trademarks can have very real value even when a business is liquidated. Other intangible assets, such as good will have little or no value in liquidation. The real measure of the value of intangible assets is shown by the ability of a company to earn a profit year after year.

Good accounting practice does not permit a business to place arbitrary values on assets, especially intangible ones. As stated previously, the assets have no value as far as the accounts are concerned unless they have been bought for a price. In 1959 four cigarette manufacturers who spent great sums of money to advertise their brands showed brands, trademarks, patents and good will in their Balance Sheets as follows:¹⁰

R. J. Reynolds Tobacco Company	\$1
The American Tobacco Company	\$1
P. Lorillard Company & Subsidiary Companies	\$1
Philip Morris (Less Amortization)	\$1,898,659.

Many large industries value their intangible assets at the nominal amount of \$1. This demonstrates the conservatism which is characteristic of accountants.

As part of the Other Assets classification of the Statement of Financial Position, we also find Prepaid Expenses and Sundry Receivables. Prepaid expenses fall into two categories. There are prepaid expenses which may have some value in liquidation and there are others (also called deferred charges to expense) for which no possibility of cash recovery exists. In the first group we find prepaid

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10. R. J. Reynolds Tobacco Company, 1960 Annual Report, p. 16.
The American Tobacco Company, 1959 Annual Report, p. 16.
P. Lorillard Company, Incorporated, 1959 Annual Report.
Philip Morris, Incorporated, 1960 Annual Report, p. 14.

insurance. Fire insurance premiums are paid in advance and usually cover a three to five year period. This expense is chargeable over the protection period on a pro rata basis. If the company cancelled the policy at the end of eighteen months, some cash refund would be received. In the second group we find items such as bond discount, organization expense, and development expense. Setting up these expenses as assets is an accounting method by which the expense may be properly charged over a period of years.

The term "sundry" is indefinite to say the least. Webster defines sundry as "several; divers; more than one or two; various."¹¹ Fortunately, the dollar amount of items such as Sundry Receivables, is usually small in relation to the total assets of a business. If sundry receivables were large, the intelligent investor would insist on a more detailed explanation. Are the receivables due from officers of the company? Are amounts due from employees? How long have the receivables been outstanding? Do they represent legitimate collectible items?

We have considered all of the main asset classifications on the Statement of Financial Position. We considered current assets and current liabilities. A good part of this chapter has been devoted to a discussion of fixed assets, the "tools" which facilitate the revolving of the current

11. Webster's New International Dictionary of the English Language, W. T. Harris, Editor in Chief; F. Sturges Allen, General Editor, (The Merriam Series; Springfield, Massachusetts: G. & C Merriam Company, 1928), p. 2080.

assets and current liabilities. Other Assets were discussed. Now we come to the sections of the Statement of Financial Position which represent the relatively fixed capital of the business.

Capital in the economic sense is the value of producer's goods as opposed to consumer goods and is the result of saving.¹² In the accounting field, the term "capital" is applied to those sections of the Statement of Financial Position which represent sources of funds, for the purchase or production of assets. There are two natural divisions of corporate capital which indicate the source of the capital. Those divisions are borrowed capital and ownership capital. Let us consider borrowed capital first.

Usually, borrowed capital is called "long term debt" or Funded Debt or Fixed Liabilities on the Statement of Financial Position. One type of long term debt is promissory notes. It is unusual for a large corporation to have a substantial amount of its long term debt in the form of promissory notes. "A promissory note is a written promise to pay a certain sum in money at a definite time to the order of a specified person or to the bearer."¹³ Ordinarily, notes payable to banks or notes given for purchased merchandise would be of short duration. The

12. Ralph Eastman Badger and Harry G. Guthmann, Investment Principles and Practices, p. 16.

13. Howard S. Noble, Accounting Principles, p. 24.

prospective investor, let us re-emphasize, should be suspicious of large current notes payable, which might indicate an inability of the business to meet its current obligations promptly or to generate its own working capital. However, in the cigarette manufacturing business, it is customary to borrow large sums from banks in order to finance leaf purchases and carry leaf inventories for about three years.

There is something to be said for borrowing money rather than issuing stock. In this period of high corporate and individual taxes on income, it is good business to borrow money rather than use one's capital, provided the borrower can make more profit with the borrowed money than the interest charges. Interest, of course, is a deductible business or individual taxpayer expense, but dividends are not.

This principle is called "trading on the equity." Here is how it works. Suppose that the owners of a corporation are convinced that their business can earn 20% per annum before taxes on all capital invested. The present capital is \$2,000,000 in common stock. The question facing the officers and owners of the corporation is whether to issue new stock, or to borrow the money at 6% interest. The following examples show the results of each course of action.

EXAMPLE 1.

Present Capital - Common Stock	\$2,000,000
New Issue - Common Stock	<u>3,000,000</u>
Total Capital	<u>\$5,000,000</u>
Assumed 20% Return on Invested Capital	\$1,000,000
Assumed 50% Income Tax Rate	<u>500,000</u>
Available for Common Stock	\$ 500,000
Rate of Return on Common Stock	10%

EXAMPLE 2.

Present Capital - Common Stock	\$2,000,000
New Capital - 6% Long Term Promissory Notes	<u>3,000,000</u>
Total Capital	<u>\$5,000,000</u>
Assumed 20% Return on Invested Capital	\$1,000,000
Less 6% Interest on Notes	<u>180,000</u>
Net Profit Before Taxes	\$ 820,000
Assumed 50% Income Tax Rate	<u>410,000</u>
Available for Common Stock	\$ 410,000
Rate of Return on Common Stock	20.5%

Let us assume that earnings dropped to 2% on invested capital. In this case, the \$100,000 earnings on invested capital would not be sufficient to pay the interest on the promissory notes shown in Example 2. These examples illustrate the potential for increased earnings per share for the common stockholder when "trading on the equity" is successful, and the possibility of no return at all to the common stockholder, in lean years. The examples also

demonstrate the greater risk which stock ownership involves. Interest payments must be made to avoid bankruptcy, but money is available for common stock only when a profit is made. The stockholder takes a greater risk than the creditor, but reserves the right to receive all of the profits after paying interest charges on the borrowed capital. The principle of "trading on the equity" applies to all long term debt, and to preferred stock to some extent.

A second type of borrowed capital is the bond. Here we encounter an instrument in which an individual can invest. Therefore, it is of prime concern to the prospective investor. A bond, like a promissory note, is a written promise to pay a definite sum of money at a definite time. However, the bond contract can contain many provisions other than the principle amount of the bond and the date of its payment. It is difficult to classify bonds by type, since the bond contracts vary so much. Certain characteristics of a particular bond are easily distinguished by reading the bond contract. The first question that the prospective investor should ask is, "Are the bonds secured or unsecured?" In other words, is the promise to pay backed up by a mortgage on certain assets of the company, or is payment merely guaranteed by the character and earning power of the borrowing company? If the bonds are secured, what is the security? Are definite tangible fixed assets pledged as security for the

bond? Do the bondholders have a first mortgage on the assets whereby they can acquire title to the property in the event of a default?

Unsecured bonds are frequently called "debentures." Unsecured bonds are issued under an indenture or bond contract just as secured bonds are. The main difference between the two types of indentures is that the unsecured bond indenture does not contain the "mortgage deed" which is present in the secured bond indenture. Debenture bonds, of course, do not have as high a claim on the assets of the corporation as secured bonds. Since the debenture bonds depend on the general credit of the borrower for their security, more risk is involved in their ownership than in secured bonds. This is one reason why debenture bond indentures often contain special features.

The most important special feature which may be written into secured or unsecured bond contracts is the conversion privilege. This privilege gives the bondholder the possibility of participating in the increased earnings of a company and it also provides a hedge against increases in the price level. Since bonds call for the payment of a fixed rate of interest, their value does not increase greatly to reflect increases in the consumer price index or a decline in the purchasing power of the dollar. Stock prices do. Convertible bonds ordinarily permit conversion into common stock of the company. The value of the conversion privilege, and whether the privilege should be

exercised, depends on relative merits of the two securities involved. Some of the considerations are:

1. Is the conversion privilege offered to stimulate the sale of an otherwise mediocre security?
2. Are dividends, or the chance of capital appreciation through common stock sufficiently greater than the interest on the bonds, to compensate for the greater risk which is inherent in stock ownership?
3. Can the stock be acquired more cheaply by conversion, than by sale of the bond, and purchase of the stock on the open market?

Sometimes bonds are classified according to the purpose for which they are issued. "Refunding" bonds are issued to pay off existing bonds, about to become due. "Construction" bonds are issued to provide for construction of new property. Often government bonds of the "construction" bond type have specific names such as "Water Bonds" and "Sewer Bonds."

Finally, bonds may be classified according to the issuer. We are frequently enjoined to buy Federal government bonds. All types of governments issue bonds; state, municipal, county and foreign governments. There are railroad bonds, industrial bonds, and public utility bonds. This

latter method of bond classification is the one followed by Moody's Investors Service. This enables the prospective investor to "look up" a bond in Moody's Manuals, simply by knowing the name and line of business of the bond issuer. Moody's not only rates thousands of bonds as to quality and risk, but gives the important features of both stocks and bonds. Let us repeat that one company's bond contract differs from every other. This is one more reason why the shrewd investor gets all of the facts before he invests.

While bonds are evidences of debt, capital stock is evidence of corporate ownership. The holder of capital stock in a corporation actually owns a fractional interest in the equity of the corporation. The development of corporation finance in the United States, however, has resulted in the issuance of some corporate securities which might be called hybrids. These securities are not strictly contractual evidences of debt, nor do they have the features normally found in common stocks. Income bonds, for example, are contractual as far as the principle amount of the bond is concerned, but the interest payment is generally contingent on the earnings of the corporation.

Preferred stocks, on the other hand, are not normally a clear evidence of proportional ownership in a corporation. Usually, the right of the preferred stockholder to participate in the earnings of the corporation is restricted. Very often the preferred dividend when it is declared payable by the company board of directors, is

limited to a certain percentage of the par value of the preferred stock. Philip Morris Inc., for example, has cumulative preferred stocks with a par value of \$100. At December 31, 1960 this company had authorized preferred stock of 169,862 shares of 4% Series and 117,540 shares of 3.90% Series. During 1960, \$4 per share was paid on the 4% Series preferred stock outstanding and \$3.90 was paid on the 3.90% Series preferred stock.¹⁴ Furthermore, the right to vote at stockholders meetings, and thereby participate in the management of the corporation is usually denied the preferred stockholders. Preferred stocks, unlike bonds, do not require the corporation to pay a definite sum of money at a definite time. Dividends do not become an obligation of a corporation until they have been declared payable by the corporation's board of directors. The equity of the preferred stockholders in the assets of the corporation is normally limited to the stated value of the preferred stock. In other words, the retained earnings of the corporation does not represent a part of the preferred stock equity. Preferred stock does have a claim on the earnings and assets of the corporation, prior to that of the common stock. Preferred stock is "preferred" as to dividends and assets in the event of liquidation. Consequently, preferred stock ownership generally involves more risk than bond ownership, but less than common stock ownership.

14. Philip Morris, Incorporated, 1960 Annual Report, pp. 16-17.

There are almost as many types of preferred stocks as there are bonds. Two outstanding types should be considered.

Preferred stocks are either participating preferred stocks or they are non-participating. They are either cumulative preferred stocks or they are non-cumulative. They can be cumulative and participating. A participating preferred stock is one which has the right to participate with the common stock in the earnings of a corporation, usually after a certain rate has been paid on the common stock.

The non-cumulative preferred stock of a particular company is entitled to a dividend, before a dividend can be paid on the common stock. This is one of the basic features of preferred stocks. In a particular year, however, if dividends are not declared on a non-cumulative preferred stock, they are lost forever. When an issue is called "cumulative" preferred stock, the meaning is that dividends which might be paid, but which are not paid shall be carried over from year to year, and eventually the accumulated total dividends must be paid before dividends can be paid on the common stock.¹⁵ One of the classic examples of a cumulative participating preferred stock is the Virginia-Carolina Chemical Company's 6% preferred. This stock has a par value of \$100 and therefore,

15. Ralph Eastman Badger and Harry G. Guthmann, Investment Principles and Practices, p. 216.

the holders are entitled to a dividend of \$6 per share every year before any dividends can be paid to the common stockholders. After the common stock receives \$3 per share, the preferred stock participates in the earnings with the common stock. The bad feature of this 6% cumulative participating preferred stock is that as of June 30, 1961, dividend arrears (back payments due before any payment can be made to common stockholders) amounted to \$90 a share.¹⁶

A cumulative participating preferred stock would seem to combine certain desirable features of both preferred and common stocks. It would appear that a cumulative, participating preferred stock would be most attractive to investors. Such a stock would not be an attractive method of financing for most sound companies. Generally speaking, the investor should be wary of special inducements in any class of security. Too often special inducements are offered because conditions are unfavorable in the financial markets, when the stock is issued, or because the company has a weak credit rating. Most preferred stocks are non-cumulative and non-participating.

It is not our purpose here to discuss the relative merits of different types of securities. Securities can be found to fit any investment program. The merit of a

16. Standard & Poor's, Standard Corporation Descriptions, T - Z, Oct. - Nov. 1961, (New York: Standard & Poor's Corporation, Publishers, November 30, 1961), Volume XXII, Number 33, Section 2, p. 7976.

particular bond, preferred or common stock, would depend largely on the purpose for which the investment is made, or the goal of the investment program. The prospective investor should know why he is buying a particular security and he should certainly know what he is buying. The corporation's charter or by-laws sets forth the preferred and common stock contracts. The most important features of these contracts are summarized in publications which are found in all good public libraries.

Common stocks are, to me, one of the most exciting investment media. What constitutes an ideal investment? Mr. T. A. Wise, in his series of articles on personal investing in Fortune Magazine answers: "The ideal investment is one offering a high rate of return, a good prospect of capital appreciation, a minimal risk of capital loss and no difficulty about converting back to cash rapidly."¹⁷ As far as stocks listed on the New York Stock Exchange or the American Stock Exchange are concerned, there is certainly no difficulty about converting back to cash rapidly. Since both of these exchanges are market places for the entire nation, almost any 100 share lot can be sold within fifteen minutes from the time the order is placed with the broker. As far as the other requirements of the "ideal investment" are concerned, I am excited by the

17. T. A. Wise, "What To Do With \$1,000,000,000,000." Fortune. (Chicago, Illinois: Time, Incorporated), Volume LXIV, Number 3, September 1961, p. 106.

prospect of finding the best combination of high return, capital appreciation, and a minimum amount of risk to achieve my own particular investment goals. Of course, the most important of these requirements to me might be the least important to you.

It has been stated that common stock represents corporate ownership. Actually, the common stockholder is in a position similar to the average American who owns his home or his car although the bank or finance company has a prior claim on these assets.

Consider the case of a man who is buying a home. When the purchase of the home is first made, the purchaser's equity is limited to the amount of his down payment. The bank or mortgage company has almost the total amount of equity in the home. After ten years of timely payments on the mortgage liability, the homeowner has increased his equity and decreased the equity of the mortgagor. The same thing happens when a corporation reduces its debts or any other claim which is prior to the common stock. The common stockholders have a larger percentage of the value of the assets. If the homeowner decided to rent his home, the entire profit (rent income less expenses including mortgage payment and taxes) would be his. In the same manner common stockholders own all of the profits and losses of a corporation after the satisfaction of all prior claims. A simple Statement of Financial Position will illustrate this principle:

X CORPORATION
STATEMENT OF FINANCIAL POSITION
DECEMBER 31, 19X2

Current Assets	\$ 300,000
Plant and Equipment	<u>700,000</u>
Total Assets	<u>\$1,000,000</u>
Current Liabilities	\$ 100,000
Long Term Debt (4½% First Mortgage Bonds)	300,000
Common Stock (500,000 Shares, Par \$1)	500,000
Retained Earnings	<u>100,000</u>
Total Liabilities & Capital	<u>\$1,000,000</u>

Let us suppose that the owners of X Corporation, pictured in the preceding Statement of Financial Position, decided to liquidate the business. Further assume that the assets are sold for their book values as they appear in the Statement of Financial Position. In such a case all of the corporation debts would be fully covered. The bondholders, with a first mortgage on the plant and equipment, would be paid out of the proceeds of the sale of that equipment. On the other hand, if the sale of the plant and equipment had not satisfied the liability to the bondholders, they would rank ahead of the general creditors in the distribution of the proceeds of liquidation. The general creditors would rank behind the bondholders, except

that if any wages, salaries or taxes are included in current liabilities, these would be paid before general unsecured creditors. Since, however, we have assumed that the assets are sold for their book values, \$600,000 would be left for the common stockholders. Conversely, if the assets had brought only \$400,000, it is apparent that the common stockholders would suffer a total loss.

The X Corporation Statement also illustrates two of the three values frequently assigned to common stock. One of these values is par value, which in the case of X Corporation is \$1 per share. The par value of a share of stock is simply the value which is assigned to the stock in the corporation charter. This value has no relation to the book value or to the market value of the stock. Some common stock has no par value and instead has a stated value assigned by the Board of Directors. If the X Corporation's common stock had a stated value of \$400,000 and \$500,000 had been paid for the 500,000 shares the stockholders' equity would appear as follows:

Common Stock (No Par Value; 500,000 Shares)	\$400,000
Capital Surplus	\$100,000
Retained Earnings	\$100,000

In determining the book value per share of common stock for any corporation, it is always advisable for the analyst or investor to deal with tangible stockholders' equity. This means that from the total stockholders' equity we should deduct the amount of intangible assets, shown on the

Statement of Financial Position. The tangible book value is a measure of the value of the stock, which assumes that the assets are worth their stated values on the Statement of Financial Position, and since some intangible assets cannot be sold, it is best to eliminate all of them. "The book value really measures, therefore, not what the stockholders could get out of their business (its liquidating value) but rather what they have put into the business, including undistributed earnings."¹⁸ The stockholders' equity in X Corporation is made up of \$500,000 representing 500,000 shares of common stock and \$100,000 in retained earnings. Since the X Corporation has no intangible assets, the book value is found by dividing the equity which is applicable to the common stock, by the number of shares outstanding. $\$600,000 \div 500,000 \text{ shares} = \1.20 per share . Neither the par value nor the book value of a stock bear any particular relation to its market value. The market value, of course, is the final measure of a stock's worth. Daily newspapers in all principle cities carry market quotations for stocks listed on national exchanges, such as the New York and American Exchanges.

Common stockholders, as owners of a business, have certain rights. Sometimes a corporation has two issues of common stock known as Class A and Class B stock with only

18. Benjamin Graham and Charles McGoldrick, The Interpretation of Financial Statements, p. 42.

one issue having full voting rights at the annual stockholders meeting. Ordinarily, however, common stockholders have the right:

1. to transfer ownership of shares;¹⁹
2. to receive dividends when earned and declared by the directors in accordance with the terms of his stock;
3. to inspect the corporate books (register of stockholders, not the financial records);
4. to subscribe to new issues of common stock in proportion to stock holdings;
5. to exercise proportionate control through voting power; (In some cases a "class" of the stock outstanding will not have the voting privilege.)
6. to vote on questions affecting the corporation as a whole, such as increases in capitalization, amendments to the charter, etc.;
7. to share in the proceeds of dissolution after bonds and preferred stock, specifically given priority as to assets, have been redeemed.

19. Birl E. Schultz, The Securities Market and How It Works, p. 44.

One other term that the investor may encounter in the Statement of Financial Position, in connection with stock, is the term "Treasury Stock." Treasury stock can refer to either common or preferred stock. Treasury stock is merely a company's own fully paid issued stock which it has reacquired. When a company purchases its own stock, the par or stated value of the stock should be deducted on the Statement of Financial Position from the total amount outstanding. The difference between the purchase price and the par value should be reflected in capital surplus.

Capital surplus usually arises from the sale of stock at an amount in excess of its par or stated value. This source of capital surplus was demonstrated in connection with X Corporation previously. Capital surplus can be donated to the corporation or it can arise as the result of the purchase by the corporation of one of its own obligations at a discount.

Surplus, especially as it is applied to earned surplus, is perhaps the most widely misunderstood accounting term to be found on the Statement of Financial Position. "We all know that there have been cases before our courts where a decision has been based upon a clear misunderstanding by the presiding judge of the significance of financial reports. The word 'surplus' has most often

been involved...."²⁰ Most of the confusion among laymen seems to stem from a tendency to think of surplus as cash. Surplus, in the accounting sense, is not cash. The only cash on a Statement of Financial Position are the items which are described as "Cash on Hand", "Cash in Bank" or simply "Cash." Accountants cannot agree what type of entries should be made in the earned surplus account. It has been stated previously that economists cannot agree on a concept of income. It is certainly no wonder that accountants and economists cannot agree on this matter. Webster offers two definitions of surplus:

1. That which remains over and above what has been used or is required.
2. LAW. - Assets in excess of liabilities.
The residue of an estate after all debts and legacies are paid.

Very little else, of a general nature, can be said about earned surplus because of the difference in views as to what constitutes a proper debit or credit to the earned surplus account. Most accountants would agree, however, that earned surplus, according to "generally accepted accounting standards", represents the residue or the excess over what has been used. This means that the earned surplus at the end of the year reflects all of the charges

20. Frank A. Singer, "Needed: A Glossary to Accompany Audit Reports", The Accounting Review. Volume XXXV, Number 1, January, 1960, p. 90.

that have been made against income and all of the entries that have been made directly to earned surplus since the business began. So much confusion has resulted from the term "earned surplus", that there is a trend toward calling this item "retained earnings" or something other than earned surplus.

CHAPTER IV

THE STATEMENT OF EARNINGS

The statement variously known as the "Statement of Earnings," the "Income Statement" or the "Profit and Loss Statement" is the link between two successive Statements of Financial Position. Actually, the Statement of Earnings explains in detail that part of the net change in the earned surplus between two statement dates which resulted from operations. Statements of Earnings vary as to detail but they all are designed to present the same story:

1. How much the company took in through operations during the period;
2. How much expense the company incurred during the period;
3. How much net profit remained after meeting these expenses.

Many of the descriptions of amounts appearing on corporate Statements of Earnings are familiar to laymen. Nearly all items are self-explanatory as far as the meaning is concerned. A manufacturer or a merchant has sales; a railroad or utility has operating revenue; a lawyer has fees. Whether income from operations is called sales or fees, it is still income.

The Statement of Financial Position was compared to a snapshot of a business, since it shows the assets,

liabilities and owner's equity as of the close of business on a given date. If we continue with this type of comparison, the Statement of Earnings would be compared to a moving picture which shows the results of the operations of a business between two successive snapshots. The Statement of Financial Position indicates the quantity of the assets, liabilities and owner's equity. The Statement of Earnings tells something of their quality. All businesses, if they are profitable, are more valuable as a going concern than they are as a group of assets on a particular day. Indeed, the real measure of the value of an asset is its ability to produce a profit. Moreover, the profits or the anticipated profits of a business affect the supply and demand for the company's common stock (and therefore, the stock's market price) as much as any other factor.

Let us see how the Statement of Earnings provides the link between two successive balance sheets. The American Tobacco Company gives the full story in one Statement of Income and Retained Earnings although many companies use a separate statement for retained earnings.

EXHIBIT D 1

THE AMERICAN TOBACCO COMPANY
CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

FOR YEARS ENDED DECEMBER 31

	<u>1959</u>	<u>1958</u>
Net Sales	\$1,161,376,858	\$1,105,176,334
Cost of Sales, Selling, General and Administrative Expenses	1,019,129,251	971,131,896
Operating Profit	\$ 142,247,607	\$ 134,044,438
Other Income	511,415	479,879
	<u>\$ 142,759,022</u>	<u>\$ 134,524,317</u>
Interest and Related Charges	\$ 5,906,001	\$ 8,005,598
Other Deductions from Income	781,751	1,524,477
Total Deductions	<u>\$ 6,687,752</u>	<u>\$ 9,530,075</u>
Income, Before Taxes on Income	\$ 136,071,270	\$ 124,994,242
Federal and Other Taxes on Income	72,823,000	66,138,000
Net Income	<u>\$ 63,248,270</u>	<u>\$ 58,856,242</u>
Retained Earnings, beginning of year (Includes December 31, 1957, Retained Earnings of a previously unconsolidated subsidiary)	<u>227,389,707</u>	<u>204,263,061</u>
	<u>\$ 290,637,977</u>	<u>\$ 263,119,303</u>
Cash Dividends:		
Common Stock, \$5 per Share	\$ 32,562,610	\$ 32,562,610
Preferred Stock, \$6 per Share	3,166,986	3,166,986
Total Dividends	<u>\$ 35,729,596</u>	<u>\$ 35,729,596</u>
Retained Earnings, end of year (Note 2)	<u><u>\$ 254,908,381</u></u>	<u><u>\$ 227,389,707</u></u>

1. The American Tobacco Company, 1959 Annual Report, p. 15.

Two notes were presented to this financial statement. The following note was printed on the statement itself:

Depreciation provided and charged to costs and expenses amounted to \$5,215,154 in 1959 and \$4,849,930 in 1958.

Note 2, accompanying the financial statements, and an important source of information about the statements made reference to the retained earnings at the end of the year as follows:

Under the provisions of the indenture relating to the twenty year 3% Debentures, due January 1, 1968, cash dividends declared on common stock and payments made in purchasing shares of any class of the Company's stock subsequent to December 31, 1947, may not exceed the aggregate of \$15,000,000 and consolidated net income earned subsequent to December 31, 1947, less dividends paid on preferred stock. At December 31, 1959 approximately \$220,600,000 of retained earnings was free of this restriction.

Several things might be noted about the American Tobacco Company Statements. The first of these is that the statements are consolidated statements. Note 1, accompanying the statements, tell us that they include all wholly-owned subsidiaries and that adjustments were made in the 1958 statements to reflect the acquisition of The Golden Belt Manufacturing Company in January 1959. Generally, this means that the income and expenses of all wholly-owned subsidiaries have been included in the consolidated statements of income and retained earnings. Secondly, we note that the statements cover a period of time rather than a condition on a particular date.

The first figures on the Consolidated Statement of Income and Retained Earnings are described as "net sales." Most companies, in their annual report to stockholders, combine accounts in order to condense the statements, and to keep stockholders and their competition in the dark about such things as advertising expenses. Gross sales would include the total value of all original billings for goods sold during the accounting period. This amount would be decreased by cash discounts and sales returns and allowances to customers, in order to arrive at net sales.

Cost of Sales, Selling and General and Administrative Expenses cover a multitude of expenses. The cost of goods manufactured, which is only a part of the cost of goods sold, for a manufacturer like The American Tobacco Company, includes many different types of expenses. A manufacturer may begin a period with a certain amount of inventory in the process of manufacture. This inventory is in various stages of manufacture. Consequently, the more nearly finished the product becomes, the higher the unit cost becomes. In order to determine the cost of goods manufactured, the manufacturer adds the cost of raw materials put into process to the beginning inventory of goods in process. To these costs, he adds labor and other factory costs which are properly chargeable to the manufactured product. From the total of these costs, he deducts the closing inventory of goods in process, arriving at the cost

of goods manufactured. Cost of goods sold, for the manufacturer, is made up of three elements. These cost elements are materials, labor and overhead. Overhead includes such items as supervision, depreciation, repairs and maintenance, utilities, plant insurance and taxes, operating supplies and cleaning supplies. The trading concern, which does not manufacture its product, deals with purchases and finished products in arriving at its cost of goods sold. Usually, purchases, and freight on purchases are added to the beginning inventory. The ending inventory is deducted to arrive at the cost of goods sold. (See Exhibit C in Chapter II, page 65.)

Generally, selling expenses are those which are closely associated with the sale of a product or service. Selling expenses might include salesmen's salaries and commissions, salesmen's expenses, sales promotion expenses, advertising, marketing and distribution expenses.

Other expenses are incurred in the general conduct of the affairs of the business which are neither direct costs of the product, nor selling expenses. This group of expenses is often called general and administrative expenses. Some of the types of expenses are officers' salaries, office expenses, computer rentals, auditor's fees, donations and bad debts.

Instead of the one item on the American Tobacco Company statement described as "Operating Profit," a more

detailed statement might show three items. When the cost of goods sold is deducted from net sales, the resulting figure is gross profit on sales. A further deduction of the selling expenses gives us the net profit on sales. When general and administrative expenses are subtracted from the net profit on sales, we arrive at the net profit from operations.

Depreciation, as a part of the cost of goods manufactured, is a major expense for many businesses. The American Tobacco Company has included depreciation in the figures described as "Cost of Sales, Selling, General and Administrative Expenses." In Chapter III depreciation was discussed at some length, in connection with fixed assets. However, it should be noted that the depreciation on the Statement of Financial Position is an allowance which serves to reduce the value of the asset. Depreciation expense is the other side of this entry (a debit), and it is included in the Statement of Earnings.

The American Tobacco Company follows the clean surplus theory advocated by the Securities and Exchange Commission.² This means that the only addition to retained earnings is the net income for the year, and the only reductions are the amounts of dividends.

There are two opposing views of Earned Surplus or

2. United States Securities and Exchange Commission, Regulation S-X, Form and Content of Financial Statements, Article 11, p. 67.

Retained Earnings. One is the current operating income concept of surplus and the other is the clean surplus theory. Those who advocate the current operating income concept, feel that the Statement of Earnings should show only income and expense for the current accounting period. Any corrections of Profits for prior years, any tax adjustments for prior years, or any extraordinary charges or credits, would be made to Retained Earnings under this theory.

One reason why most large corporations follow the clean surplus theory, charging extraordinary items against current income, is that it is impossible to perfectly match income with expenses in a particular accounting period. No matter how hard accountants try to accrue all income earned but not received and all expenses incurred, but not billed, the time comes when errors are made.

Finally, we notice that the Retained Earnings appearing on The American Tobacco Company Consolidated Balance Sheets at December 31, 1959 was \$254,908,381, the same figure which appears at the bottom of the Statement of Income and Retained Earnings for that year. Thus, we are told in this statement how much the Company sold, how much cost and expenses were incurred, and how much net income was added to Retained Earnings at the beginning of the year.

At this point, if the writer has been clear in this exposition, the prospective investor should have an

understanding of the nature of almost any item he encounters on a Statement of Financial Position. He should know the purpose and the significance of the Statement of Earnings. How then does the investor determine from these statements whether an investment is good, bad or indifferent?

CHAPTER V

ANALYZING FINANCIAL STATEMENTS FROM THE COMMON STOCKHOLDERS' VIEWPOINT

If someone told you that a certain company, about which you had never heard, had current assets of \$300,000, you would not know, from this fact alone, whether the \$300,000 was good, bad or adequate. If this same friend told you that the company's current liabilities amounted to \$400,000, you would probably think that a company having more in current obligations than in current assets must be near bankruptcy. In making this analysis, you may have used one of the analytical methods to be described in this chapter. Essentially, however, analysis is a matter of comparison. We all have yardsticks or standards in our minds, which are the result of our knowledge and experience and which we use to judge new facts as they are presented to us. If we do not have a suitable yardstick, we try to find one. As far as financial statements are concerned, analysis takes the form of comparison of numbers. This comparison can be internal or external. By internal comparison is meant the comparison of different but related aspects of the same company. External comparison compares one company or group of companies with another company or group of companies.

One of the most effective methods of internal or external comparison of financial statements is by means of ratios, or relationships. When expressing the relationship between two numbers, several methods can be used. We can say that the working capital (current assets minus current liabilities) is X dollars. One amount can be expressed as a percentage of the other amount. We can say that the company has \$1.50 in current assets for every \$1 of current liabilities. Or, we can use a ratio, which expresses the percentage relationship but uses whole numbers and decimal fractions rather than the percentage sign. For example, if current assets amounted to \$450,000 and current liabilities amounted to \$300,000, the current ratio would be 1.5 to 1 ($\$450,000 \div \$300,000 = 1.5$).

Many ratios used in statement analysis have the preposition "to" in the name by which the ratio is called. The current ratio is sometimes referred to as current assets to current liabilities. In the case of these basic ratios, the beginner need only remember that the word "to" means divided by.

The use of a ratio to express a meaningful relationship between two numbers has one distinct advantage over the visual comparison of the two numbers. Suppose that we wanted to compare the R. J. Reynolds Tobacco Company sales of over one billion dollars with their accounts receivable (uncollected sales). The use of the sales to

receivables ratio would reduce two very large dollar amounts to a ratio which could be most significant.

The sales to receivables ratio is calculated by dividing total net sales for the period under review by the trade accounts receivable outstanding at the close of the period. This ratio may be called a qualitative ratio, rather than a quantitative ratio, since it gives the user some idea of the quality of the receivables. The ratio may be carried one step further to give the analyst a good indication of the number of day's sales which the receivables represent. For example, the net sales of the R. J. Reynolds Tobacco Company¹ amounted to \$1,532,757,685 in the calendar year 1961. At December 31, 1961 net accounts receivable from customers amounted to \$52,693,818. \$1,532,757,685 divided by \$52,693,818 equals 29.09. Three hundred and sixty-five days in the year divided by 29.09 equals roughly $12\frac{1}{2}$ days. This final calculation simply tells us that the receivables represent approximately $12\frac{1}{2}$ days sales. The number of days can be no more than an approximation because net sales usually include at least a small amount of cash sales which do not involve accounts receivables. Retail concerns may have a substantial amount of installment sales as well as cash sales. However, regardless of its limitations, when the sales to receivables ratio for a particular company moves downward (or the number

1. R. J. Reynolds Tobacco Company, 1961 Annual Report, p. 18.

of days moves upward) over a preceding period, the analyst has a right to assume that the year end receivables for the latest period are being collected more slowly. The following table shows the relationship between the R. J. Reynolds Company sales and accounts receivable. The ratios, calculated from the Company's Annual Report, are also expressed in number of days.

R. J. REYNOLDS TOBACCO COMPANY²

	<u>Sales to Receivables</u>	<u>Day's Sales</u>
1959	28.90	12.6
1960	27.97	13.0
1961	29.09	12.5

Here we have made an internal comparison of this tobacco products company, comparing related aspects of the business and also comparing several years. External comparison can also be helpful, especially when we do not know whether 12½ days is good, bad or mediocre. The next table compares the year end day's sales represented by the trade accounts receivable for two tobacco products manufacturers.

DAY'S SALES REPRESENTED BY YEAR END RECEIVABLES

	<u>R. J. Reynolds²</u>	<u>American Tobacco Co.³</u>
1959	12.6	16.3
1960	13.0	17.0
1961	12.5	17.2

2. R. J. Reynolds Tobacco Company, 1960 and 1961 Annual Reports.

3. The American Tobacco Company, 1959 and 1961 Annual Reports.

Reference to the two companys' reports reveals that both sell products other than tobacco products. R. J. Reynolds has its Archer Aluminum Division. One of The American Tobacco Company subsidiaries, The Golden Belt Manufacturing Company, "manufactures printed labels, cartons, cloth and cloth bags."⁴ Nevertheless, it is apparent that at the close of the three years mentioned, R. J. Reynolds Tobacco Company Accounts Receivable represented fewer days sales than did those of The American Tobacco Company. In other words, Reynolds is turning this asset into cash, which can be put back to work, faster than The American Tobacco Company.

Another qualitative ratio which is often helpful involves sales and inventory. This ratio is called the sales to inventory ratio and like the sales to receivables ratio, involves the Statement of Earnings and the Statement of Financial Position. I prefer, however, to calculate this ratio using the cost of sales, rather than sales, since sales include an element of profit which presumably the inventory does not include. The relationship between inventory and the cost of sales is obvious. Inventory as it is sold becomes a part of the cost of sales. This ratio can give the prospective investor some indication of the number of month's sales represented by the inventory at the statement date. The analyst should be careful in

4. The American Tobacco Company, 1959 Annual Report, p. 9.

interpreting this ratio. A ratio of 12.00 for example, would indicate a one month supply of inventory. This conclusion assumes that sales are evenly divided throughout the year and this is rarely the case. Furthermore, it is essential that the user of this ratio understand the inventory requirements of the industry. A decline in the cost of sales to inventory ratio might not necessarily mean that the inventory is slower moving. The company may be building up its inventory position in anticipation of increased prices by the supplier or a strike at the plants supplying its inventory. Perhaps they expect to increase their own sales. Furthermore, the analyst should realize that cigarette manufacturers include excise taxes of eight cents per pack in their sales and cost of sales. Any ratio of cost of sales to inventory, expressed in terms of days (by dividing 365 by the ratio), for cigarette manufacturers would be less than half the actual number of day's inventory on hand. Consolidated non-tobacco subsidiaries and the method of inventory valuation would also influence this ratio.

Stockholders have been accused of being interested in only one fact in corporate annual reports. "How much did they earn per share?" If this is the case, it should not be. And yet there is some justification for this attitude. In Chapter IV it was stated that the real measure of the value of an asset is its ability to produce a profit. The same thing might be said of an investment. In Chapter III

the ideal investment was defined as "one offering a high rate of return, a good prospect of capital appreciation, a minimal risk of capital loss, and no difficulty about converting back to cash rapidly."⁵ Whether the individual investor thinks that these considerations are listed in the order of their importance, or not, he certainly is interested in the rate of return that the investment might produce through income and through capital appreciation.

If we assume that all investors are interested in an investment's rate of return, it is logical to analyze a company or group of companies from the standpoint of a company's past ability to earn a profit on the capital which the management has at its disposal.

I believe that any meaningful appraisal of a company must take into consideration certain facts.

1. Businesses exist to make a profit.

Businesses are going concerns. They do not expect to liquidate tomorrow. Therefore, the accountant who prepares the financial statements is not particularly concerned about the market value of assets which do not have a ready market. Likewise, the investor should not be disturbed because fixed assets are shown on the Statement of

5. T. A. Wise, "What To Do With \$1,000,000,000,000." Fortune, Volume LXIV, Number 3, September 1961, p. 106.

Financial Position at cost. After all, the cost of the total assets represents the total amount of capital invested in the company, and the investor is interested in the return on his part of that investment.

2. The investor who is able to understand financial statements can make some tests to indicate the quality of some assets, but the average investor must rely, in the last analysis, on the certified public accountant for the very existence of some assets. The best indication of the quality of the inventory, for example, is the certificate of the certified public accountant which states, "We were present when inventories were taken by the company and checked procedures followed in determining quantities and valuation."⁶ The independent accountant's certificate is the investor's best indication that the assets are accurately and conservatively valued.

6. R. J. Reynolds Tobacco Company, 1961 Annual Report, (Report of Independent Accountants, Ernst & Ernst), p. 19.

3. Thanks to the New York Stock Exchange, and other national exchanges, the Securities and Exchange Commission, the Internal Revenue Service and other governmental regulatory agencies and to trade and accounting associations there is a fair degree of "conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."⁷ This means that the analyst can assume that the net earnings were determined this year in substantially the same manner as they were last year and that assets were valued in the same manner.
4. There is usually a direct conflict between security and a high rate of return. This principle applies to both individual investments and corporate investments. The corporation which operates on a large percentage of borrowed capital may be said to have a speculative rather than a conservative financial plan. And yet, if the management is able to earn more on total invested capital, than the

7. Ibid, p. 19.

interest cost of the borrowed capital, the owners will earn a higher rate of than they would by supplying all of the capital themselves. This is the leverage principle or "trading on the equity."

Let us compare the two largest United States tobacco products manufacturers from the return on investment standpoint. This approach reminds us of the Biblical parable of the talents. It looks upon the management of a company as stewards and the Statement of Financial Position and the Statement of Earnings as reports of their stewardship. Several calculations can be made to determine whether the stewards gained five talents or two talents or whether they hid the talent in the earth.

The first calculation, which gives the investor an idea of the overall efficiency of the management is called return on total capital. This ratio might also be called net profit plus interest expense to total assets. To calculate this ratio, we would add to the final net profit, the interest expense also appearing on the Statement of Earnings and divide the total by the total assets. This ratio recognizes the fact that the capital in the business is supplied by short-term (current) and long-term creditors and by the owners or stockholders. It also recognizes the fact that the interest expense which has been deducted on the Statement of Earnings in arriving at net profit, is a

return on the creditor's investment, and therefore should be included in computing the return on total capital. Some people might take the position that intangible assets should be deducted in determining the return on total capital or the return on common stockholder's equity. On the other hand, it is logical to assume that the intangible assets such as good will and patents will increase the return if they are worth anything. If the intangible assets are not worth their stated value, this ratio should reflect that fact. The return on total capital ratios shown in the following table include \$1 of intangible assets for each of the companies. ⁸

RETURN ON TOTAL CAPITAL

	<u>1961</u>	<u>1960</u>	<u>1959</u>
American Tobacco Co.	8.30	8.11	8.57
R. J. Reynolds	11.76	12.01	11.37

These ratios tell us that in 1961 The American Tobacco Company earned over eight cents for every dollar of assets while R. J. Reynolds earned over eleven cents. The question which arises immediately is, "Why the difference?"

The answer to a change in any ratio from one year to the next, or to a difference between companies lies in the variable factors which influence the ratio. As far as the

8. All of the ratios appearing in this chapter have been calculated from financial statements of The American Tobacco Company, 1959 and 1961 Annual Reports, and R. J. Reynolds Tobacco Company, 1960 and 1961 Annual Reports.

return on total capital is concerned, this means that a change in any one of several factors will change the ratio.

The factors are:

1. The stated net profit on the Statement of Earnings.
2. The amount of interest paid on borrowed capital.
3. The amount of the total assets. The productivity of the assets would influence the net profit and therefore influence the ratio. A change in the distribution of the capital investment among the classes of assets might also affect net profit.

The common stockholder is naturally interested in the return on his investment. The prospective common stockholder should judge the company's performance in this respect for a number of years. How did the company fare during the 1953-54 recession? What is the trend in the return on common stock? The more facts we have, the better decisions we make. Many things affect the rate of return on common stockholder's equity.

One factor affecting the rate of return on the common stockholder's equity is the relative percentage of the total capital which is supplied by the owners and by the creditors. The ratio which measures this relationship is usually called the debt to worth ratio. "Debt", of

course, refers to the total liabilities shown on the Statement of Financial Position. "Worth" refers to the net worth section of the Statement of Financial Position. It is sometimes called "Capital", or "Capital and Surplus" or "Stockholders' equity." If we recall the equation on which the Statement of Financial Position is based: Assets = Liabilities plus Net Worth, we can see that the net worth is the difference between the total assets and the liabilities. Our two tobacco companies have somewhat different capital structures.

DEBT TO WORTH

	<u>1961</u>	<u>1960</u>	<u>1959</u>
American Tobacco Co.	.59	.58	.56
R. J. Reynolds	.78	.77	.76

While the relative percentage of debt has increased in both companies over the years, a much larger percentage of the Reynolds capital is represented by debt. The ratios tell us that on December 31, 1961, The American Tobacco Company showed 59 cents of debt for every dollar of net worth. The R. J. Reynolds Tobacco Company statement showed 78 cents.

A second factor which affects the rate of return on common stockholders' equity and the profitability of "trading on the equity," is the interest expense on borrowed capital. This relationship might be called interest expense to total debt. It is computed by dividing the interest expense on the Statement of Earnings by the total debt on the Statement of Financial Position. Of course, whenever we

compare an amount on the Statement of Earnings with an amount on the Statement of Financial Position, we are dealing with the results of a period of time, and a condition as it existed at the close of business on a particular day. For this reason we could not say that by dividing the interest expense by the total debt at December 31, 19X1, we would arrive at the average interest cost.

Perhaps it seems strange that the interest expense should be divided by the total debt, rather than the debt to which the interest applies. Corporations do not have to pay interest on accrued salaries and wages. Ordinarily they do not have to pay interest on trade accounts payable or accrued taxes. On the other hand, all of these creditors are supplying a part of the capital which is invested in the assets. The interest which was paid during the year applies to certain notes payable and bonded indebtedness during the year. These balances are not readily available to stockholders. However, as long as we are comparing businesses in the same industry, the ratios have significance.

INTEREST EXPENSE TO TOTAL DEBT

	<u>1961</u>	<u>1960</u>	<u>1959</u>
The American Tobacco Co.	1.92%	2.08%	2.03%
R. J. Reynolds Tobacco Co.	1.58%	2.07%	1.80%

Here again, Reynolds seems to do a little better than The American Tobacco Company. The financial review in the R. J. Reynolds Tobacco Company, 1961 Annual Report states,

"Due to smaller average borrowings during the year and lower interest rates, interest and debt expense amounted to \$7,335,084 compared with \$8,516,573 for 1960."⁹ This reduction occurred in spite of the fact that at December 31, 1961, notes payable amounted to \$258,200,000 compared with \$216,270,000 at the close of 1960.¹⁰ Long-term debt decreased \$6,000,000 during the same period.¹¹

The rate of return on the common stockholder's equity is the most interesting of all ratios to me. This ratio takes so much of a company's financial structure and operations into account. It compares the residual amount in the Statement of Financial Position with the residual amount on the Statement of Earnings after the dividend payment to preferred stockholders. The common stockholders' equity on the Statement of Financial Position is what remains after deducting from the total assets, the creditors' interest in the assets (total liabilities) and the preferred stockholders' interest. The net earnings applicable to the common stock is the final result of the corporation's operations for the year. It is the amount remaining after all costs and expenses, including interest expense and taxes, have been deducted from the sales or income. Even the dividends paid to the preferred shareholders

9. R. J. Reynolds Tobacco Company, 1961 Annual Report, p. 5.

10. Ibid., p. 5.

11. Ibid., p. 17.

are deducted in computing this ratio. The ratio is the net earnings applicable to the common stock divided by the common stockholders' equity. The percentage of debt to worth and the interest expense to total debt materially affect the rate of return on stockholders' equity. Also, the ratio is affected by the percentage of preferred stock in relation to the total capital. Actually, almost any percentage change in the Statement of Financial Position or the Statement of Earnings will change the percentage or rate of return on the common stock equity.

RATE OF RETURN ON COMMON STOCKHOLDERS' EQUITY

	<u>1961</u>	<u>1960</u>	<u>1959</u>
The American Tobacco Co.	12.72%	12.20%	12.99%
R. J. Reynolds Tobacco Co.	20.63%	20.70%	19.95%

We can see that the R. J. Reynolds Tobacco Company has earned a higher rate of return on the capital supplied by the common stockholders for the three years under review. This has been accomplished because the R. J. Reynolds Company earned a higher rate on total capital, because they had lower interest cost on borrowed capital and because a larger percentage of the capital was supplied by creditors. However, the question still arises, "Why does Reynolds earn more on total capital than American?" Perhaps another analytical tool will give us some of the answers.

Financial Statements can be shown in percentage form.

This method permits the analyst to compare businesses which are vastly different in size on the same basis. Sometimes these statements are called "common size statements." When this tool is used to compare Statements of Earnings, net sales are regarded as the base figures. Net sales equal 100% and all other figures are expressed as a percentage of net sales. Examine Exhibit E on the next page.

EXHIBIT E

STATEMENT OF EARNINGS
IN RATIO FORM
AS A PERCENT OF NET SALES

	1 9 6 0		
	<u>American Tobacco Co.¹²</u>	<u>R. J. Reynolds Tobacco Co.¹²</u>	<u>Tobacco Manufacturers¹³</u>
Sales (Net of Returns & Discounts)	100.0	100.0	100.0
Deduct: Costs & Expenses	<u>88.3</u>	<u>83.1</u>	<u>88.0</u>
Net Profit from Operations	11.7	16.9	12.0
Add: Other Income or Deductions (Net)	<u>-0.6</u>	<u>-1.1</u>	<u>-0.8</u>
Net Profit before Income Taxes	11.1	15.8	11.2
Deduct: Provision for Income Taxes	<u>6.0</u>	<u>8.4</u>	<u>5.4</u>
Net Profit After Taxes	<u>5.1</u>	<u>7.4</u>	<u>5.8</u>
Depreciation included above including accelerated amortization of emergency facilities	<u>0.5</u>	<u>0.7</u>	<u>0.8</u>

12. Percentages for The American Tobacco Company and the R. J. Reynolds Tobacco Company have been computed from their 1961 Annual Reports and cover the year ended December 31, 1960.
13. United States, Federal Trade Commission and Securities and Exchange Commission, Quarterly Financial Report For Manufacturing Corporations, (Third Quarter, 1961), p. 22.
Percentages are for Fourth Quarter, 1960.

EXHIBIT E
(CONCLUDED)

STATEMENT OF EARNINGS
IN RATIO FORM
AS A PERCENT OF NET SALES

	1 9 6 0		
	<u>American Tobacco Co.</u>	<u>R. J. Reynolds Tobacco Co.</u>	<u>Tobacco Manufacturers</u>
<u>OPERATING RATIOS</u>			
		(PERCENT)	
Annual Rate of Profit on Stockholders' Equity before Income Taxes	25.0	42.5	27.4
After Taxes	11.6	19.6	14.2
		(TIMES)	
Current Assets to Current Liabilities	4.39	3.95	3.63
Total Cash & U. S. Government Securities to Total Current Liabilities	.12	.09	.17

The rates of profit shown at the bottom of the Statement are rates of return on total stockholders' equity which include preferred stockholders. Apparently, one reason why Reynolds is able to earn a high rate of return is because their costs and expenses as a percentage of sales, are lower than American, and the industry sample.

The Statements of Financial Position, expressed in percentage form, show clearly the relative percentages of capital invested in various classes of assets. When the Statement of Financial Position is shown as a "common size statement," the total assets represent 100% and all other amounts on the statement are shown as a percentage of total assets. Exhibit F compares The American Tobacco Company and the R. J. Reynolds Tobacco Company in this manner.

EXHIBIT F

STATEMENT OF FINANCIAL POSITION
IN RATIO FORM
AS A PERCENT OF TOTAL ASSETS

ASSETS	1960		
	American Tobacco Co. ¹⁵	R. J. Reynolds Tobacco Co. ¹⁵	Tobacco Manufacturers ¹⁴
Cash on Hand & in Banks	2.4	3.1	3.4
U. S. Government Securities	-	-	0.6
Total Cash and U. S. Gov't. Securities	2.4	3.1	4.0
Receivables from U. S. Gov't. excluding Tax Credits	-	-	0.1
Other Notes and Accounts Receivable	6.8	5.4	7.3
Total Receivables	6.8	5.4	7.4
Inventories	81.5	78.4	75.0
Other Current Assets	-	-	0.4
TOTAL CURRENT ASSETS	90.7	86.9	86.8
Property Plant & Equipment	15.0	17.5	19.7
Deduct: Reserve for Depreciation	6.9	5.8	8.2
Total Property, Plant & Equipment (Net)	8.1	11.7	11.4
Other Non-Current Assets	1.2	1.4	1.8
TOTAL ASSETS	100.0	100.0	100.0
<u>LIABILITIES & STOCKHOLDERS' EQUITY</u>			
Short-term loans from banks (1 yr. or less)	9.2	22.8	9.8
Trade Accounts Payable	2.8	2.6	6.2
Federal Income Taxes Accrued	6.3	8.3	5.5
Installments due in one year on long-term debt	1.2	0.6	0.9
Other Current Liabilities	1.1	-	1.5
TOTAL CURRENT LIABILITIES	20.6	34.3	23.9
Long-term debt due in more than 1 year	16.0	9.1	14.3
Other Non-Current Liabilities	-	-	0.2
TOTAL LIABILITIES	36.6	43.4	38.4
Reserves not reflected elsewhere	-	-	0.6
Capital Stock, Capital Surplus and minority interest	30.6	14.1	24.7
Earned Surplus and Surplus Reserves	32.8	42.5	36.3
TOTAL STOCKHOLDERS' EQUITY	63.4	56.6	61.6
TOTAL LIABILITIES & EQUITY	100.0	100.0	100.0

14. Ibid., p. 22

15. Percentages for The American Tobacco Company and the R. J. Reynolds Tobacco Company have been computed from their 1961 Annual Reports and represent balances on the Statements of Financial Position at December 31, 1960.

We should note that at the end of 1960, cash represented a larger percentage of total assets for Reynolds than it did for American. The last ratio on Exhibit E, however, shows that Reynolds had less cash than American in relation to current liabilities. Reynolds also has a lower current ratio on Exhibit E. Exhibit F suggests how Reynolds is able to operate with a lower current ratio than American. Reynolds has a smaller percentage of its capital invested in accounts receivables and inventory. The sales to receivables ratios for the respective companies bear out this fact.

It is interesting to speculate about the reasons for the difference in the percentage of net profit from operations on Exhibit E. We can only speculate, since we do not have an analysis of the costs and expenses for the two major cigarette manufacturers. However, one possibility, suggested on Exhibit F, is that the R. J. Reynolds plant and equipment is more modern, and presumably more efficient.

On the liabilities side of Exhibit F, it is apparent that R. J. Reynolds has more short-term loans from banks and more current liabilities on a percentage basis than The American Tobacco Company or the industry sample. Conversely, they have a smaller percentage of stockholders' equity to total liabilities and equity. The debt to worth relationship is expressed in percentage form by the percentages shown for total liabilities and total stockholders' equity.

Many things can be done with numbers. Too many numbers can be confusing, especially to a person who does not enjoy working with numbers, and who is not able to look beyond mere numbers. Many ratios can be calculated and many tests can be made to help the investor judge the performance of a company or group of companies. If the analyst wishes to determine a trend over a period of years for a particular ratio, or a statement item, the base year can be considered 100%, and the amounts or ratios for all of the other years can be expressed as a percentage of the base year. Suppose, for example, that the analyst wanted to know what had been the trend of a company's return on common stockholders' equity. Assume that the company's experience was calculated to be as follows, and that 1957 was taken as the base year. The ratios as a percentage of the base year appear in the last column.

X CORPORATION

RETURN ON COMMON STOCKHOLDERS' EQUITY

<u>YEAR</u>	<u>RATIO</u>	<u>PERCENT OF 1957</u>
1952	12.00	120%
1953	9.00	90
1954	8.00	80
1955	9.50	95
1956	11.00	110
1957	10.00	100
1958	14.00	140
1959	14.50	145
1960	12.00	120
1961	13.00	130

The percentages can be plotted on a graph in much the same way some investors and speculators chart stock prices. Exhibit G charts the results shown in the X Corporation table and makes the trend somewhat more visible.

No one ratio or series of tests can give the investor an absolute answer. The prospective investor should not expect to be able to calculate a few ratios, pick a winner, and make a fortune. Many things may enter into a decision to buy or sell a particular stock. Some investors and traders are greatly influenced by market averages such as the Dow Jones Averages or the Standard and Poor's Averages. Some investors and traders are excited by management decisions to declare dividends in the form of stock, or to split the authorized number of shares into a greater number of shares. Neither of these actions changes the common stockholder's equity one dollar. The stock dividend merely involves a transfer of the amount of the stock dividend from retained earnings to common stock. A two for one stock split merely doubles the number of shares and cuts the stated per share value in half without changing the total dollar value of the outstanding stock.

Investors are interested in the price of an investment. A common stock can be very desirable at one price and almost out of the question at another price. Many investors like to know the ratio of the market price of a stock to the earnings on the stock. There was a time when people, who

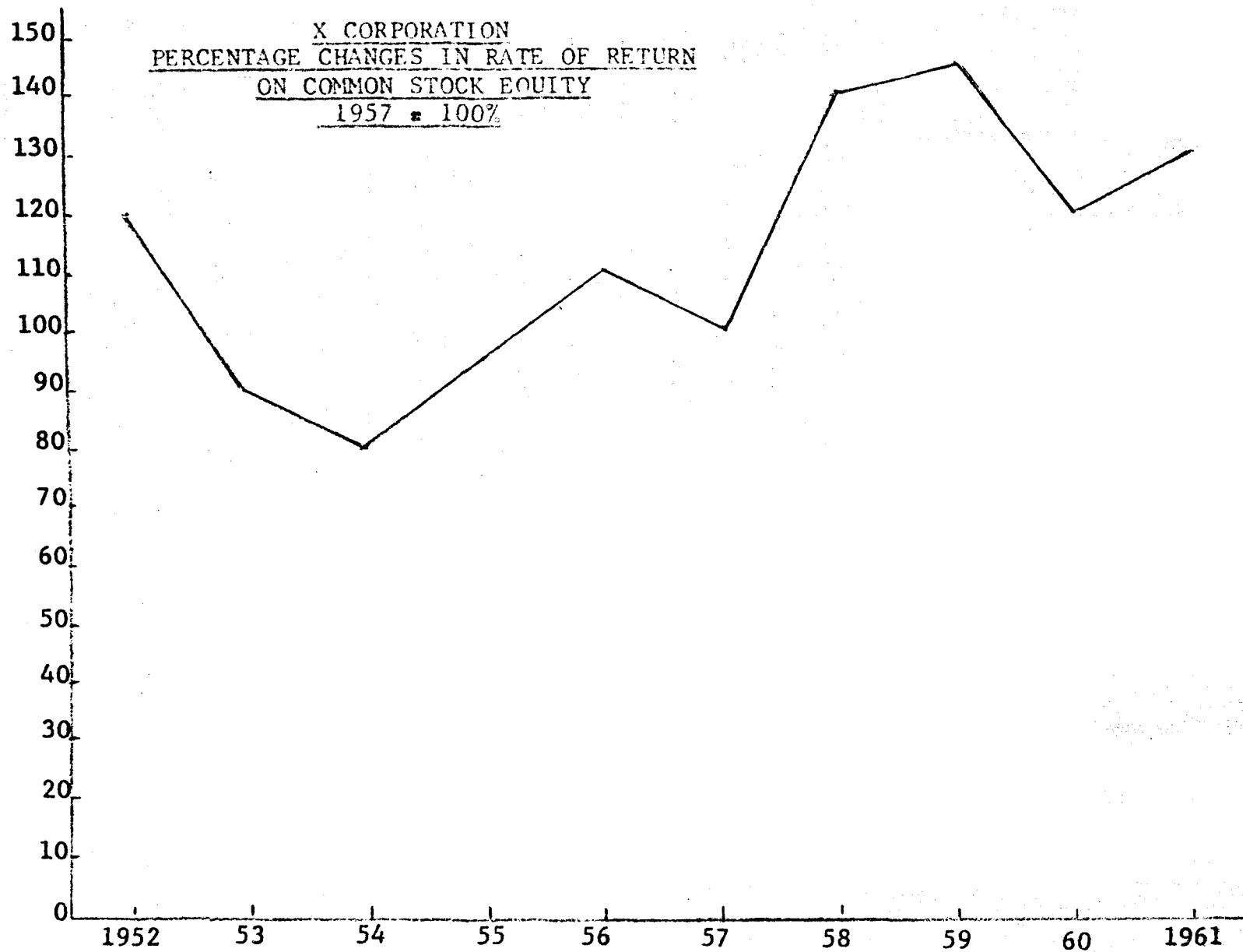


EXHIBIT G

were familiar with stock markets, felt that a stock should sell at a price which was from nine to fifteen times its earnings.¹⁶ Exhibit H, which lists the fifteen most popular stocks among 1,600 institutional investors, surveyed by Data Digest, Inc., demonstrates that the old conception of price earnings ratios does not apply today. Notice that International Business Machines, the glamorous growth stock, had a price earnings ratio of over 95. Ordinarily, however, the investor is not too concerned about day to day business news unless it affects the long-term outlook of his investment.

The investor should be interested in certain other factors before he invests. "The outlook for the industry, general business and security market conditions, periods of inflation or depression, artificial market influences, the popular favor of the type of security--these factors cannot be measured in terms of exact ratios and margins of safety."¹⁷ What is the position of the corporation within the industry? Is the corporation in a business that appeals to the public? Has the enterprise been a consistent producer of earnings over the years?¹⁸

16. The New York Times, "Margin Rise Fails to Dampen Boom," Section 3, October 19, 1958, p. 1.

17. Benjamin Graham and Charles McGoldrick, The Interpretation of Financial Statements, p. 70

18. Birl E. Schultz, The Securities Market and How It Works, p. 70.

EXHIBIT H

15 INSTITUTIONAL FAVORITES¹⁹

IN ORDER OF POPULARITY	NET EARNINGS PER SHARE		% CHANGE PER SHARE 1950-1960	YEAR ANNUAL DIV. SINCE #	CASH DIVS. LATEST 12 MONTHS (INCL. EXTRA)	CLOSING PRICE 11/1/61	PRICE EARNINGS RATIO
	1950	1960					
Standard Oil Co. (New Jersey) ..	\$2.25a	\$3.18	41.3	1899	\$2.25	\$ 46 3/8	14.6
General Motors Corp.....	3.12a	3.35	7.4	1915	2.00	50	14.9
General Electric Co.....	2.07a	2.26	9.2	1899	2.00	74 5/8	33.0
American Tel & Tel Co.....	4.19a	5.53	32.0	1881	3.45	121 5/8	22.0
duPont de Nemours (E.I.) Co....	6.59	8.10	22.9	1904	6.75	232	28.6
Texaco Inc.....	1.27a	3.17a	149.6	1903	1.49a	51 5/8	16.3
Union Carbide Corporation.....	4.30	5.25	22.1	1918	3.60	127	24.2
U.S. Steel Corp.....	3.65a	5.16	41.4	1940	3.00	76 3/8	14.8
Socony Mobil Oil Co., Inc.....	3.22	3.76	16.8	1902	2.00	46 1/2	12.4
Phillips Petroleum Co.....	2.12a	3.29	55.2	1934	1.70	55 7/8	17.0
International Business Mchs...	1.34a	6.12a	356.7	1916	2.20a	585	95.6
Standard Oil of Calif.....	2.39a	4.21	76.2	1912	2.00	50	11.9
Gulf Oil Corp.....	1.12a	3.14a	180.4	1936	1.02a	38 7/8	12.4
Sears, Roebuck & Co.....	1.99a*	2.55*	28.1	1935	1.40	82 3/8	32.3
Westinghouse Electric Corp....	2.68a~	2.22~	17.2**	1935	1.20	39	17.6

a Adjusted for stock dividends and split-ups.

* Fiscal year other than calendar year.

At least one cash dividend annually.

** Decrease

19. "Wall Street's Favorite 50," The Exchange, Vol. XXII, No. 12, December 1961, pp. 16, 17.

It is apparent that sound judgment is an essential ingredient in successful investing. It is true that good brokers and investors' services such as Moody's, Fitch's and Standard and Poor's can be of help to the prospective investor, but it is the individual who must make the final decision to buy, sell or hold a particular security. For his own enlightened self interest, the individual should be able to make this decision on the basis of facts rather than rumor. Whether the facts are presented to him, or whether he secures the facts for himself, the investor should be in a position to evaluate a company's prospects on the basis of its financial statements before he acts. To do so does not make an individual immune to investment losses. However, I believe that an understanding of financial statements, and the ability to calculate the "return on capital" ratios set forth in this chapter will enable him to pick a sound investment, judge the performance of his investment and minimize his losses.

CHAPTER VI

Summary

Not long ago, The Wall Street Journal carried a front page account of a telephone conversation between a customer and his broker. The conversation was described as being rather typical of a certain type of interest in the stock market. The gist of the conversation follows:

Customer: What do you know about Widgetronics, Incorporated?

Broker: I've never heard of it. What do they make?

Customer: I don't know. I understand the stock was just issued over the counter.

Broker: I'll see what I can find out about the company and call you back.

Customer: Never mind. Buy 100 shares for me.

This telephone conversation illustrates again a major point of this thesis. It indicates that there is a great deal of interest in the stock market. It also indicates that some of the interest is uninformed.

Common stocks offer unique opportunities to the prospective investor. They offer him the opportunity to provide venture capital for industry, and express his faith in our free enterprise system. Common stocks offer the

possibility of sharing in the industrial growth which lies ahead. Common stocks can be selected to fit almost any investment goal.

In order to be a successful investor in corporate securities, one does not have to be a political analyst, an economist and a financial analyst. These qualifications would help. I believe that successful investment decisions, in the long run are based on informed, good judgment. All of us take risks of one kind or another every day. Only a foolish man assumes an investment risk with no knowledge of the extent of the risk.

How does one determine the relative risks of corporate securities? Certainly one of the best methods is to examine the companies' Statements of Financial Position and the results of their operations as revealed in their Statements of Earnings. However, in order to give meaning to the examination, the prospective investor must have an understanding of the financial statements.

The investor should understand that the Statement of Financial Position presents a picture of a concern as of the close of business on a particular day. This picture shows a group of working or revolving assets which are called current assets. The investor should be familiar with the major current assets.

The picture also shows fixed assets such as Plant and Equipment, which facilitate the conversion of the current assets. The investor should remember that fixed assets are

valued at cost, and that depreciation charges are an effort to charge a part of the cost to operations as the fixed assets wear out. At the same time, the allowance for depreciation reduces the net book value of the fixed assets.

Other assets include intangible assets, prepaid expenses, investments and sundry receivables. Ordinarily, these assets do not represent a large percentage of the total assets. All of the assets should be viewed as a part of a going concern.

The capital represented by the total assets is supplied by short and long term creditors, and by the owners of the business. Current liabilities are those which fall due within one year of the statement date. Current liabilities include trade accounts payable, salaries and wages payable, taxes payable, dividends payable, other accruals and installments of long term debt which are due within one year.

Long term debt can take the form of promissory notes. It can also be in the form of secured or unsecured bonds. The investor in corporate bonds should know the conditions and privileges of the bond contract before he buys.

There are many different types of preferred stocks. Here again, it is wise to know the provisions of the issue as well as the profit potential of the investment.

Common stockholders are the entrepreneurs of

corporations. As suppliers of venture capital, they assume the greatest risks. On the other hand, they can receive the greatest rewards.

The Statement of Earnings shows how much income the company had over a period of time, how much expense was incurred and how much profit remained after expenses and taxes. The profit which a business earns over a period of years is the best indication of the value of the assets.

Investors are naturally interested in the return on their investments. To appraise the relative merits of a particular company's common stock, I believe that the investor should analyze the financial statements before he invests. Several tests are suggested.

1. Calculate the return on total assets for several years.
2. Calculate the Debt to Worth ratio for several years.
3. Calculate the rate of return on common stock for a period of ten years.
4. Calculate these same ratios for other companies in the same industry.

Generally, the more facts we have, the better decisions we make. Although an understanding of the facts does not preclude mistakes, it should help to prevent them.

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