NEUBIG, Robert Doane, 1926—
A STUDY OF THE EFFECT OF PERIODICITY ON CERTAIN INTERIM CORPORATE REPORTING PRACTICES.

The Ohio State University, Ph.D., 1961
Economics, commerce—business

University Microfilms, Inc., Ann Arbor, Michigan
A STUDY OF THE EFFECT OF PERIODICITY
ON CERTAIN INTERIM CORPORATE
REPORTING PRACTICES

DISSERTATION

Presented in Partial Fulfillment of the Requirements for
the Degree Doctor of Philosophy in the Graduate
School of The Ohio State University

By

ROBERT DOANE NEUBIG, B.Sc. in Bus. Adm., M.B.A.

*****

The Ohio State University
1961

Approved by

[Signature]
Adviser
Department of Accounting
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I Introduction</td>
<td>1</td>
</tr>
<tr>
<td>II Problems of Interim Corporate Reporting Practices</td>
<td>15</td>
</tr>
<tr>
<td>III Interim Reporting Practices</td>
<td>37</td>
</tr>
<tr>
<td>IV Seasonal Variations</td>
<td>73</td>
</tr>
<tr>
<td>V Comparative Statements and Corporate Acquisitions</td>
<td>96</td>
</tr>
<tr>
<td>VI Unusual and Nonrecurring Transactions and Non-Period Adjustments</td>
<td>111</td>
</tr>
<tr>
<td>VII Last-In, First-Out Inventories in Interim Statements</td>
<td>136</td>
</tr>
<tr>
<td>VIII Summary and Conclusions</td>
<td>146</td>
</tr>
<tr>
<td>APPENDIXES</td>
<td>156</td>
</tr>
<tr>
<td>BIBLIOGRAPHY</td>
<td>162</td>
</tr>
<tr>
<td>AUTOBIOGRAPHY</td>
<td>165</td>
</tr>
</tbody>
</table>
# LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Number and Percentage of Controllers Replying to the Questionnaire by Frequency of Interim Reports</td>
<td>40</td>
</tr>
<tr>
<td>2.</td>
<td>Information Included in Interim Reports</td>
<td>41</td>
</tr>
<tr>
<td>3.</td>
<td>Time Periods Covered by the Initial Quarterly Report of the Year</td>
<td>44</td>
</tr>
<tr>
<td>4.</td>
<td>Time Periods Covered by Quarterly Reports Other Than the Initial Report</td>
<td>45</td>
</tr>
<tr>
<td>5.</td>
<td>Reasons Why Corporations Issue Interim Reports</td>
<td>47</td>
</tr>
<tr>
<td>6.</td>
<td>Methods of Reporting a Material Adjustment Found in the Second Quarter that Effects Profits of the First Quarter</td>
<td>50</td>
</tr>
<tr>
<td>7.</td>
<td>Consolidated Eliminations and Adjustments Made Before Presenting Interim Financial Statements</td>
<td>58</td>
</tr>
<tr>
<td>8.</td>
<td>Methods Used to Determine Interim Inventory Quantities or Dollar Amounts</td>
<td>59</td>
</tr>
<tr>
<td>9.</td>
<td>Number of Companies Using Lower of Cost or Market Valuations</td>
<td>61</td>
</tr>
<tr>
<td>10.</td>
<td>Methods of Accounting for a Liquidation in Interim Lifo Inventories</td>
<td>65</td>
</tr>
<tr>
<td>11.</td>
<td>Number of Companies Prorating Certain Expenses Between Interim Periods</td>
<td>69</td>
</tr>
<tr>
<td>12.</td>
<td>Illustration of Quarterly Sales and Computation of Deseasonalized Sales</td>
<td>87</td>
</tr>
<tr>
<td>Table</td>
<td>Description</td>
<td>Page</td>
</tr>
<tr>
<td>-------</td>
<td>-----------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>13.</td>
<td>Income Statements with Fixed Costs Allocated on the Basis of Time</td>
<td>89</td>
</tr>
<tr>
<td>14.</td>
<td>Deseasonalized Sales and Variable Costs with Actual Fixed Costs Allocated on the Basis of Time</td>
<td>90</td>
</tr>
<tr>
<td>15.</td>
<td>Income Statements with Fixed Costs Allocated on the Basis of Sales</td>
<td>92</td>
</tr>
<tr>
<td>16.</td>
<td>Effect on Profits when Accounting for a Decrease in an Interim Lifo Inventory</td>
<td>140</td>
</tr>
</tbody>
</table>
CHAPTER I
INTRODUCTION

The practice of submitting financial information to the stockholders of a corporation, at various times and intervals between fiscal years, has become widespread in the United States. This practice was adopted by many companies after the New York Stock Exchange and other national security exchanges required them to publish the sales and net income figures at least quarterly. Even though the information could be obtained from the financial services, many stockholders did not take the time to avail themselves of the latest results. In many cases the stockholders obtained the information by word of mouth. This unreliable source sometimes perpetuates rumors which might result in unwise decisions. Therefore many corporate managements elected to mail the operating results to their stockholders in order to provide them with reliable current information.

An interim report has been defined as "A report at any date other than the end of a fiscal year: example: the quarterly report of a corporation in which profits for
the quarter or year to date are announced."¹ In practice there are two types of interim reports. The first might be described as the regular interim report. This report is submitted at regular intervals each year. It could be monthly, quarterly, or semi-annually. The other type of interim report is a special report that is issued for the purpose of registering securities with the Securities and Exchange Commission, or it might be issued for any one of a number of other special purposes. It covers a particular period of the current year. A similar report would probably not be issued in subsequent years. The term interim report, as used here, will refer to the reports that are issued at regular intervals unless specifically stated otherwise.

The Securities and Exchange Commission requires two reports to be filed each year by corporations required to submit reports. One report, Form 10K, is an annual report that contains an income statement for the fiscal year and a balance sheet at the end of the fiscal year. The other report, Form 9K, is referred to as a semi-annual report. This report, however, is filed annually six months after the Form 10K. The information in these reports is available, at a nominal cost, to any stockholder who would be

willing to go to the trouble to obtain it from the Securities and Exchange Commission.

The New York Stock Exchange requires all corporations that list their stock on the Exchange to sign a listing agreement. Section 4 of the agreement states:

The Corporation will publish quarterly statements of earnings on the basis of the same degree of consolidation as in the annual report. Such statements will show net profits before and after federal taxes and disclose any substantial items of unusual or nonrecurring nature.2

The American Stock Exchange listing agreement is substantially the same as that of the New York Stock Exchange. Section 16 of that agreement states:

If reports of earnings are published for any period of less than a fiscal year, such interim statements of earnings will show net profits on the basis of the same degree of consolidation as in the annual report and after depreciation, depletion, normal income taxes and interest, estimating the proportionate amount of these items as accurately as may be if not finally determined, and will disclose any substantial item of an unusual or nonrecurrent nature.3

The agreement between the listing companies and the American Stock Exchange as well as the New York Exchange provides that any changes that are made in accounting methods or in policies as to depreciation, depletion, or

3Ibid., p. 498.
in basis of valuation of inventories must be brought to the attention of the stockholders in the next succeeding interim or annual report.

Nothing is said about submitting information to the individual stockholders in either the New York Stock Exchange or the American Stock Exchange agreement. Publication is required. This would imply that as long as the company sent the current years net income figure, before and after taxes, to the wire services the corporation would have complied with the agreement.

Many corporations supply financial information, at a substantial cost, to their stockholders. It has been found that much of the information is not understood by the average stockholder. A survey made in 1948 by the Controllership Foundation divided the "public" into five subdivisions. Out of the five, three were interested in receiving at least quarterly reports, while one group expressed an interest in receiving monthly reports. The five groups consisted of (1) average stockholder, (2) employee in plant or office, (3) large investors, (4) national and local labor union officials, (5) financial analysts and bankers. The last three groups were interested in quarterly reports and, in addition, the last group was
interested in monthly reports. This survey proved interesting in several respects. The first two groups, average stockholders and employees in office and plant, were not interested in additional financial information. The information that they were given could not be used, in most cases, because of a lack of ability to understand its meaning. It would appear from this survey that additional information, such as quarterly statements, would not be useful to the average stockholders. However, the quarterly statement is not as difficult to understand as the usual annual report. In quarterly statements most companies furnish information about sales, net income before and after taxes and usually a computation of the net income per share of common stock. This information is presented on a single sheet of paper and in that way can be more easily read and understood by the stockholders than the annual report.

The stock exchanges and the Securities and Exchange Commission require that corporations provide information about the results of their operations for the interim period. While some companies furnish balance sheets and statements of changes in owners' equity, the majority submit income statement information only. The interim income

---

statement information would only be as good as the accountants ability to measure the net income for the interim period. W. A. Paton wrote that "Accounting might almost be defined as the art which attempts to break up the financial history of business into specific units, a year or less in length." Many textbooks and articles have been written on the theory of the determination of periodic net income. If it were possible to compare the amount of money the investors received when the corporation was dissolved, with the amount that had been invested during the life of the corporation, it would be a very easy matter to determine the net income of the corporation during its lifetime. According to Louis H. Rappaport:

Accountants know that the value of an income statement as an indication of earning power is in direct proportion to the length of the period covered by the statement - the longer the period the better. The shorter the period, the more apt it is to be influenced by unusual, extraneous, or nonrecurring factors, and by errors in estimates and apportionments.

Accounting for the interim periods is discussed by another author as follows:

The arbitrary convention of annual accounting periods offers more serious problems than are apparent at first thought. The original mechanism

---


6Rappaport, op. cit., p. 163.
of accounting as applied to a single venture was both simple and logical. As soon as accounting was treated from the going concern valuation basis, it became necessary to provide the interim accounting reports for which it was quite natural to select the calendar year as the fiscal period.

The problem of allocating income and expense as between periods was responsible for many difficulties in attempting to formulate specific principles of accounting.7

The authors quoted give an insight into the problems that are encountered with interim corporate reports. Many of the problems are found in attempting to arrive at the annual net income. When the period is shortened to a quarter or a half of a year the problems are increased.

In the economic world a large number of legal contracts that are based on the concept of the "annual net income" have developed. Corporate officers are often paid a bonus based upon the "annual net income." While these computations of "annual net income" are estimates and in fact "interim reports," the annual determination of profits has developed into one of the normal business procedures. Historical writings throw very little light on the reasons why the year was selected as the basis for income determination. It appears that the selection was made, as Gilman indicated above, ".... it was quite natural to select

the calendar year as the fiscal period.\textsuperscript{8}

Many of the estimates that must be made when attempting to measure net income for a period less than a year will have to be made on the assumption that the annual determination is correct. The determination of net income for an interim period is only as good as the estimates. For this reason it is important that the annual net income be based upon sound accounting principles. Interim income determination problems could be reduced if the profession accepted and developed a specific set of principles for interim accounting.

The practice of sending annual reports to the stockholders of corporations has become well established. Sending quarterly reports appears to be limited to the large corporations. Management in the larger corporations is dependent upon the approval of the many small stockholders for their continued existence in office. The quarterly report is another means of keeping the stockholder informed about the efforts of the present management on behalf of the stockholders. Even though the corporations are required to publish information quarterly, many corporate managements have elected to send reports to each stockholder.

\textsuperscript{8}Ibid.
It would be possible to develop a list of valid arguments, from the stockholders standpoint, for interim reports. It is doubtful, however, that the current practice of sending interim reports developed as a result of the demands of the stockholders. The stockholders and potential investors should require the information that is published quarterly. This interim information is often given as the reason for fluctuations in the stock market. Specific issues of stock rise or fall on the stock market as the result of news that quarterly earnings just reported were higher or lower than had been expected. Current economic predictions are often confirmed or denied by the interim reports of corporations.

It appears that the annual reports have satisfied the need for stewardship reporting. The auditors opinion of the annual financial condition has been accepted as fulfilling the need for an independent statement that the stewardship function has been properly accounted for. While the auditor is often asked to prepare a statement at an interim date and for an interim period, it is rare to find a situation in which the auditor has been asked to audit the accounts each quarter.

While it is true that the information has been made available in published form it is much more desirable to
place the information in the hands of the stockholders at
the same time that it is made available to the press. The
advantages of interim reports appears to be limited to the
investing public. It is doubtful whether other groups,
such as employees, creditors, government and management,
would benefit materially from quarterly reports. Manage­
ment reports are presented monthly, or even more often for
certain information. The creditors, employees, and their
union representatives, and the government require reports
at specific dates not necessarily at the end of a quarter.

Definition of the Problem

Interim reports may be inaccurate or tend to be mis­
leading because of the accountants technique for income de­
termination or because the business is highly seasonal.
These two problems will be analyzed in order to propose
standards for reporting interim period results to the in­
vesting public.

Income determination has been the subject of interest
to accountants for many years. The income statement has
become the financial statement that is of primary importance
according to A. C. Littleton:

For many uses the most important data from
accounting are the revenue charges that the revenue
credits by means of which enterprise efforts are
periodically matched against enterprise accomplishments. The matching process referred to by A. C. Littleton is the method that the accountants must employ in order to properly determine net income. Whenever financial statements are prepared estimates must be made in order to include revenues and expenses in the proper period of time. Management has the responsibility of presenting interim reports that are as accurate as possible if they intend to continue the current practice of issuing quarterly reports.

Seasonal fluctuations produce results that could, if not interpreted correctly, mislead the reader of the interim statement. A calendar quarter of very low sales might result in operating losses. If these financial figures were presented without explanation the poor results could lead to an unwarranted liquidation of an investment.

Objective

The objectives of research in this area are as follows:

1. To investigate current interim reporting practices
2. To investigate alternative methods of presenting interim information in order to:
   a. Establish short period income determination and reporting techniques
   b. Produce comparability between periods of time

---

c. Reduce possibility of misinterpretation

3. To recommend recording and reporting standards

In order to establish a foundation on which a theoretical study of income determination, and effect of seasonal variations can be based, it was considered necessary to determine what is being done in actual practice. On the basis of these findings the study of possible alternative approaches could be made. If it is found that alternative methods are more satisfactory than the methods currently employed, the recommendations would include the alternative methods. If on the other hand the present methods are found to be satisfactory, the recommendations would have to be made in such a way as to stipulate that the current practices should be continued and adopted by companies not presenting interim reports.

Scope and Limitations

This is a study of the current practices of reporting the stewardship function of management. As an extension to but not in place of the annual report, interim reports are considered to provide important additional information. The term "interim" will refer to any period that is shorter than a calendar year. It will be necessary to consider reports that are prepared monthly, quarterly, three times a year or semi-annually. Primary emphasis will be placed on the regular interim reports rather than the special interim reports.
This study will be limited to corporate reports to stockholders of industries performing the merchandising and manufacturing function of the economy. Regulated companies will be excluded, i.e. public utilities, and railroads. The problems of reporting to management will also be excluded.

No attempt will be made to study the uses to which the interim reports are put. The assumption will be made that interim reports are useful and that management prepares and sends the reports to stockholders for reasons other than the fact that proxy votes might be won because the stockholders receive a quarterly report. It will also be assumed that the annual report is submitted to the stockholders in order to inform them that the assets of the corporation are properly safeguarded. The annual audit by a Certified Public Accountant will be accepted as sufficient, in terms of number of audits per year. The quarterly report will be thought of as a report of management to its stockholders and the investing public. The independent auditors, as a rule, do not give an opinion on interim reports and, therefore, no attempt will be made to investigate the problems that arise from such an examination.

Approach to the Problem

Income determination for the short periods of time will be reviewed as to the theory as well as the methods that are
used in practice. Wherever possible the methods that are being used in practice will be developed through the articles that have been written, the use of a questionnaire and through personal contact with an accountant who has encountered the problem. The questionnaire will be used in order to establish that certain practices are being followed.

Interim reports will be examined for reporting practices. Seasonal fluctuations will be investigated from the standpoint of materiality and its effect on the interpretation of the financial results. Inter-year as well as intra-year reporting of seasonal fluctuations will be investigated. Transactions and adjustments that take place in one period that pertain to another period of time present a major problem of short period income reporting. While this is a problem that results from income determination, it is of such great importance that a special section of this study will be devoted to it. The current methods of reporting non-period adjustments will be investigated and recommendations will be made as to the most advantageous way in which they should be reported.
CHAPTER II
PROBLEMS OF INTERIM CORPORATE REPORTING PRACTICES

There are three major problem areas in accounting for interim periods. The interim net income might be distorted if large expenditures are charged in a single calendar quarter. The same would be true of receipts. The fact that an expense is to be recorded in a given fiscal year does not necessarily mean that the total amount of the transaction should be applied to the results of a given quarter. The first problem, to be considered at greater length in this chapter, might be referred to as "profit equalization."

The second problem area is "incomplete transactions." At the close of the quarter the accountant must prorate expenses such as Federal Income Taxes and Officers' Bonuses, both of which are based on the annual net profit. The fact that during the first three quarters the annual net profit is unknown, and will not be known until all transactions are completed, presents a definite problem of determining the amount of the tax and the bonus applicable to each quarter.

The third problem area falls under the classification of "specific information unknown." Inventory quantities on hand are important to the determination of cost of goods sold. Unless the company takes a physical inventory at the
end of each quarter or maintains perpetual inventory records, the accountant is presented with a problem of how to determine the cost of the goods sold during the period.

The three accounting problems, previously stated will be analyzed in the early part of this chapter. This will be followed by several interim reporting problems.

**Profit Equalization**

Profit equalization or "the smoothing of periodic net income" has been criticized for many years. The process of equalizing results may be accomplished by capitalizing certain expenditures in periods of relatively low sales and net income, and charging a similar expenditure in a year of high sales and higher profits. This inconsistent treatment of the same type of expenditure is not in accordance with sound accounting theory. The techniques of profit equalization of periodic net income are normally not considered proper. When this process is carried out over several fiscal years the profits are reduced in some years and increased in others. Profit equalization will be used here to mean the spreading of items that effect one quarter or period of a given fiscal year to other quarters or periods of the same fiscal year.

While it is beyond the scope of this work to set out income determination principles for the annual income statement, it is well within the scope, and in fact, a real part of this work to set income determination principles for the
short period covered by interim statements. Given the net income for a fiscal year there are questions that might be raised as to how it should be divided between the four calendar quarters. For example, a large expenditure is made in the first quarter of the year to repaint the inside of the factory building. This expenditure is required annually and the company will show the entire amount as an expense during the fiscal year. The problem arises as to whether or not this expenditure should be considered an expense of the first quarter. If the expense is prorated between quarters of the year the result is profit equalization or smoothing.

If, in this example the expense is prorated, it follows that a similar problem arises if the expenditure is made in a quarter other than the first quarter. The accountant is able to estimate, with accuracy, the recurring expenditure similar to the one discussed above.

In certain industries expenditures will be prorated automatically if they are considered to be a part of manufacturing overhead. Predetermined overhead rates are often used in order to allocate manufacturing overhead to the products being produced. If the accountant has anticipated the expense at the time the overhead rate was determined the product will include a portion of the expense even though the expenditure was made in a quarter other than the one in which the product was produced.

Accountants have long recognized the difference
between "product" and "period" costs. Expenses in connection with the distribution of a product or the administration of the company are considered expenses of the period in which they are incurred and therefore are referred to as "period costs." On the other hand expenses incurred in the production of a product are "product costs" and are deferred until the product is sold.

The effect on quarterly net income of large non-recurring expenses is more pronounced with period costs than with product costs unless the company includes the under or over applied overhead in the income statement each quarter. In that case the effect of a large expense, on net income, would be the same as a product or a period cost.

The conclusion that can be drawn from the discussion of product and period costs is that the absorption costing techniques tend to equalize expenses throughout a fiscal year. This will be true if the over or under applied overhead is not included in the determination of net income of a given interim income statement. At the present time accountants have not accepted a technique for prorating period costs to the same extent as they have product costs.

Prorating period costs for an expenditure that was made in the first quarter involves the use of prepaid expense accounts in the earlier quarters of the year. This prepaid expense is then written off to an expense account each quarter thereafter. If the expenditure is made in a
quarter other than the first the accountant must provide for the expense in the first quarter by crediting a liability or "equalization reserve." The liability or "equalization reserve" is closed out at the time payment is made. Unless payment is made in the fourth quarter a prepaid expense will develop because the payment will exceed the amount that had been provided.

An "equalization reserve" is defined as - an absorption account credited at regular intervals by amounts offsetting charges to operations of sufficient proportions to cover expenditures made more or less irregularly during an accounting period, the object being to spread the expense as uniformly as possible over each subperiod's operations or product.1

Paton and Littleton recognize the problem of profit equalization as follows:

The reasonable assignment of charges to the revenues of months, quarters, or other short-term periods may require exceptions to the general rule that charges shall be recognized only as incurred on a cash or equivalent basis. Such costs as advertising and maintenance, for example, are often incurred (in terms of expenditures, or services and supplies received) very irregularly throughout the year, and if monthly charges to revenues are correspondingly irregular, unwarranted variations in short-term reckonings will appear. Greater accuracy will result from accruing the revenue charges through the use of so-called "equalization" reserve accounts on the basis of cost budgets which recognize utilization and benefit rather than expenditure.2


2W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, American Accounting Association, 1940, p. 76.
One group of authors wrote about maintenance and repairs as follows:

While the primary purpose of the accounts is to record the amount actually incurred during the period for these purposes, consideration must also be given to the adequacy of this amount to maintain the property in good working order. If all the costs of ordinary repairs and maintenance have not been charged, the accounts should in some way indicate that fact.

Reserves to equalize maintenance over the months of the fiscal year, or even over successive fiscal years, may properly be employed, so long as the practice is clearly disclosed.

Profit equalization or smoothing has been used here in the sense of removing the peaks and valleys brought about by the inherent nature of certain types of business transactions. Accepting the fact that income and expense for the fiscal year will not be altered and that quarterly statements are expected to indicate the progress that a company has made during a short segment of the year it appears reasonable to state that specific transactions should not alter the results of one quarter sufficiently to obscure the overall trend of the business.

Matching costs and revenue - The objective of income accounting is to secure the best possible synchronization of periodic revenue and cost recognition by the development of parallel accrual methods. The fineness of the allocation techniques required is dependent chiefly on two factors, namely, the degree of instability of physical output volume, and the shortness of the accounting period.

Likewise, where the accounting period is fairly long (a year or more), less accurate methods of accrual are required. Revenue may be defined so as to more nearly equal "receipts" and expenses may approximate "expenditure." But as the accounting period is made shorter, many expenditures, charges, and expirations must be spread over more than one accounting period. Equalization reserves may be used to bring about an appropriate distribution of bulky items of expense, thus offsetting the random incidence of such things as major repairs to equipment and extraordinary appropriations for advertising, etc. In general better accrual techniques and allocation methods must be developed for short accounting periods if the reported income figures for successive periods are to be consistent, and free from erratic influences traceable to accounting procedure.  

No attempt has been made to indicate the method that should be used to prorate the expense to a given quarter of the year. In many cases it would not be reasonable to prorate the expense equally between the quarters. Depending upon the nature of the item under consideration the accountant should decide how to make the allocation. For example, an advertising campaign that was designed to stimulate the sale of a given product for the Christmas season, assuming that the expenditures were made in the third quarter of the year, might be allocated to the last two quarters of the year rather than to the four quarters. In this case an attempt was made to match the costs with the revenues that were generated by the costs. This principle has

---

become well established in accounting and should be followed wherever possible. Many examples could be given, similar to the one above of expenses that should be prorated on an unequal basis between the various quarters of the year.

On January 18, 1957, the Securities and Exchange Commission issued a stop order against Ultrasonic Corporation. In the findings and opinion of the Commission the corporation was charged with "false and misleading financial statements" and failure to disclose substantial developments subsequent to period covered by financial statements. For an interim period the Corporation estimated profits on a specific contract in process under the percentage of completion method of accounting. The Commission stated that "...we do not consider that registrant was warranted in singling it (the one contract) out for special treatment with respect to the recording of estimated profits." At the time the Corporation presented an interim statement there were approximately thirty contracts that could have been subjected to the percentage of completion method of accounting. This is a case of inconsistent treatment of an acceptable accounting principle.


6Ibid., p. 2.
In 1954 the Internal Revenue Code was amended to include a provision that fixed asset acquisitions during 1954 and subsequent years, could be depreciated by using one of the declining amount methods. The "sum-of-the-years" digits method and the declining balance method are the two methods mentioned in the code. Each of these methods provide for higher depreciation charges in the earlier years than in the later years of the asset life. It would be possible to compute monthly or quarterly depreciation charges so that a larger amount of depreciation would be recorded in January, or the first quarter, than would be charged in December or the fourth quarter. It is important to note that the computation on a monthly or quarterly basis will not result in the same depreciation charge for a twelve-month period than would be obtained if the computation was based on annual periods. In order to reduce the complication of minor differences in depreciation charges it is suggested that depreciation for the year should be determined and then allocate the annual charge over the interim periods equally.

No attempt will be made here to discuss all of the problems of allocating depreciation costs to the interim periods. There is one problem, however, that should be considered. Many companies elect, for tax purposes, to take a half year depreciation in the year of acquisition and a half year in the year of sale without regard to the
date of purchase or sale. In that case an asset purchased in December will increase depreciation expense for the year by one-half of the depreciation expense for the first year. It has become an accepted practice to prepare the tax returns in such a way as to pay the lowest amount of tax permitted the company under the existing tax law. It does not follow, however, that the company is required to present financial statements to its stockholders, or management, in the same way that it prepares the tax return. It is possible, therefore, to include in the tax return six months depreciation while reporting to the stockholders and management the amount of depreciation for the period that the asset was actually in use. To the extent that the depreciation expense deducted in the tax return exceeds that deducted in arriving at book net income, the tax liability would be less than would be the case if the book depreciation had been reported on the tax return. The opposite would be true if the book depreciation exceeded that reported on the tax return. If the same depreciation method is used on the tax return as is used for reporting purposes this difference will result in a different book value for the asset at the time the company disposes of it. If the depreciation that was deducted on the tax return was greater than that reported to the stockholders the book value that will be used in computing the capital gain will be less and
therefore the profit will be greater or the loss will be less on the tax return. While these differences appear to be complicated and in the long run insignificant in amount, it is important to formulate a principle that will result in comparable results over a period of time. Accounting principles must be adopted that will produce the most accurate estimate of asset consumption without regard to the optional legislative principles in the revenue code.

Accounting principles relative to the valuation of specific assets are applied at the year-end. The comparison of cost to the market value of temporary investments or inventories are examples of normally acceptable procedures. If the market or replacement cost is below the original cost of a current asset it is an acceptable policy to state the working capital position at the reduced amount. Paton and Littleton object to the write down to market with respect to inventories because of the effect on income.

It cannot be gainsaid that a sharp change in cost prices, in either direction, may have a bearing through the inventory-on the working capital position of the enterprise. Nevertheless, the complete substitution of estimated replacement costs of inventory for costs actually incurred in the process of matching revenue and cost is seriously objectionable.7

Interim statements are prepared and sent to the stockholders in order to provide current information about the operations of the company. Balance sheet valuation, from the stockholders point of view, would not be the cause of a decision to either buy, sell, or hold the securities of a company. Substantial changes in operating results and dividend payments effect such decisions. For these reasons it would follow that the accountant should provide pertinent information affecting net income. Day-to-day fluctuations of the market value of inventories and temporary investments would not affect income determination to the extent necessary to require adjustment. Substantial and permanent changes in replacement cost would, in the long run, affect income determination and therefore should be reflected. A material drop in the price of copper that is considered to be permanent by management would properly be recorded. The fact that it was considered to be permanent would mean that the problem would exist at the year-end and the usual reduction to the "lower of cost or market" would bring about a substantial year-end adjustment if it had not been anticipated in an interim period.

Incomplete Transactions

The second problem in accounting for interim periods was referred to as "incomplete transactions." Certain expenses and revenues depend upon a future act to be
accomplished before the exact effect can be known. At the end of a taxable year the taxable net income has to be a positive figure in order for income tax expense to exist. The first two quarters of the year might prove to be profitable while a strike during the subsequent two quarters might more than offset the profits for the year as a whole. At the end of the first quarter the accountant might be innocently unaware of the impending strike. The question arises as to whether provision should be made for federal income taxes that might never become a reality. A similar but opposite situation arises if the strike occurred in the first two quarters of the year and the following two quarters proved to be exceedingly profitable resulting in an over-all profit for the taxable year. If the accountant ignored the tax effect of the two loss quarters the result would be an overstatement of the loss in the first two quarters and an overstatement of the profits of the last two quarters. Other expenses, based on profits for a period of time, that is longer than a quarter, would create the same problem.

The internal revenue code provides, for corporations, a single graduation of tax rates at $25,000.00 and a provision for the carry-back and carry-over of corporate losses. Provided that a corporation has been profitable during either or both of the last two years or is profitable in the
next five years the net operating losses, to the extent of the profits, may result in a refund or a reduction in future tax payments. These two provisions simplify the problem.

The interim report for the quarter in which an operating loss occurs should include a negative provision for federal income taxes if it can be established that the loss would result in reduced income taxes in the future or could be carried back and a refund received. The effect of the negative provision would be to reduce the loss for the quarter. Claims for refund, because of the carry back provision, have been honored by the Internal Revenue Service without as much difficulty as is usually the case with other types of request. For that reason an accountant is justified in recording a receivable for the amount of the claim even before notice is received that it has been accepted.

While claims for refund of income taxes ordinarily should not be included in the accounts prior to approval by the taxing authorities, a claim based on the carry-back provisions of the Internal Revenue Code presumably has as definite a basis as has the computation of income taxes paid in prior years which are refundable to the taxpayer as the result of the carry-back of losses or unused excess-profits credit arises.®

®American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, (New York: American Institute of Accountants, 1953), p. 91. On June 1, 1957 the name of this organization was changed to the American Institute of Certified Public Accountants.
The amount of the negative provision should be the amount of refund that the loss would generate.

Officers' and employees' bonuses present a problem that was not a part of the tax problem discussed above. If the first two quarters result in a loss it would be possible to record a negative provision, only to the extent that the loss will offset profits in subsequent quarters of the same year. Depending upon the agreement with the persons involved, the accountant should compute the effect of the loss on the anticipated annual bonus payments. If the amount that will be paid during the year will be reduced because of the loss in a given quarter, or two, it would be proper and, in fact, should be reflected in the interim statement for the quarter as a negative expense.

Income taxes and bonuses are examples of the type of expense that might require estimates of future events and have been described as "incomplete transactions." The basis for estimating the future transactions, at the time interim statements are being prepared, is the budget. At the time a budget is prepared a study is made of all aspects of the business in order to provide a complete picture of the future operations of that business. Management, at all levels, is consulted about the expected level of operation. Such a thorough study cannot help but uncover the
anticipated programs, even though they have not been started. Adequate provision should be made in the interim statements for "incomplete transactions" that will result from events of the past. The accountant is in a position to judge, within limits, the future effect on the historical results. The accountant should attempt to minimize the effect of year-end adjustments throughout the year to the best of his ability.

Specific Information Unknown

The third problem area in accounting for interim periods was described as "specific information unknown." The major item directly related to income determination that would fall in this area is the problem of inventory determination and its direct effect on cost of goods sold and profits.

Corporations usually determine the inventory quantities at a date that is reasonably close to the year-end. In case a Certified Public Accountant intends to express an opinion on the results of operations for an interim period the following statement has been issued as a guide:

Where there are well-kept and controlled perpetual inventory records the observation of quantities may be undertaken at a date other than that of the balance sheet; or it may be staggered throughout the year if the client takes physical inventories of individual items from time to time so that the quantity of each item on hand is compared with the related perpetual inventory record
at least once in each year. If this is done no exception as to the scope of the interim examination with respect to inventory quantities is necessary. However, where "well-kept and controlled inventory perpetual records" are not tied in with the inventory control accounts maintained in dollars, it is essential that they be so tied in as of the balance sheet date or some date reasonably close to it.\footnote{American Institute of Accountants, Codification of Statements on Auditing Procedure (New York: American Institute of Accountants, 1951), p. 24.}

Ideally interim results are determined on the basis of perpetual inventory records tied into the books of account. If a corporation does not maintain the perpetual records of inventories another method must be devised to accurately determine the amount of inventory on hand at the interim date. Physical inventories are expensive to take. For this reason most companies take an inventory only once a year. The importance of accurate inventory determination, and its direct effect on net income, cannot be over-emphasized.

There are several acceptable methods of estimating inventories. The retail inventory method can be used by certain types of industries.
an average mark-on percentage to the final inventory stated at selling price.\textsuperscript{10}

A company that maintained its records on the retail inventory method could prepare interim statements with reasonable uniformity, without taking a physical inventory. From the records, the accountant is able to determine the total goods available for sale at the selling price. By deducting the sales for the period an estimate can be made of the final inventory stated at selling price. From this estimate the inventory can be reduced to an estimated cost figure.

Other methods, such as the "gross profit method," "relative sales value method," and "standard cost method" are available to estimate the amount of inventory on hand and the cost of goods sold. Each method has certain advantages as well as certain limitations. Each requires that certain information be accumulated throughout the interim period. In each case the dependability of the results will depend upon the accuracy of the accounting records used to obtain the data for the computation.

A company using one of the estimating methods, presented above, to determine the amount of the inventory at the interim dates would be well advised to apply the same procedure to the fourth quarter of the year to estimate the

year-end inventory. The difference between the estimated year-end inventory and the inventory determined by physical count would provide the accountant with the amount of error that had resulted from the use of the estimating procedure. Future estimates could be made more accurate if the procedure is corrected for errors of the past.

The accounting problems inherent in interim reporting have been outlined and discussed in the preceding section of this chapter. The remainder of the chapter will be devoted to the two problems of reporting interim results; namely, seasonal fluctuations, and year-end adjustments.

**Seasonal Fluctuations**

A technical definition of "seasonal fluctuations" is given below:

> A periodic movement is one which recurs, with some degree of regularity, within a definite period. The most frequently studied periodic movement is that which occurs within a year and which is known as seasonal variation, or merely seasonal.\(^{11}\)

Seasonal patterns are present in many industries. The movement in the automobile industry is well known. New models are brought out and placed in the showrooms only after a period of retooling. This period of reduced production is quite often accompanied by reduced sales. The

canning industry is also seasonal and in certain areas of the country the plants work during only one or two quarters of the year. Larger companies in the canning industry are in a position to spread their product lines so that the sales for the company, as a whole, do not reflect as substantial a seasonal variation as would be the case with smaller companies that have not been able to diversify their product line. In the not too distant past, the retail coal companies added ice to their product line in order to keep their delivery equipment busy during the summer months when coal sales were reduced.

Companies have objected to reporting interim results on the basis of misleading inferences that might be made because of seasonal fluctuations. Reduced sales and profits during a given quarter of a year might be inferred by some who receive the information to mean that the company was experiencing a long-run period of decline. Most interim reports are presented by comparing the interim results for a particular period of one year with the same period of the preceding year. In this way the effect of seasonal fluctuations is substantially reduced. Another technique that has been used is to present the previous twelve months results even though the twelve months does not coincide with the fiscal year. In this way each statement includes periods of reduced sales and periods of increased sales. In a
later chapter another technique will be developed that will permit the comparison between quarters of the same year as well as an individual quarter or quarters of the preceding year. Such a comparison cannot be made using the techniques that are in practice at the present time.

**Year-End Adjustments**

The underlying concept of improving the accounting for periods of less than a year is to reduce the magnitude of year-end adjustments. In the past these adjustments have resulted in a material distortion of the operating results for the period in which the adjustments were discovered and made. In 1952 the U.S. Circuit Court of Appeals handed down an opinion in the celebrated case of Kaiser-Frazer v. Otis & Co. This case dealt specifically with the problem of adjustments that are made in one period and affected periods in addition to the one in which the adjustment was discovered.

When the U.S. SUPREME COURT refused to grant a writ of certiorari in the *Kaiser-Frazer v. Otis* case in October, it in effect made final the decision of the U.S. Circuit Court of Appeals, Second Circuit, which had held for Otis. Interim income statements were found by this court to be misleading because of failure to spread inventory adjustments over the whole period affected, rather than lump the entire adjustment into the one month
in which it was discovered. The effect of this latter course was to overstate the month's income by some $3,100,000.12

The problem of year-end adjustments is important when the reader of an annual income statement interpolates the fourth quarter results by subtracting the reported results of the first three quarters from the net income for the year. A substantial adjustment at the year-end would be considered, by the reader, as though it occurred in the fourth quarter. If the facts were known, the first three quarters might have been misstated by a portion of the adjustment.

Improvement in accounting techniques during the year will reduce the quantity and amount of the year-end adjustments. Improvement in the reporting techniques will minimize the possibility of misinterpretation of the effect of the remaining year-end adjustments. This topic will be discussed in more detail in a later chapter.

CHAPTER III
INTERIM REPORTING PRACTICES

The stockholder of today is better informed about the progress of the company, of which he is a part owner, than the stockholder of not too many years ago. In addition to the annual report, he receives interim financial information. Unusual developments that occur between interim reports have been reported to the stockholder by means of a special letter. Stockholders and investors are able to evaluate investment decisions with up-to-date facts that were available only to a select few in the past.

A questionnaire was mailed to 151 corporate controllers to ascertain the methods companies use to determine interim net income and to find out just why companies send interim reports to their stockholders. Only those companies were included that are large enough to be of interest to investors throughout the nation. Many smaller companies send interim reports to their stockholders and their practices are important but, the practices of the larger companies are usually advanced and, in time, will be imitated by the smaller companies. In attempting to develop standards of interim reporting, practices of the larger companies
will be compared with the theory of interim income determination discussed in Chapter II.

The results of the questionnaire will be included in this chapter and compared with the conclusions in Chapter II. A list of the companies circularized appears in Appendix A and a copy of the questionnaire is included in Appendix B.

Table 1 gives the number of mail questionnaires returned and the frequency of interim reports sent to the stockholders. Of 151 questionnaires mailed to the controllers, 113 were returned. This represents 74.8 per cent of the controllers. To obtain as large a response as possible the controllers were not asked to identify themselves. In this chapter reference will be made to specific comments made by controllers on specific portions of the questionnaire. These comments were made possible, in part at least, because of the promise that individuals or companies would not be identified. Many of the comments were useful and important to the interpretation of the results and will be included here without disclosing the identity of the author.

Quarterly reports are mailed to stockholders by 88.5 per cent of the companies. These reports include information that the company is required to publish in accordance with their agreement with the New York Stock Exchange.
These companies go beyond the agreement and actually send the information to their owners so that they will be informed without having to go to the newspapers or the financial services.

Twelve companies send semi-annual reports to their stockholders. The semi-annual reports are mailed at a time when the company is required to send a report to the Securities and Exchange Commission. Again, there is no requirement by either the Securities and Exchange Commission or the New York Stock Exchange, that semi-annual reports must be mailed to the stockholders. Only one company indicated that it mailed monthly reports to its stockholders.

The percentage of companies responding to the questionnaire that they send reports for a particular period of time cannot be applied to all corporations. The sample of 151 corporations was not selected on a basis that would warrant such a conclusion. The selection was intentionally biased by selecting accountants and controllers employed by well known companies that send interim reports. There was no attempt to limit the companies to those with stock listed on the New York Stock Exchange.
TABLE 1
NUMBER AND PERCENTAGE OF CONTROLLERS REPLYING TO THE
QUESTIONNAIRE BY FREQUENCY OF INTERIM REPORTS

<table>
<thead>
<tr>
<th>Item</th>
<th>Number</th>
<th>Percent of Total</th>
<th>Percent of Replies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly</td>
<td>1</td>
<td>0.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Quarterly</td>
<td>87</td>
<td>57.6</td>
<td>77.0</td>
</tr>
<tr>
<td>Semi-annually</td>
<td>12</td>
<td>7.9</td>
<td>10.6</td>
</tr>
<tr>
<td>Total interim reports</td>
<td>100</td>
<td>66.2</td>
<td>88.5</td>
</tr>
<tr>
<td>Did not send interim</td>
<td>13</td>
<td>8.6</td>
<td>11.5</td>
</tr>
<tr>
<td>reports</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total replies received</td>
<td>113</td>
<td>74.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Did not reply</td>
<td>38</td>
<td>25.2</td>
<td></td>
</tr>
<tr>
<td>Total questionnaires</td>
<td>151</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

One respondent to the questionnaire made the following comment:

We too are interested in knowing the different practices that are being followed in providing information to stockholders through the medium of interim reports. To some substantial degree it would normally be assumed that under the Stock Exchange surveillance information contained in the reports would be somewhat consistent in pattern. Our own observations, of course, have indicated that this is hardly the case.1

1From a letter accompanying one of the questionnaires. All respondents were informed that their comments, if used, would not be identified with the individual or company.
Within the group that responded to the questionnaire stating they furnished interim reports to their stockholders there was a degree of uniformity in the information they presented in 1959. Table 2 indicates that of the ninety-eight answering this question eighty-six included the net income per share for the interim period.

TABLE 2
INFORMATION INCLUDED IN INTERIM REPORTS

<table>
<thead>
<tr>
<th>Information</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income per share</td>
<td>86</td>
</tr>
<tr>
<td>A complete income statement, even though condensed</td>
<td>70</td>
</tr>
<tr>
<td>A written statement of the highlights of the operations since the last report</td>
<td>70</td>
</tr>
<tr>
<td>Partial income statement information</td>
<td>28</td>
</tr>
<tr>
<td>A complete balance sheet</td>
<td>24</td>
</tr>
<tr>
<td>Partial balance sheet information</td>
<td>7</td>
</tr>
<tr>
<td>Other information</td>
<td>7</td>
</tr>
</tbody>
</table>

Some of the companies indicated that, although they presented a complete income statement, they also presented partial income statement information. By partial income statement information is meant net income before and after income tax expense for the period. This information is published quarterly as one of the requirements of the New York Stock Exchange.\(^2\) By presenting this information and, in addition, a complete income statement the reader is able

\(^2\)Supra, p. 3.
to determine the reason why there were fluctuations in the partial income statement information. On an average three types of information are presented. A typical interim report of the group, that responded to the questionnaire would include; net income per share, an income statement or income statement information and a written statement about the operations. The seven that indicated that other items of information were presented included; two that furnished the stockholders with unit sales volume statistics, one presented information about dividends that had been declared but not yet paid, and one included information about the number of units that were produced during the period. One company presented "pertinent ratios," another presented information concerning unfilled orders and still another disclosed data about its depreciation charges.

Of the companies reporting 87.7 per cent furnished the net income per share. They recognized the necessity of presenting information in a form that is understandable to the stockholders. Net income, in so many millions of dollars, has little or no meaning to the reader of the statement. If it is reduced to a per share basis the reader is able to relate it to the market price per share, and to the dividends per share, both of which are common information available to the average investor.
In an effort to obtain information concerning the periods of time covered by each report, a question was included to determine the reporting periods for the initial interim report of the year (first quarter) and for the subsequent interim reports. The first quarter report is unusual, in that the preceding quarter falls in a different fiscal year and corporations have avoided the practice of comparing two succeeding quarters in the same year, let alone comparing a quarter that is in one fiscal year with the previous quarter in another fiscal year. The answers to this question brought out that the companies are aware of the difficulties, in the first quarter, of comparing quarters other than the same quarter of the preceding year. Table 3 indicates there is almost unanimous agreement, among the controllers, with reference to the content of the first report for the year. Seventy-one of the seventy-two companies answering this question sent reports with the current period (first quarter) in comparison with the same period of the previous year. One company furnished the stockholders with a statement for the first period of the current year only. While there are certain objections to a comparison with the same period of the preceding year, such a comparison is better than no comparison at all. In addition to presenting a statement for the first quarter of two years, one company included comparative statements for the
<table>
<thead>
<tr>
<th>Time Periods</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current period only</td>
<td>1</td>
</tr>
<tr>
<td>Current period in comparison with the same period last year</td>
<td>71</td>
</tr>
<tr>
<td>In addition to one of the above, comparative figures for twelve months ending on the date of the initial quarterly report</td>
<td>1</td>
</tr>
<tr>
<td>Companies not answering this question</td>
<td>15</td>
</tr>
</tbody>
</table>

twelve months ending on the date of the first quarter. This practice is to be commended because the effects of seasonal variations are reduced when the four quarters are combined.

Income statement information for the three remaining quarters of the year may be presented for the current quarter as well as the year-to-date. Table 4 gives the various possibilities that were used by the eighty-seven companies that presented quarterly reports in 1959.

Interim reports after the first quarter are not as uniform in content as the first quarter reports. It is again apparent that the corporations prefer to give comparative figures each time a report is issued. Out of ninety-seven reports only four were not comparative. Thirty-nine companies presented statements for the year-to-date without including the figures for the current period, while only five companies did not give year-to-date figures in their interim reports. It is significant that the year-to-
### TABLE 4

**TIME PERIODS COVERED BY QUARTERLY REPORTS OTHER THAN THE INITIAL REPORT**

<table>
<thead>
<tr>
<th>Time Periods</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current period only</td>
<td>2</td>
</tr>
<tr>
<td>Current period in comparison with the same period last year</td>
<td>3</td>
</tr>
<tr>
<td>Current period and the year-to-date</td>
<td>1</td>
</tr>
<tr>
<td>Current period and the year-to-date and the same periods last year</td>
<td>43</td>
</tr>
<tr>
<td>Year-to-date only</td>
<td>1</td>
</tr>
<tr>
<td>Year-to-date and the year-to-date last year only</td>
<td>37</td>
</tr>
<tr>
<td>In addition to one of the above, comparative figures for twelve months ending on the date of the interim report</td>
<td>4</td>
</tr>
<tr>
<td>Current year-to-date and two prior years for the same period</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>4</td>
</tr>
<tr>
<td>Did not answer</td>
<td>1</td>
</tr>
</tbody>
</table>

Date figures are given by most of the companies. This may be interpreted as an attempt, by the controllers, to present the information for as long a period of time as possible while adhering to the division of time set by the fiscal year. The four reports included in Table 4 as "other time periods," were reports of two companies covering certain periods of time for the second quarter and including different periods of time in the third quarter report.

The twelve corporations that send semi-annual reports indicated that the current period was shown in comparison with the same period of the preceding year. Except for a statement for the twelve months ending with the end of the semi-annual period the only other alternative that would be
available would be to present the report for six months without comparison with other periods.

One controller commented on a problem that he finds with interim reports in his industry as follows:

Main problem re: interim reports in the industry is the seasonal nature of the industry (a major customer in another industry). Not only are the quarters within a year not comparable but the same quarters for different years are also not always comparable because of varying weather conditions affecting (the customer's) activity.¹

This controller indicated that beginning in 1960 the interim reports for his company, other than the first quarter report, would contain statements for the year-to-date, and also twelve months to date, for both the current and preceding year. This change is being made to remove, as much as possible, the objection that they have found with their interim reports.

Of the eighty-seven corporations that send quarterly reports to their stockholders, ten indicated that they send a report for the fourth quarter. If the fourth quarter report was not available information for that quarter would be obtained only after a considerable amount of effort, on the part of the stockholder. The corporations that send the fourth quarter report did not indicate that the statements included in that interim report applied only to the

¹Anon.
fourth quarter report. Two companies did indicate that they sent a different report for the second quarter than they did for the third quarter as indicated by the comments on Table 4.4

Seventy-eight corporations answered the question concerning the reason interim reports were sent to their stockholders. The results of this question are tabulated in Table 5.

**TABLE 5**

REASONS WHY CORPORATIONS ISSUE INTERIM REPORTS

<table>
<thead>
<tr>
<th>Reason</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>To provide information to their stockholders</td>
<td>62</td>
</tr>
<tr>
<td>Required by New York Stock Exchange</td>
<td>10</td>
</tr>
<tr>
<td>New York Stock Exchange requires publication</td>
<td>3</td>
</tr>
<tr>
<td>Stockholder relations</td>
<td>5</td>
</tr>
<tr>
<td>Customary in the industry</td>
<td>2</td>
</tr>
<tr>
<td>Requested by stockholders</td>
<td>2</td>
</tr>
<tr>
<td>Recommended by Securities and Exchange Commission</td>
<td>2</td>
</tr>
<tr>
<td>Company policy</td>
<td>2</td>
</tr>
<tr>
<td>Matter of principle</td>
<td>1</td>
</tr>
<tr>
<td>Consistent custom and practice of long standing.</td>
<td>1</td>
</tr>
<tr>
<td>Urged by the New York Stock Exchange</td>
<td>1</td>
</tr>
<tr>
<td>Obligation by officers to owners</td>
<td>1</td>
</tr>
<tr>
<td>We believe in full disclosure</td>
<td>1</td>
</tr>
<tr>
<td>To maintain interest in company and product</td>
<td>1</td>
</tr>
<tr>
<td>Maintain relations with financial analysts</td>
<td>1</td>
</tr>
</tbody>
</table>

4Supra, p. 45.
The three companies that listed the publishing requirement of the New York Stock Exchange are more accurate than the ten companies that stated that the New York Stock Exchange requires interim reports to be sent to the stockholders. The New York Stock Exchange does not require a mailing to the stockholders, only a publication of the information is required. Quotations were given in Chapter I from listing agreements of both the New York Stock Exchange and the American Stock Exchange indicating the requirements of publication.  

One controller made the following comment about the reason why his company sends interim reports (semi-annual) to its stockholders:

Principally due to stockholders desire for more current information and in part the result of a general trend by corporations having a large number of stockholders. Furthermore certain selected financial data is required on an interim basis by the Securities and Exchange Commission of corporation whose stock is traded on the exchanges.

From the comments furnished by the respondents to the questionnaire it is apparent that the impetus to mail interim reports to stockholders comes from three major sources. Management is interested in keeping the stockholders informed of managements constant efforts on behalf of the

5Supra. pp. 2-3.
6Anon.
owners. The stock exchanges are interested in having the stockholders and prospective stockholders informed of current developments because activity on the market will be increased if the public receives notices about a company more often than once a year. The third group that has asked for, and received, interim reports are the stockholders themselves.

Table 6 includes the results of a question concerning non-period adjustments. The answers indicate that the majority of the accountants would include the adjustments in the net income computation for the period in which the adjustment was made.

Year-end adjustments present a problem to the corporation mailing interim reports to the stockholders. If three quarterly reports have been mailed a year-end adjustment might significantly alter the results of the first nine months. If the fact that the adjustment was made in the fourth quarter was not made known to the reader of the interim statements a serious error might be made in any decision. Failure to disclose the effect of a year-end adjustment means that the reader is led to believe that the profits for the fourth quarter are normal, when, in fact, they have been materially altered by the year-end adjustments. A substantial inventory adjustment, increasing the
book inventory to the physical inventory, might be the result of differences throughout the year rather than just during the fourth quarter. If the amount of this adjustment, and the fact that it increased net income or decreased net income in the fourth quarter, is not brought to the attention of the reader he would naturally imply that the difference between the nine month profit and the twelve month profit was the amount of earnings applicable to the fourth quarter.

TABLE 6

METHODS OF REPORTING A MATERIAL ADJUSTMENT FOUND IN THE SECOND QUARTER THAT AFFECTS PROFITS OF THE FIRST QUARTER

<table>
<thead>
<tr>
<th>Method</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Included in the determination of the profit of the second quarter</td>
<td>53</td>
</tr>
<tr>
<td>Does not effect the second quarter—shown in the year-to-date column</td>
<td>17</td>
</tr>
<tr>
<td>Explained as to its nature</td>
<td>11</td>
</tr>
<tr>
<td>Held for year-end adjustment</td>
<td>1</td>
</tr>
<tr>
<td>A reserve is provided, based on experience, to cover such contingencies</td>
<td>1</td>
</tr>
<tr>
<td>Did not answer</td>
<td>11</td>
</tr>
</tbody>
</table>

Of the eighty-seven companies sending quarterly reports six did not answer the question regarding the reporting of material adjustments at year-end, forty-nine indicated that they did report the adjustments, and thirty-two indicated that they did not report the adjustments. The fact that better than 36 per cent of the companies did not
report a material year-end adjustment is significant. The effect of this on past and future reports will be discussed in detail in Chapter VI.

The controllers who answered that question in the affirmative were asked to indicate the method that was used to inform the reader that such adjustments were made. Three of the controllers did not give a method and two offered two reasons. Forty-eight indicated their methods. Forty-seven report material year-end adjustments in the annual report. Thirty-eight of the forty-seven mentioned the annual report without indicating the method that was used, or the location of the description of the year-end adjustment. Nine of the controllers indicated that they would report the adjustment as a separate item in the financial statements. One reported that his company sends an interim statement for the fourth quarter and the year-end adjustments would be explained by that means.

A question was included in the questionnaire about the adjustment of statements for the prior year when a new subsidiary was acquired during the current year. This question was asked to ascertain whether or not comparative statements would be, in fact, comparable if a new acquisition was made. Answers to this question indicated very little agreement among the controllers. Sixteen of the controllers did not answer the question. Of the seventy-one
answering, thirty-six indicated that they would adjust the statements of the prior period to include a new subsidiary (some with reservation) and thirty-five indicated that they would include the new subsidiary in the statement for the current period but would not adjust the prior periods for comparative purposes. Of the thirty-six answering in the affirmative one indicated that sufficient information, about the new subsidiary would be included in a footnote so that the statements could be made comparable. Five indicated that they would include them if there was a pooling of interests but would not adjust the statements of the prior year if it was an outright purchase.

Business combinations such as an outright purchase or a pooling of interests was the subject of an Accounting Research Bulletin issued by the Committee on Accounting Procedure of the American Institute of Accountants in January, 1957. The committee in this Bulletin No. 48 made a distinction between a purchase and a pooling of interests. They also indicated the different methods that should be followed in accounting for the two. The essence of the problem revolves around the fact that a purchase is an acquisition by a corporation, under approximately the same

---

ownership that the acquiring corporation had before the new facilities were acquired. A pooling of interests, on the other hand is a combination of two or more corporations with the ownership of the new organization made up of the owners of all the corporations entering into the combination, and the owners of the new and larger corporation must have received equities in this new corporation in approximately the same proportion to their interest in the predecessor corporations. One, the purchase is accounted for on the same basis as the acquisition of any new asset. The other, the pooling of interests is accounted for as though the predecessor corporation where continuing to operate and it is proper to carry forward the earned surplus, or retained earnings, of all the corporations. The five controllers who indicated that they would adjust the interim statements of previous years, when making a comparison, if the new subsidiary was acquired as a pooling of interests are following Bulletin No. 48. The last paragraph of that bulletin reads as follows:

When a combination is considered to be a pooling of interests, statements of operation issued by the continuing business for the period in which the combination occurs should ordinarily include the combined results of operations of the constituent interests for the part of the period preceding the date on which the combination was effected; if combined statements are not furnished, statements for the constituent corporations prior to the date of combination should be furnished separately or in
appropriate groups. Results of operations of the several constituents during periods prior to that in which the combination was effected when presented for comparative purposes, may be stated on a combined basis, or shown separately where, under circumstances of the case, that presentation is more useful and informative. Disclosure that a business combination has been, or in the case of a proposed combination will be, treated as a pooling of interests should be made and any combined statements clearly described as such.®

That statement about the presentation of the statement of operations is the only mention that is made on the subject. The five controllers have inferred from this that it would be improper to show, for comparative purposes, the sales and other operating statistics for a new subsidiary that had been obtained on the basis of an outright purchase.

The question, as it was stated, in the questionnaire, did not specify whether the new subsidiary was acquired by either a purchase or a pooling of interests. Thirty-five controllers stated, without qualification that they would not adjust the figures of the preceding year, while thirty stated, without qualification, that they would.

Comparative financial statements, both annual and interim, are prepared and presented to interested parties, in order to provide a basis for judgment as to the progress of the company during the most recent period. If in the second year a significant subsidiary was acquired, whether it be

by an outright purchase or by a pooling of interests, the increase in sales, between years, should be the result of expanded production and sales efforts and one that would be attainable in future years. If two corporations of equal size and equal sales were combined by either a purchase or a pooling of interests, and the statement of the preceding year was not adjusted, by the amount of the sales of the absorbed company, the statements would reflect the fact that the sales of the company had doubled in a year. The reason for such an increase is not apparent to the reader, and he might imply that such an aggressive organization could substantially increase their sales next year. Adjusted statements would reflect sales for the two years as being the same, with a footnote to the effect that the statements were adjusted to include the new subsidiary and that with the additional sales outlets, or new products, the corporation should move ahead. If the reader has a false impression from the adjusted statements, which require a footnote, it would result in caution, on his part, rather than over-confidence about the future. A year later the statements will include both companies, for both years and the change in sales will be the result of the efforts of the sales department, not the purchase of sales with capital stock.
The next question, asked of the controllers, concerned the policy of consolidation and whether the interim statements were presented following that same policy as are the year-end statements. Out of eighty-seven companies sending quarterly statements eighty-four answered this question. Eighty-three answered in the affirmative and one answered that it did not follow the same policy for interim reports as it does in the annual report. One of the few requirements of the stock exchanges is that any statement presented during the year must be on the basis of the same degree of consolidation as in the annual report. For example, if a parent company, in the annual report, consolidates all subsidiaries in which it owns more than 50 per cent of the voting stock it is required to do the same for all interim reports. The reason for such a requirement is to prevent the reporting corporations from removing loss companies, during the year, and including them in the annual report, causing the reader to conclude that the organization, as a whole, is doing better than it actually is.

The questions that have been discussed to this point were designed to determine the content and frequency of interim reports. The results indicate an awareness by management of its responsibilities to the absentee owners and to the investing public. Important economic conditions
that affected the business, since the last report, are usually included in the comments with the interim reports.

These questions were included in the questionnaire to develop the current practices of companies that use this media of reporting. Although the sample was relatively small and intentionally biased the results appear to be representative of current interim reporting practices. This conclusion was drawn after the results were tabulated and compared with interim reports reviewed over a two year period. The actual reports revealed all major variations in reporting practices were brought out by the questionnaire.

Corporations sending interim reports currently, or those contemplating interim reports would be well advised to compare their reports, or tentative ideas with the practices of the major United States corporations. Many of the practices are common to a majority of the companies sending interim reports. Certain of the practices are unusual. In certain cases the unusual practices merit consideration by the majority as they represent an improvement in reporting interim financial information.

The controllers were asked to indicate whether or not certain eliminations were made before presenting consolidated interim statements. Table 7 is a compilation of the results of this question.
TABLE 7
CONSOLIDATED ELIMINATIONS AND ADJUSTMENTS MADE BEFORE PRESENTING INTERIM FINANCIAL STATEMENTS

<table>
<thead>
<tr>
<th>Eliminations and Adjustments</th>
<th>Yes</th>
<th>No</th>
<th>Did Not Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercompany profits in inventories</td>
<td>74</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Dividends received by one company, in the consolidation against the dividends paid to it by another company in the consolidation</td>
<td>73</td>
<td>1</td>
<td>13</td>
</tr>
<tr>
<td>Is the portion of the net income applicable to the minority interest deducted from the net income for the interim period in arriving at the reported net income?</td>
<td>49</td>
<td>2</td>
<td>36</td>
</tr>
</tbody>
</table>

The eliminations and adjustments that were included in the question are the major items that would alter the results of interim periods. The affirmative response of a number of controllers support the conclusion that they do recognize the problem and that it is being handled, in most cases, in the proper manner. Many of the controllers who did not answer the question indicated that the particular problem was not applicable to their corporation. This was especially true of the elimination of net income applicable to the minority interest.
Income determination, for interim periods, is made possible by different techniques of determining either the amount of inventory on hand at the end of the period or by computing the cost of goods sold directly. For larger corporations, such as the ones selected to answer the questionnaire, inventory accounting is accomplished with large accounting staffs and modern mechanical and electronic equipment. Table 8 given below, indicates the various methods, and the frequency of which each is used, by eighty-seven corporations distributing quarterly reports to the stockholders.

**TABLE 8**

**METHODS USED TO DETERMINE INTERIM INVENTORY QUANTITIES OR DOLLAR AMOUNTS**

<table>
<thead>
<tr>
<th>Method</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical count</td>
<td>31</td>
</tr>
<tr>
<td>Perpetual inventory records</td>
<td>76</td>
</tr>
<tr>
<td>Retail inventory method</td>
<td>3</td>
</tr>
<tr>
<td>Actual costing of sales</td>
<td>3</td>
</tr>
<tr>
<td>Estimated (on the basis of purchase, sales and gross profit percentage)</td>
<td>5</td>
</tr>
<tr>
<td>Standard cost system</td>
<td>2</td>
</tr>
<tr>
<td>Did not answer</td>
<td>1</td>
</tr>
</tbody>
</table>

Approximately 40 per cent of the controllers answering this question indicated that their company employed two methods to arrive at the amount of inventory at an interim date. Twenty-nine of the controllers out of thirty-one who
indicated that their companies used physical inventories as a basis for determining interim inventory quantities combined the physical inventory method and the perpetual inventory method. There were only two controllers who indicated that the physical inventory was the only method that was used to determine interim inventory quantities. Many of the controllers indicated that they gave two answers because their company takes physical inventories throughout the year on a cycle basis but that they use perpetual inventory records for interim statements. One of the well known advantages of perpetual inventory records is that it reduces the amount of work required in taking physical inventories. The items are counted at the low point, no matter when it occurs during the year, and in that way the accuracy of the perpetual records is determined at least once a year.

Eighty-seven controllers answered the question relating to methods of pricing inventories in interim statements. Twelve controllers indicated that they used two methods of pricing. Out of ninety-nine responses to this question, eighty-eight were divided almost evenly between last-in, first-out, with thirty-two, first-in, first-out and average cost with twenty-eight, apiece. The remaining eleven were divided among the following: standard costs which are substantially first-in, first-out or market
whichever is lower accounted for six; lower of average cost or market was used by one company; progressive average cost was used by another company; periodic cost studies were the basis for work in progress valuation by another company; and the lower of cost or market was used by two companies.

The next question was divided into two parts. The controllers were asked to indicate whether or not the company adjusted the inventories to the market values (replacement cost) at either the year-end or at the interim dates. In Table 9 the results are given to this question.

<table>
<thead>
<tr>
<th>Type of Report</th>
<th>Yes</th>
<th>No</th>
<th>Did Not Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year-end</td>
<td>77</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Interim</td>
<td>50</td>
<td>22</td>
<td>15</td>
</tr>
</tbody>
</table>

Several controllers commented on their reason for not reducing the inventories to the lower of replacement cost or market. One indicated that "such a writedown is not permissible under the last-in, first-out basis." It is true that under the tax laws it is not permissible to reduce an
inventory that is costed on the last-in, first-out method to market value when the market is below cost. An accountant may reduce the inventory on the books and the financial statements and file the tax returns in accordance with the tax law. More accurate comments were as follows: "Lifo cost is far below replacement costs"; "not a problem on Lifo"; and "It has not happened since we adopted Lifo."

While these comments indicate the reason inventories were not reduced below cost in the 1959 interim reports they do not give an indication of what would be done if economic conditions changed and replacement cost was below the last-in, first-out cost.

Fifty of the controllers indicated that they review the market value of the inventory at the interim date and that they would make the normal adjustment, at that time, if the conditions warrant it. There were sixteen companies that changed from a writedown at the year-end to not making a writedown for an interim period. For these sixteen, at least, it means that a writedown, if any, will be made in the fourth quarter of the year. This is another problem that shifts interim losses to the fourth quarter.

Controllers who had indicated that the inventories were costed on the last-in, first-out method were asked to indicate the procedure that would be followed to determine the cost of goods sold for the current interim period, if,
the inventory quantity at the interim date was less than the inventory quantity on hand at the beginning of the period. If it is assumed that prices rose during the interim period current purchases would be at a higher price than the opening inventory. A strict last-in, first-out computation would result in all of the current purchases being charged to cost of sales plus a portion of the opening inventory. Purchases and sales during the remainder of the year might result in an inventory at the end of the year of more than was on hand at the end of the interim period. On the other hand, sales might exceed purchases during the remainder of the year and the final year-end inventory might be even less than the interim inventory. The question involves the problem of whether or not to take into the interim income statement a portion of the profit resulting from inventory liquidation or to assume that the inventory will be replaced and therefore no profit, in the long run, will result. The answers to this question indicated a wide range of practices, from recording the profit in the interim period to not recording the profit until the end of the year.

The last-in, first-out method of pricing inventories has become well established in theory and practice and is consistently applied on an annual basis. Table 10 provides the results of a question that was included in the questionnaire in order to determine if the practices in interim
reporting of Lifo inventories is as consistent as it is in annual reports. It is apparent from Table 10 that the respondents indicated a variety of methods that produce a variety of results.

One of the controllers made a comment that might provide a possible reason for the inconsistent treatment of the hypothetical situation presented in the questionnaire. He indicated that, in his corporation the year-end inventories were always at a lower point than at any other time of the year. If a corporation has an obvious natural business year, the year-end inventories should be at the lowest point. In theory, the situation, that was described in the question, would only occur in a corporation that has, and reports on, the basis of the natural business year, after an unusual situation that reduced the interim inventories below what they would normally be at that time of the year. Not only are there companies that do not report on the basis of natural business year for their industries but there are companies that have a variety of operations that would have different low points in the inventories, during the year. For this reason the question that was given to the controllers has wide practical significance. The diversity of results indicates a need for formal statements of accounting procedures that are applicable to periods of less than a year.
### TABLE 10
**METHODS OF ACCOUNTING FOR A LIQUIDATION IN INTERIM LIFO INVENTORIES**

<table>
<thead>
<tr>
<th>Method</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit or losses taken during interim period-</strong></td>
<td></td>
</tr>
<tr>
<td>a) Last-in, first-out is determined monthly.</td>
<td>4</td>
</tr>
<tr>
<td>b) No interim adjustments to the reserve</td>
<td>2</td>
</tr>
<tr>
<td>c) Uses dollar value Lifo</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>7</td>
</tr>
<tr>
<td><strong>Profit or losses would be taken in the interim periods if liquidation by year-end is expected</strong></td>
<td>6</td>
</tr>
<tr>
<td><strong>Partial recognition in interim period-</strong></td>
<td></td>
</tr>
<tr>
<td>a) Base stock method - base will be replaced, balance not expected to be replaced</td>
<td>2</td>
</tr>
<tr>
<td>b) Year-end adjustments to Lifo reserves are estimated and prorated over the year.</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>6</td>
</tr>
<tr>
<td><strong>Profit or losses would not be taken during interim period-</strong></td>
<td></td>
</tr>
<tr>
<td>a) Current costs charged to cost of sales.</td>
<td>6</td>
</tr>
<tr>
<td>b) Profit on liquidations is deferred until year-end when known</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>9</td>
</tr>
<tr>
<td><strong>Indeterminant effect on interim net income-</strong></td>
<td></td>
</tr>
<tr>
<td>a) Estimates are used</td>
<td>1</td>
</tr>
<tr>
<td>b) Inventory is always lowest at year-end.</td>
<td>1</td>
</tr>
<tr>
<td>c) Not applicable-immaterial</td>
<td>1</td>
</tr>
<tr>
<td>d) Did not answer this question</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>4</td>
</tr>
<tr>
<td><strong>Grand total of companies reporting on Lifo basis</strong></td>
<td>32</td>
</tr>
</tbody>
</table>
The sub-headings of Table 10 were adopted as representative of the written descriptions given in answer to the question. Four of the controllers indicated their company computed the inventory and cost of sales monthly on the basis of last-in, first-out. By this computation variations in the inventory would be reflected in the cost of sales monthly and therefore would be a determining factor in the net income of each interim period. Two controllers indicated that no adjustment would be made to the Lifo reserve during the fiscal year. Such a reserve is established to provide for the replacement of inventory quantities at prices other than the actual Lifo cost. By not adjusting the reserve during the year the effect of inventory reductions and price differences are reflected in the interim net income. The controller who stated that his company used the dollar value Lifo indicated that the full impact of inventory changes would be determined currently and shown in the cost of sales portion of the interim income statement. The seven companies, just referred to, would determine interim net income in the same way, even though the method of stating the solution to the problem was different. This position, is at one extreme of the practices reported by the controllers. Nine controllers reported that they would not include the effect of inventory reductions and price differences between the beginning
inventory and the current purchase price in interim income determination. This is the other extreme. Between these two positions there were other controllers who reported that they would, in certain situations, report the profit or loss in the interim statements.

Six of the nine controllers withholding the effect of the inventory liquidation stated that the cost of sales would be charged with current costs, without regard to the level of the inventory quantities. The other three stated that they preferred to wait until the end of the year when the actual reduction in inventory was known. Their argument was that Lifo is an annual calculation and the difference between the opening and closing inventories of the fiscal year are the determining factors as to whether or not the inventory has been reduced to the point of Lifo layer for which the cost is less, or greater, than the current prices. They would contend that to include a profit, or loss, on a temporary reduction in inventory quantity that might not be a reduction at the end of the year, is anticipating a situation that might never occur. In the period since most companies adopted the last-in, first-out method prices have been increasing. In the majority of cases a reduction in the inventory would mean that lower costs would be included in cost of sales and higher profits
would result. In most cases the use of current costs as a charge to cost of sales would produce a more conservative interim net income. If the year-end inventory quantities were lower than the opening inventory quantities the profits would be included in the fourth quarter.

In between these two extremes six controllers reported that they would include in current interim net income the effect of inventory reductions to the extent that they expect such a reduction at year-end. There were six more controllers who would recognize a portion of the profit or loss in the interim period. Two use the base stock method and to the extent the inventory quantities exceeding the base stock were depleted the profit or loss would be included in the interim net income. The base stock if depleted would be replaced at the lower price and profits or losses would not be recognized. Four controllers indicated that they estimate the year-end adjustments to the Lifo reserves and prorate them over the year. This would be done on the basis of time rather than on the basis of quantities sold during any one interim period.

This question concerning the treatment of reductions in Lifo inventories brought out the varied methods that produce inconsistent results between the various companies.
Table 11 contains the results of a five part question dealing with the allocation of certain expenses between interim periods of the year.

TABLE 11
NUMBER OF COMPANIES PRORATING CERTAIN EXPENSES BETWEEN INTERIM PERIODS

<table>
<thead>
<tr>
<th>Expense</th>
<th>Prorated Between Interim Periods</th>
<th>Did Not Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>A major expenditure in one period of the year for advertising</td>
<td>53  32  2</td>
<td></td>
</tr>
<tr>
<td>A major expenditure in one period of the year for research and development</td>
<td>41  42  4</td>
<td></td>
</tr>
<tr>
<td>Vacation pay, where most of the vacations are taken during the summer</td>
<td>76  10  1</td>
<td></td>
</tr>
<tr>
<td>Officers' bonuses</td>
<td>55  7  25</td>
<td></td>
</tr>
<tr>
<td>Employee pension plan</td>
<td>84  1  2</td>
<td></td>
</tr>
</tbody>
</table>

In addition to indicating a yes or no answer to the questions that are tabulated in Table 11, several of the controllers commented on individual items. Twenty-five either did not answer the section about officers' bonuses or indicated that it was not applicable to their case. Many
corporations do not have bonus plans specifically for the officers. There could have been other controllers in that category who left the space blank, thereby, accounting for the large number of unanswered forms. The question concerning the employee pension plan produced the most consistent answers. Many pension plans require the employer to contribute a relatively large sum, once or twice a year, to a trustee or fund. Large expenditures at infrequent intervals would produce substantial fluctuations in interim profits. Eighty-four of the eighty-five controllers answering this portion of the question would prorate the expense for an employee pension plan between the various quarters of the year.

Of the sixty-two controllers who answered the question about officers' bonuses and the eighty-six answering the portion about vacation pay, more than 88 per cent in each case, indicated that they prorated the expense between interim periods. Approximately 62 per cent of the eighty-five controllers who answered the portion of the question about the treatment of a major expenditure, in one period of the year for advertising, indicated that they would prorate it among other interim periods. The answers to this question indicate a large percentage of controllers prorate the more common expenses. A smaller percentage of the controllers prorate the more unusual expenses.
Less than 50 per cent of the controllers would allocate a major expenditure for research and development to interim periods other than the one in which the expenditure was made. Several of the respondents indicated that expenditures, of this nature, usually did not fluctuate very much from month to month.

The data used to compile Table 1 and Table 2 were obtained from the questionnaires returned by companies that send interim reports, without regard to the period of time covered by those reports. Subsequent tables were derived from those questionnaires sent by controllers representing companies that report on a quarterly basis only. While the information, that was included in the questionnaires from companies that report on semi-annual and monthly periods is important to this study the tables, other than the first two, dealt primarily with quarterly reports. The monthly and semi-annual questionnaires were reviewed and tabulated. Nothing was included in these questionnaires that would alter, in any way, the overall results that were obtained from the quarterly questionnaires.

The interim reporting practices of certain larger companies have been studied by means of a questionnaire and the results have been tabulated and reviewed in this chapter. While the results reflect a certain amount of uniformity,
in content and method there appears to be a need for a specific set of principles and standards of interim reporting.

The major areas of difference that were brought out by this questionnaire were the problems of reporting comparative income statement information when a new subsidiary was acquired during a given period, the methods of reporting year-end adjustments, and the treatment of profits and losses resulting from liquidation of Lifo inventories during an interim period.
CHAPTER IV

SEASONAL VARIATIONS

A reason that is often given for not submitting interim statements is the possibility of misinterpretation due to seasonal variations. Andrew Barr, Chief Accountant for the Securities and Exchange Commission, wrote:

At the behest of financial analysts and others, we started preparation in 1954 to request comments and suggestions from interested parties relative to reviving our interim reporting on a semi-annual basis. Unfavorable comments received covered a wide variety of subjects including the misleading effect that might be inferred because of seasonal variations, . . . ¹

Sales and profit information, over a period of time, may be subject to several types of variations. The seasonal variation is but one of four types that will be discussed in the early part of this chapter. The other variations are important contributing factors to the growth or decline of a company. It will be brought out later that in interim statements, seasonal variations tend to mislead, and by eliminating their effect, the statements would be improved.

An upward or downward trend, over a period of years, is referred to as a "secular trend." Throughout the life of a corporation this trend is very important. In most industries a corporation that does not have an upward trend is not obtaining its share of the market. Many factors enter into this trend. For some industries the growth in population is important. In others, such as the entertainment field, a trend toward the shorter work week results in a larger market potential. The reader of financial statements must be able to discern the trend for a particular company and compare it with the trend for the industry.

The second variation, to be considered here, is called a "periodic movement." A technical definition of periodic movements was given in Chapter II. In addition to seasonal variation, several other periodic movements are found in economic data. Intra-month movements are found in a commercial bank. Weekly or semi-monthly payrolls result in peak activity around the first and fifteenth of each month. Most of the known movements are within periods that are shorter than the seasonal variations and therefore they can be ignored for quarterly statements.

2Supra., p. 33.
"Cyclical movements" differ from periodic movements in that they are of longer duration, than a year, and they do not ordinarily exhibit regular periodicity. An economic recession and the following recovery are considered to be one of the cyclical movements. Investors must be aware of this type of change in the economic condition of the company and therefore the effects of such movements should not be removed from the data. The reason for a change in sales or net income as the result of a cyclical movement should be brought to the attention of the reader of financial statements by means of a footnote or in a letter from the president of the company which often accompanies the statement.

"Irregular movements" include strikes or other unusual conditions that have an immediate effect on the financial results of a company. These changes are also important to the financial analyst and should be explained in the same manner as cyclical movements.

Interim statements are prepared for a period that is too short to remove the effect of seasonal variations. Fluctuations in sales and other income items may be due entirely to the time of the year rather than to expanding sales effort. The reader of a quarterly statement might be misled into thinking that the company was increasing its
share of the market when the increase was due to the fact that sales for the industry, as a whole, were increasing.

In a given quarter the sales for an industry might increase by 20 per cent because the demand for their particular product normally increased during that period. A company that reported a 15 per cent increase in sales that quarter is actually falling behind its competitors. Conversely a decrease in sales for a particular company might lead the reader to conclude that the company is falling behind. The actual facts could be that by a more aggressive sales manager, the company sales did not fall as far as did the sales of the other companies in the industry.

The effect of seasonal fluctuations is reduced by presenting statements for longer periods of time. By definition the seasonal variation occurs within a year. Annual statements, therefore, do not contain seasonal variations. Each year contains periods of higher sales and periods of lower sales. When these periods are combined into a statement for a year the effect of individual periods is lost.

One word of caution is expressed by Roy A. Foulke:

To analyze the results of a season of business operations, an analyst should be able to view the season as a unit, to begin with causes and follow through the sequence of events to the effects. If annual financial statements are prepared as of any date other than at the end of a natural business year, they include the results of the latter portion of one season and the beginning of a subsequent
season. Under those conditions, it is difficult at times to obtain a clear picture of either period.\(^3\)

The natural business year, referred to above, is the twelve consecutive months ending at the lowest point of activity. A company that selects the natural business year as the end of its fiscal year has several advantages over other companies. Inventories are lowest at that point, and therefore, are more easily determined. More time can be devoted to the closing by employees who are normally engaged in other activities during the busy season. An example of a natural business year that is quite common is the January 31, closing for department stores. The Christmas season is past and all returned merchandise has been received. The January clearance sales are completed and the payables have been reduced. If instead of January 31, the department stores had used October 31, it is obvious that a different financial position would be presented to the owners. In analyzing the income statement, which is important to the investor, it would be necessary to determine the effect of the peak period that was nine months past at the date of the statement. Inventory valuation would have been difficult because of the substantial amount on

---

hand and the unknown effect of current market conditions. By selecting the natural business year the company has eliminated most of these problems.

Quarterly statements are improved if the end of the quarters fall at times other than the exact peaks and valleys of seasonal operations. This is an ideal to be strived for while it is granted that it may not always be possible.

Many companies have attempted to even out seasonal fluctuations by changing product lines. Furnace manufacturers have added air conditioners to pick up the slack periods. Oil companies sell more gasoline during the summer months than during the winter. Fuel oil sales pick up during the winter months to even out the sales for the year. Diversification of products permits the maximum utilization of the facilities throughout the year and increases the profits of the companies. A not too uncommon occurrence is described by an auditor of a company. He found that one quarter of the year was a loss quarter. He proposed a line of goods to improve that quarter and therefor increased profits.  

Reporting techniques that have been used in the past to reduce the effect of seasonal variations have followed two patterns. The first is to compare the results for the current period or periods with the same period or periods last year. The other is to compare the twelve months ending with the date of the interim report with the twelve months immediately preceding that.

The technique of reporting comparable quarters of each year is a step in the right direction. While it has the advantage of simplicity and is a statement that is easily understood, it does have certain disadvantages. If, for example, the second quarter of the current year is compared with the second quarter of the preceding year it is possible that the results might be misinterpreted. If the second quarter of the preceding year followed a strike or a period of recession the current year's sales might be less, not because of any fault of the present management, but because the sales for the second quarter of the preceding year were out of line with normal operations. Comparisons of this type result in a comparison between two quarters that are, theoretically at least of the same season but they may be in a different portion of cyclical pattern. Reports are improved if the statements are accompanied with a written explanation as to the reason why the results are different.
It should be noted that nothing has been said about comparing the current quarter with the quarter immediately preceding it. If the company has a seasonal pattern the sales and profits should not be compared with the preceding quarter. Such a comparison would have the advantage of comparing two quarters that are more nearly alike as to the phase of the cyclical pattern but they might be far different as far as the seasonal pattern is concerned.

The technique of comparing two twelve-month periods eliminates the seasonal effect, but again, a comparison is being made of two periods that might be in different phases of a cyclical pattern. This technique is praised as follows:

It was originally the accepted view that companies with a pronounced seasonal bias in their results should not publish interim figures, on the ground that these could be misleading. As we have seen, this prejudice has been almost entirely overcome in the matter of publishing quarterly sales. It is now assumed that the investing public will make due allowance for seasonal variations in interpreting the figures. The same sophistication could no doubt be counted upon in the use of interim profit figures. One method of overcoming the objection to seasonally unstable interim figures is by publication of successive twelve-month totals at quarterly intervals. This is a sound idea, but at this time it is practiced by only a few industrial concerns - e.g., Continental Can - although it is the general practice among utilities.

The authors assume that the investing public is able to make an allowance for seasonal variations. While financial information is freely given today, and probably understood by more individuals than ever before, it seems to be asking a lot of the reader to make an estimate of this type. The fact that few companies have adopted the twelve-month method reporting might be due to the fact that the current quarterly information would not be available or would be available only after a rather complicated computation.

The fact that these two methods are used in practice indicates that there is an awareness of the seasonal variation problems when reporting interim figures. The solutions that have been adopted are not completely satisfactory because the figures to which the current period or twelve-month period are compared may not be comparable because they may be in another portion of the cyclical pattern or secular trend. The longer the time period between periods to be compared, the more chance there is that the figures will not be comparable.

The ideal interim report would contain comparative figures for periods that are, in fact, comparable. In a situation where the seasonal fluctuations are not present the company could compare the results of the current quarter with the results of the preceding quarter. The effect of
cyclical movements and secular trend would be reduced over that of a comparison between the current quarter and the same quarter last year. The effect of irregular movements cannot be avoided. Where one quarter is effected by an irregular movement an explanation is required in the notes to the statement or in the written appraisal of the events since the last report. In the situation where the preceding quarter contained the effect of a strike or a shutdown due to a flood comparison could be made with a quarter that was not affected by an unusual situation. This flexibility is available for companies that do not have a seasonal pattern in their sales.

It is possible to revise the actual figures statistically so that a company with a seasonal pattern could obtain the same flexibility as a company without a seasonal pattern. This is referred to as deseasonalizing.

Not infrequently, however, it may be desired to study economic and business series adjusted only for seasonal variation. Thus businessmen, in making decisions, may consider not so much whether their sales are increasing (or decreasing) relative to a not-too-easily-visualized combination of trend and seasonal movements, but rather in relation to the ordinarily expected sales for the particular season of the year. It is of interest that many deseasonalized series appear in the Federal Reserve Bulletin, issued by the board of Governors of the Federal Reserve System, and in
the Survey of Current Business, published by the Office of Business Economics of the Department of Commerce.\(^6\)

As the authors pointed out, the seasonal factor is eliminated from information presented by many organizations that deal with national income statistics. This has become an accepted practice and the public is better informed by such a practice. Employment statistics would show an actual increase in unemployment in the summer months due to the increased number of students available for employment at that time. By deseasonalizing the actual figures the reader is able to determine, to what extent there was an increase, if there was an increase at all, over the expected unemployment figures for the summer months.

A common statement was made in the July 16, 1960 Business Week which analyzed retail sales, for the nation, as follows:

Sales of all types of retail establishments broke all the old records, either for a quarter or a half year.

The quarter just ended is estimated at \(\$56.1\)-billion, (on a seasonally adjusted basis). That was 3.2\% higher than last year's second quarter (which incidentally, was 1959's best quarter).\(^7\)


While the second quarter sales were compared with the same quarter of the preceding year, it would have been possible to compare the $56.1-billion with the seasonally adjusted figures of the first quarter. This constant referral to seasonally adjusted figures in business articles and statistics published by national organizations and in the local newspapers has made the public aware of the significance of the adjustment.

If business data were adjusted for seasonal variations, before they were presented to the stockholders, the investing public would not have to make due allowances for seasonal variations in interpreting the figures as was stated by two well-known authors. There are several other advantages, to the reader, in presenting deseasonalized figures. Comparisons may be made for consecutive quarters which cannot be done with actual figures. Relationships, such as the percentage change between quarters, remain the same if compared with the same quarter of a preceding year and the relationships are improved if a comparison is made with a quarter other than the same quarter of any year. In order to illustrate these points Table 12 was developed. Actual sales for the fourth quarter of each year are greater than any other quarter. Because that quarter is normally

8Graham & Dodd, loc. cit.
the best quarter (seasonal index of 122 is higher than the index for any other quarter), the seasonally adjusted figures indicate that the fourth quarter was one of the poorest. It is apparent that the relationship between the sales in 1959 and 1960 is the same after being deseasonalized as they were before. The relationship of one quarter to the previous quarter is changed. In each year there was a marked increase in actual sales in the fourth quarter over that of the third quarter. During the third quarter the sales held up much better in the two years than was expected based upon normal conditions of the past. The additional information that can be obtained from the deseasonalized sales represents an important contribution to the understanding of the business operations.

Several important assumptions are made when the seasonal index, computed on the basis of historical information, is used. The first assumption is that the sales mix in the current period is the same as it has been in the past. If the company added a product line, that has a different seasonal pattern than the other lines sold by the company, the seasonal index would have to be revised. A company would have to make a change in the index if they had traditionally sold heating equipment as the primary product and then added a line of air conditioning equipment. The second assumption is that the company, or industry, has
done nothing that would change the relationship between the seasons. The most common example of this is in the automotive industry. Not too many years ago the automobile companies displayed their new cars in January and February of each year. The industry, as a whole, changed this practice to the latter part of the year prior to the year in which the car is to be sold. The cars for the current year are now first displayed during September and October of the previous year. In this case, a substantial portion of the sales were shifted from the early part of the year to the last quarter of the preceding year. Again, this shift would require a change in the seasonal index. The examples given above are abrupt changes that would be apparent to the individual preparing the statement. There might be a gradual change that would not be as apparent. Under the first assumption, that the sales mix remained the same, it would be possible for the sales of a product that was once predominant to fall off and to be replaced by sales of another product with a different seasonal pattern. If this change was gradual there would be an effect on the seasonal index that would produce misleading results if the index had not been changed.
TABLE 12

ILLUSTRATION OF QUARTERLY SALES AND COMPUTATION OF DESEASONALIZED SALES

(Thousands of dollars)

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Seasonal Index</th>
<th>Actual Sales 1959</th>
<th>Actual Sales 1960</th>
<th>Deseasonalized Sales 1959</th>
<th>Deseasonalized Sales 1960</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>95</td>
<td>42.0</td>
<td>47.0</td>
<td>44.2</td>
<td>49.5</td>
</tr>
<tr>
<td>2</td>
<td>103</td>
<td>50.0</td>
<td>56.0</td>
<td>48.5</td>
<td>54.4</td>
</tr>
<tr>
<td>3</td>
<td>80</td>
<td>40.0</td>
<td>48.0</td>
<td>50.0</td>
<td>60.0</td>
</tr>
<tr>
<td>4</td>
<td>122</td>
<td>55.0</td>
<td>58.0</td>
<td>45.1</td>
<td>47.5</td>
</tr>
</tbody>
</table>

Data: hypothetical.

Industrial indexes may be quite different from the index for an individual company in the industry. If the company was an "average company" for that industry it would be possible for the indexes to be quite similar. If an index is prepared for an industry the company index should be compared with it and major differences, if any, should be explained. In deseasonalizing sales the company index, rather than the industry index, should be used.

Up to this point the discussion has been limited to the adjustment of actual sales by seasonal indexes in order to obtain a sales figure that is more meaningful in seasonal businesses. There are many other figures on the income statement that are subject to fluctuations because of the seasonal characteristics. All variable costs, to the extent
the costs are truly variable, will fluctuate with revenues. Fixed costs, on the other hand, will not be affected by volume changes. The method of deseasonalizing sales could be used to deseasonalize variable costs but there is some question as to whether it would be appropriate for fixed costs. There would be an advantage to reporting both sales and net income on a deseasonalized basis if a method could be developed to accomplish this. The advantage given for reporting deseasonalized sales would be equally applicable to net income.

There are two possible approaches to the determination of the interim net income that could be deseasonalized, either in part or in its entirety. The first approach would call for an accounting on a direct costing basis and deseasonalizing only those costs that relate to the product. In other words, the seasonal index would be used to adjust the variable costs only. Net income would then be determined, on a seasonally adjusted basis, by subtracting the direct costs (deseasonalized) from the sales (also deseasonalized) and then subtracting the fixed or indirect costs to arrive at a seasonally adjusted net income.

Table 13 is a hypothetical situation. Figures are presented for sales, variable and fixed costs, and the resulting net income. Since the fixed costs were allocated
to the quarterly periods on the basis of time periods, the percentage change in net income is considerably more than the percentage change in sales.

**TABLE 13**

**INCOME STATEMENTS WITH FIXED COSTS ALLOCATED ON THE BASIS OF TIME**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Sales</th>
<th>Variable Costs</th>
<th>Fixed Costs</th>
<th>Net Income or (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$95,000</td>
<td>$38,000</td>
<td>$45,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>20,000</td>
<td>45,000</td>
<td>(15,000)</td>
</tr>
<tr>
<td>3</td>
<td>85,000</td>
<td>34,000</td>
<td>45,000</td>
<td>6,000</td>
</tr>
<tr>
<td>4</td>
<td>130,000</td>
<td>52,000</td>
<td>45,000</td>
<td>33,000</td>
</tr>
<tr>
<td>Total</td>
<td>$360,000</td>
<td>$144,000</td>
<td>$180,000</td>
<td>$36,000</td>
</tr>
</tbody>
</table>

Data: Hypothetical.

Table 14 reflects the results of deseasonalizing sales and variable costs. It is assumed that the seasonal index for this company is exactly the same as would be obtained if this year had been the only year used in arriving at the index.
TABLE 14
DESEASONALIZED SALES AND VARIABLE COSTS WITH ACTUAL FIXED COSTS ALLOCATED ON THE BASIS OF TIME

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Sales</th>
<th>Variable Costs</th>
<th>Fixed Costs</th>
<th>Net Income or (Loss)</th>
<th>Seasonal Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$90,000</td>
<td>$36,000</td>
<td>$45,000</td>
<td>$9,000</td>
<td>105.56</td>
</tr>
<tr>
<td>2</td>
<td>90,000</td>
<td>36,000</td>
<td>45,000</td>
<td>9,000</td>
<td>55.56</td>
</tr>
<tr>
<td>3</td>
<td>90,000</td>
<td>36,000</td>
<td>45,000</td>
<td>9,000</td>
<td>94.44</td>
</tr>
<tr>
<td>4</td>
<td>90,000</td>
<td>36,000</td>
<td>45,000</td>
<td>9,000</td>
<td>144.44</td>
</tr>
<tr>
<td>Total</td>
<td>$360,000</td>
<td>$144,000</td>
<td>$180,000</td>
<td>$36,000</td>
<td>400.00</td>
</tr>
</tbody>
</table>

Data from Table 13.

The other method allocates all costs to the period on the basis of sales volume. A predetermined rate is established including both fixed and variable costs. This rate is used to allocate the costs to the income statement. Fixed costs are absorbed to a greater extent in periods of larger volume than in periods of lower volume. Deseasonalizing net income, in this case, can be accomplished on the same basis as deseasonalizing sales. The same index would be used for sales and net income. The effect of accounting for costs in this manner is to increase profits, or reduce losses, during periods of reduced sales. In some
businesses sales are below the break-even point during certain seasons of the year. Fixed costs are deferred in those seasons to seasons of higher sales. Under this method fixed costs are absorbed in periods on the basis of the ability of that period to absorb the costs. This system was used in practice by a seasonal business and the accounting techniques were described in an issue of the N.A.A. Bulletin.9

For the purposes of interim statements of seasonal businesses this second approach to the problem of fixed costs appears to be a reasonable solution. It does aid in the problem of adjusting net income for seasonal variations. Unless fixed costs are accounted for in this manner the seasonal index cannot be applied to net income.

Table 15 includes the income statement information that would result from accounting for fixed costs on the basis of sales rather than on time periods.

If this method of accounting is used, the seasonal index that was used in Table 13 can be applied to the net income for each quarter. Deseasonalizing the net income for each quarter, under this method, results in net income of $9,000 each quarter.

If seasonally adjusted sales and net income are reported for four consecutive quarters the sum of either the adjusted sales or the net income will not necessarily equal the total of the actual sales or net income for the same period of time. The amount of the difference will depend upon the direction of the change in the actual figures and the seasons of the year in which these changes occur. While this difference may be disturbing to some, it appears that the advantage of increased comparability outweighs the disadvantage of not balancing.

A common practice is to report the percentage increase or decrease in sales of a quarter over that of the same quarter of the preceding year. This is subject to the same criticisms as reporting the actual figures for those periods. An increase of ten per cent might be due to the fact that last year's sales were low because of economic conditions at that time. While the increase is impressive the reader should not be misled into believing that the company has made an impressive sales effort during the current year. One possible solution to the problem was given above. De-seasonalizing sales will accomplish this if the adjusted sales are compared with a period that is, in fact, comparable economically. The percentage change between this quarter and the same quarter last year would be the same for the actual figures as it would be for the adjusted figures.
Deseasonalizing is a solution to the problem in that it is not necessary to compare figures that are separated by almost a year.

Instead of computing a percentage increase or decrease for the current quarter compared with the same quarter of the preceding year it would be possible to make the comparison with a figure that would represent "normal sales" for that quarter. In computing the "normal sales" all periods in which the sales were abnormal should be eliminated. Abnormal periods are eliminated when a seasonal index is computed so that this process is not unusual. The comparison between the sales of the current period and the "normal sales" produces a percentage that might be referred to as an "index of performance," or "level of activity index." This index eliminates the criticism that was made against the comparison of actual figures for the current period with the same period of the previous year. The index may be compared from one period to the next without serious effect.

In summary, statistical techniques provide a solution to the interim reporting problem of seasonal variations. After deseasonalizing income statements for several periods of time comparisons may be made that could not be made before. If the information is deseasonalized it is possible
### TABLE 15

**INCOME STATEMENTS WITH FIXED COSTS ALLOCATED ON THE BASIS OF SALES**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Sales</th>
<th>Variable Costs</th>
<th>Fixed Costs</th>
<th>Net Income or (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$95,000</td>
<td>$38,000</td>
<td>$47,500</td>
<td>$9,500</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>20,000</td>
<td>25,000</td>
<td>5,000</td>
</tr>
<tr>
<td>3</td>
<td>85,000</td>
<td>34,000</td>
<td>42,500</td>
<td>8,500</td>
</tr>
<tr>
<td>4</td>
<td>130,000</td>
<td>52,000</td>
<td>65,000</td>
<td>13,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$360,000</strong></td>
<td><strong>$144,000</strong></td>
<td><strong>$180,000</strong></td>
<td><strong>$36,000</strong></td>
</tr>
</tbody>
</table>

Data from Table 13.

This method produces the same deseasonalized net income as did the other method (Table 14) because the sales for each quarter were in exactly the same relationship to the other quarters as was the seasonal index. In an actual situation the results would vary slightly between the two methods of accounting. When the fixed costs are allocated to the various quarters on the basis of sales the process of deseasonalizing net income is less complicated.
to compare a calendar quarter with the preceding quarter. A comparison of two consecutive periods with normal operating results is usually a better comparison than a comparison of two periods that are farther apart. The two consecutive periods are more likely to be in the same portion of a cyclical trend than if the periods being compared were a year apart.
CHAPTER V
COMPARATIVE STATEMENTS AND CORPORATE ACQUISITIONS

The practice of sending stockholders financial information, in comparative form, is well established. The extent to which this has been followed in interim reporting practices was demonstrated by the results received from the questionnaire. Practically all of the controllers, responding to the questionnaire, indicated that their corporations sent comparative information each quarter.\(^1\) The fact that such a high percentage of statements are presented in comparative form indicates that the companies presenting the statements, at least, consider a comparison to be helpful.

A question arises as to whether or not consolidated statements are comparable when a company acquires a new subsidiary and the prior years' statements are not adjusted to include the operating results of the new subsidiary. The results of the questionnaire disclosed that out of seventy-one answering the question thirty-six controllers would adjust the statement for the prior year and thirty-five would

\(^1\text{Supra, pp. 44-46.}\)
not. The controllers, who would not make an adjustment, would include the sales and other operating information for the new acquisition in the current income statement. This would be compared with the income statement for the preceding year that does not include the sales and other operating information for the new acquisition.

The second quarter interim report of the Gardner-Denver Company and Subsidiaries contains the following comment by the president.

The Apex Machine & Tool Company joined Gardner-Denver on April 1, 1960 through issuance of 156,000 shares of Gardner-Denver common stock for all outstanding stock of Apex. Operations of Apex are included retroactively to January 1, 1960. In accordance with past policy, we have not adjusted previously reported financial data to reflect inclusion of Apex. Therefore, the 1960 figures are not strictly comparable with those of 1959.

In addition to the above comment in the interim report, information was given so that the reader could remove certain of the data from the current figures to make them comparable. In this case the company furnishes sufficient information to enable the reader to prepare comparable statements. At the close of the third quarter Gardner-

---

2 Supra, p. 52.

3 First Quarter Report to Stockholders-1960, Gardner-Denver Company and Subsidiaries.
Denver Company issued a press release that contained the following statement:

G. V. Leece, president, today reported sales totalling $63,239,318 for the first three quarters of the year. This is an increase of nearly 12 per cent over last year's record sales of $55,672,973 for the corresponding period. He said these figures are not strictly comparable because the 1960 total includes approximately $3 3/4 million sales by Apex Machine & Tool Company which joined the Gardner-Denver group in April of this year.4

While the statement was made that the figures were not comparable, the company did point out that the sales increased by nearly 12 per cent. Press releases are not always used in their entirety and the newsman might leave out the important sentence about the lack of comparability. If the sales of Apex were removed, the percentage increase would have been 6.4 per cent instead of nearly 12 per cent as reported to the press.

The semi-annual report of Adams-Millis Corporation contained the following note to comparative earnings information:

Although the above comparison indicates an increase of 68% in net earnings for the period, it should be noted that a contributing factor was the acquisition in 1960 of all remaining shares of your

subsidiary, MAC Panel Company. Adams-Millis had previously held 57% of MAC Panel's stock.5

This comment does not contain sufficient information so that the reader can understand the effect of the acquisition or the results of the operations on a comparable basis. A footnote to the operating results contains a statement that the earnings for the previous year excludes the amounts applicable to minority interests. If the amount of the minority interests for that year had been given the reader could have compared the results for the two years.

The first quarter report of The Ohio Oil Company for 1960 contains the following information:

Our operations in the first quarter of 1960 resulted in net profits of $10,279,000 compared to $10,198,000 earned in the similar period last year. The 1960 earnings include those of the Aurora Gasoline Company, the stock of which was acquired in the third quarter of 1959.6

Again, this comparison is made when the figures are not exactly comparable. Neither the 1960 results nor the 1959 results are given for the new company and, therefore, it is impossible to measure the magnitude of non-comparability. The second quarter report contains comparative statements for the year-to-date only. In this six month


6Interim Report to Shareholders for the first three months of 1960 The Ohio Oil Company, Findlay, Ohio.
report the new company is not mentioned. If this second report is prepared on the same basis as was the first report the six month figures are not comparable. The new subsidiary was acquired in the third quarter of the preceding year and an adjustment would have been required in order to make the statements comparable.

National Distillers and Chemical Corporation reported to their stockholders, at the end of the second quarter of 1960, an increase in the investment in a company from a one-third interest to a sixty per cent interest. The financial information, included in the report is not placed on a comparable basis. An adjustment was made at the time the new stock was acquired, to place the assets at "realistic values." This resulted in a write-down that reduced the earned surplus of National Distillers. At the same time earned surplus was reduced by the parent company's portion of losses of the subsidiary for the last two years. The note contains the statement that the new subsidiary has operated at a profit since acquisition of the new stock and that they expect profitable operations to continue. The magnitude of the sales and profits were not disclosed.7

7Interim Report, National Distillers and Chemical Corporation and Subsidiary Companies, Second Quarter - 1960.
There are many examples of subsidiary acquisition where the prior year statements have been adjusted so that the statements will be comparable. Federated Department Stores, Inc. includes the following footnote to their six month report in 1960:

. . . Figures for periods prior to the current quarter are as previously reported to the shareholders, except that all have been revised to include Rike-Kumler, which became a division on October 3, 1959, and whose figures have been combined retroactively with those of the Company in accordance with the "pooling of interests" concept of accounting. Goldsmith's became a division on August 1, 1959 and is included only from that date.

Federated Department Stores acquired two new operations during the period covered by this report. One was considered to have been acquired in accordance with the accounting definition of a pooling of interests. The other was acquired by purchasing the stock. The accountant for Federated has implied from the accounting literature that there is a difference between the two methods of acquisition when it comes to the presentation of comparative income statements. The latter part of this chapter will be devoted to a comparison of the two types of acquisition and the differences, if any, that should be made in reporting comparative financial statements.

May Department Stores Company adjusted the financial statements of the preceding year for the acquisition of another company. Boeing Airplane Company made the following comment in their first quarter report of 1960. "For comparative purposes, the 1959 amounts have been adjusted to give effect to the acquisition of Vertol."  

Commercial Solvents Corporation disposed of a segment of its operations during the year. 

Sales for the quarter were $14,468,349, as compared with $19,348,071 a year ago, reflecting the sale of the Company's automotive chemicals marketing operations earlier this year.  

It is implied that the nearly five million decrease in sales, between the two periods, was due entirely to that act. If the amount of sales by that division for the preceding year had been given the reader could have determined the actual growth or decline in sales of the remainder of the operation.  

Interim reports are the basis for disclosure of major changes in corporate organization that occur during the year. A sample of typical footnotes and comments were

---


included above. This information ranges from a complete
description and adjustment of financial information to make
it comparable, to vague references with a comparison of non-
comparable financial information. The following statement
was included in the six month report of Phillips Petroleum
Company:

As reported to the Securities and Exchange
Commission in May, Phillips has invested in the
common stock of Union Oil Company of California.
The Company owns 1,182,800 shares of this stock.12

This type of information cannot help but raise more
questions in the minds of the reader than it answers. If
the ownership of that number of shares constitutes more
than fifty per cent of the outstanding shares Phillips
would have actual control of the Union Oil Company. In
practice a company is able to control another company with
much less than a fifty per cent interest if the remaining
shares are widely held. In order to determine the actual
relationship between the two companies the reader would
have to determine the percentage of ownership. The reader
is not given the reason for the acquisition which has a
bearing on the future earnings and financial position of
the acquiring corporation.

12Report to Stockholders First Six Months of 1960,
Phillips Petroleum Company.
Eric Kohler defines a business combination as follows:

The bringing together of two or more business entities, usually corporations, into one, accomplished by transferring the net assets of one or more of the entities to another of them (a merger) or to a new one created for that purpose (a consolidation). Either action may, in effect, be a purchase, with one or more groups of stockholders retiring, or a pooling of interests may occur in which the stockholders of all the participants share.¹³

When consolidated financial statements are prepared, the end result is the same whether the combination is handled as a merger or as a subsidiary company. A merger is possible only when 100 per cent of the outstanding stock is acquired. A subsidiary company can be established with either a 100 per cent ownership or with a minority interest in existence. The form of the new acquisition is not important to the problem at hand. Accountants have developed different techniques on the basis of the resulting ownership of the new entity or entities. In Chapter III this problem was introduced because of the inconsistent reporting practices brought out by the questionnaire.¹⁴

An interim reporting problem has emerged as a result of subsidiary acquisitions being considered either an outright purchase or a pooling of interests. This problem

¹⁴Supra, pp. 51-55.
relates to the presentation of comparative earnings statements, and in particular, the adjustment of prior statements to include the operating statements of the new acquisition. When the owners of the acquired corporation do not participate in the ownership of the enlarged entity, or entities, a purchase is said to have been made. In that case the assets acquired are valued at current prices and then the book value may be ignored. Earnings retained in the business are not carried forward as part of the new ownership equity. When the owners of the predecessor corporation receive stock in the new corporation in substantially the same proportion to what they held before, the acquisition is said to be a pooling of interests. The assets, liabilities, and equity items would be brought onto the books of the new entity or entities on the same basis as they had been carried by the acquired corporation.

Retained earnings of each of the predecessor corporations are brought onto the statements of the enlarged group in a pooling of interests. The fact that the operations continue to exist instead of the combination signaling the end of one operation and the beginning of another gives the logic to the adjustment of prior statements, in the case of the pooling of interests and the presentation of operating statements on a different basis for an outright purchase.
Accountants have interpreted the pronouncements on this subject in such a way that comparative income statements are usually not comparable. When the acquisition is considered to be a purchase the statements are never adjusted to include the new operation in periods that did not include that operation. When there is a pooling of interests, on the other hand, the accountants are inconsistent. In certain instances the statements are adjusted to include the new acquisition as though it had been a part of the group for the entire period. In other instances the pooling of interests is handled on the financial statements in the same manner as an outright purchase. The question that is to be considered here, is, are the two situations so different that they call for a different presentation when comparative operating statements are given?

Comparative statements provide a reader with a standard on which to judge the current operations. Without something by which to relate the current operations and status the reader cannot determine the progress a company has made. Unusual economic conditions that caused a particular figure to be out of line with normal conditions should be accurately brought to the attention of the reader. In the case at hand, there is a change between periods, that is not in the ordinary course of business yet it is not the result of economic conditions beyond the control of
management. The reader should be able to expect that an increase in sales, for example, is the result of an increased sales effort. Sales of the newly acquired corporation will increase sales of the new entity for one year without the possibility of a similar increase the following year. If a corporation, on the East Coast, wants to expand its operation to the West Coast there are two methods available to it. By hiring new salesmen and supervising an expansion into a new territory, the corporation through its own efforts, can increase sales. On the other hand, it would be possible to find a corporation that had been operating on the West Coast, for years, with a long list of customers and by acquiring that company distribute the parent company's product. In either case the sales in the first year will probably increase more than in the following year. When an already existing company is acquired the sales will increase, the first year, by the amount of the annual sales of the new company. The following year sales will probably not increase as much.

The method of financing the two types of expansion will probably be different. Normal expansion will be financed either internally or through borrowing. An outright purchase of an existing corporation could be by one of these methods or through the issuance of stock. A pooling of
interests by its very nature must be financed through the issuance of stock. If the new operation is acquired through the issuance of stock the net income per share will not change materially from one year to the next. This assumes that the number of shares distributed is in line with the current operations of the acquired company, and it will be true even though the statements for the previous year are not adjusted to include the new company. The corporations that adjust the statements for the prior year also adjust the shares outstanding at the end of that year to include the number of shares issued in connection with the acquisition of the company. While it is implied from the above that the net income per share will not be materially distorted even though the statements are not comparable the individual items within the statement will reflect increases or decreases, between years that will not be duplicated the following year.

Accountants are urged to present comparative statements that are actually comparable in accordance with the authoritative statement as follows:

The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise. Such presentation emphasizes the fact that statements for a series of periods are more significant than those for a
single period and that accounts for one period are but an installment of what is essentially a continuous history. . . .

It is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out.15

The above quotation was taken from a restatement and revision of the Accounting Research Bulletins published in 1953. The original pronouncement of the advantages of comparative statements was published over twenty years ago.16

The second paragraph of the above quotation directs the accountant to footnote any exception to comparability. This is usually done by stating that the new subsidiary is included in the statements for the current period only. While this does put the reader on notice that the statements are not comparable, it does not facilitate his analysis which is one of the objectives of financial reporting in the first place.

In order to present comparative interim statements


that are in fact comparable when a subsidiary has been acquired the following recommendations are made:

1. Financial information for every period in the report should include the new acquisition. Financial statements for all periods prior to the date of acquisition should be adjusted to include the new company as though it were a part of the operation for the entire time covered by the report.

2. If the above is not practicable sufficient information should be given so that the financial information for the new acquisition can be removed from the current period and thereby make it possible to produce comparable statements.
CHAPTER VI

UNUSUAL AND NONRECURRING TRANSACTIONS AND NON-PERIOD ADJUSTMENTS

For many years accountants have stressed that the annual net income for a corporation is only an installment in the overall record of economic development of that company. Quarterly statements should be considered as a subdivision of each annual installment.

In 1941 the American Institute of Certified Public Accountants' Committee on Accounting Procedure made the following statement:

There is a marked tendency to exaggerate the significance of the net income for a single year, and particularly the degree to which the net income can be exclusively identified with that one year.¹

The accounting profession recognizes the annual net income figure as the best possible estimate of operating results, the accuracy of which can only be determined at a later date. The dangers inherent in interim statements for periods shorter than a year in length are also well known to accountants. The emphasis that is placed on

interim net income figures in the quarterly reports to stockholders, by management and financial writers in the press, gives the impression of exactness to the reader.

Many of the interim reports contain a comment that is similar to the following:

This balance sheet and profit and loss statement have been prepared from the books of account for the period covered and are subject to adjustment by independent public accountants at the end of the year.2

Income reported in this quarterly statement is necessarily based in part on approximation, and is subject to adjustments that may develop in the course of the year and in connection with the annual audit of the accounts for the full year of 1960.3

The reader is warned of year-end audit adjustments that might apply to the current period. Even though this gives the impression of an approximation, or estimation, of the interim net income the analysis of the operations include a comparison of earnings per share as though it was an exact amount. Corporate officers point with pride to any increase in the per share earnings from one year to the next. Quarterly earnings are reported in the press, as though they were exact measurements without any indication of possible adjustments.

2Interim Report for the 6 months ended June 30, 1960, Mead Johnson.

3The U.S. Steel Quarterly, United States Steel Corporation, May, 1960.
Newspapers often publish only the net income and the net income per share figures for an interim period. In one issue of a newspaper, interim reports of sixty-seven companies were summarized. One of the companies listed was Commercial Solvent Corporation. The newspaper reported the net earnings for six months of 1960 of $2,618,178 compared with $1,367,312 for the same period of 1959. On a per share basis the 1960 earnings were 93¢ compared with 49¢ for 1959. The reader would be somewhat less impressed if he could refer to the interim report. In 1959 the company recorded a "special charge" that reduced earnings by approximately 13¢ a share. The interim report contains the following note: "This statement has not been examined by independent certified public accountants." Investment decisions are often made on the basis of less information than that obtained from a newspaper. Local press reports can be quite misleading, especially when they print less information than is shown in the interim reports.

Inconsistent treatment of unusual and nonrecurring transactions in financial statements results in earnings per share figures that are not comparable. There are two concepts of net income that provide different methods of reporting unusual and nonrecurring items. The two concepts

are referred to as the "current operating performance" concept and the "all-inclusive" concept. Unusual and non-recurring items are excluded from the income statement under the "current operating performance" concept and included in the income statement, after the net income for the period, under the "all-inclusive" concept.

Accountants are to select one of the concepts, for the corporation, and apply that concept consistently. In that way the net income and net income per share figures will be comparable, between years, even though not necessarily comparable with other companies.

Armour and Company presented its semi-annual interim report for 1960 under the "all-inclusive" concept and compared it with the 1959 report that was prepared in accordance with the "current operating performance" concept. The following statement is taken from that report:

Armour and Company earned $7,057,352, or $1.35 a share, in the six months ended April 30, 1960. This compares with $4,525,866, or $0.88 a share, in the same period in 1959 and represents an improvement of over fifty percent. In addition, in the current year, a nonrecurring profit was realized on the sale of South American real estate of $1,965,074, or $0.38 a share; thus, total operating and nonrecurring profits were $9,022,426, or $1.73 a share.5

The profit on the sale of South American real estate was included in the income statement and included in what the company refers to as "total profits." The company failed to point out an "extraordinary charge in connection with replacement and relocation of facilities" during the same period of 1959 that amounted to 29¢ a share and would reduce the reported profits, for 1959 from 88¢ a share to 59¢ a share. In this case a favorable transaction was included in the income statement, while an unfavorable transaction was excluded.

The presentation of unusual and nonrecurring transactions in annual statements, has been a problem for many years. In interim statements the problem is even more acute. An unusual item that might not be as material in a twelve month statement could be quite material to the earnings for a three month statement. In presenting unusual and nonrecurring items in annual statements the American Institute of Certified Public Accountants makes the following recommendation:

...... it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption relates to items which in the aggregate are material in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations such as the following may be excluded from the determination of net income for the year, and they
should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:

(a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;

(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;

(c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes, and similar calamities or catastrophes except where such losses are a recurrent hazard of the business;

(d) The write-off of a material amount of intangibles;

(e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of the debts before maturity.

Even though the committee expressed an opinion it left the decision to the accountant. Accountants have been unable to agree on just what is material. This accounts, in part, for the inconsistent treatment of unusual and non-recurring items in annual reports.

Another problem that confronts the accountants was included in the questionnaire. The controllers were asked to indicate how they would present a material adjustment that was discovered in the second quarter of the year when it pertained to the profits of the first quarter. Of the

---

eighty-five answers received, fifty-three would include the item in the determination of profit for the second quarter. Seventeen would show the item in the year-to-date column, thereby excluding it from the second quarter net income. This is a case of a non-period adjustment that applies to the same fiscal period as the quarter in which it was discovered. By including the adjustment in the second quarter the four individual quarters will add up to the net income for the year. If the adjustment was included in the year-to-date column that would not be the case.

A somewhat different problem is encountered when an adjustment is made that applies to a fiscal year other than the one in which it is discovered. This is similar to the unusual and nonrecurring transaction of a profit or loss on the sale of a fixed asset. In this case the accountant may exclude it from the income statement if the amount is material because it would tend to distort net income or loss for the period.

Two examples are given below, to indicate different approaches to the same problem:

Earnings for nine months of 1959 include $3,557,000 resulting from (1) nonrecurring profit of $7,857,000 after provision for income taxes, realized from the sale of partial interests in

7**Supra**, p. 50.
certain oil and gas leases, and (2) an increase of $4,300,000 in provision for Federal income taxes due to changing accounting policy to record taxes deferred by using declining-balance depreciation in the determination of taxable income.

Excluding gains, net after taxes: in 1960 $5,155,300 ($0.95 per share of common stock) from sale of 20,375 shares (6.25%) of Southern Peru Copper Corp. stock; in 1959 $15,601,400 ($2.90 per share of common stock) from sale of Garfield Smelter and Cerro de Pasco Corp. stock.

There was a difference in the magnitude of the transactions. In the first case the net change in profits amounted to a little better than 17 per cent, while, in the other case, profits in 1960 would have been increased by 31 per cent. It would be impossible to determine whether or not materiality was the reason for making the decision to exclude the unusual items from the income statement.

Finney and Miller in their textbook conclude a discussion on this subject with the following statement:

Accountants have not yet arrived at a unanimity of opinion with respect to these conflicting concepts of net income. Differences exist in practice. The American Accounting Association, in its official publications, has taken a strong position in favor of the clean surplus concept (all-inclusive concept). The Committee on Accounting Procedure of The American Accounting Association, in its official publications, has taken a strong position in favor of the clean surplus concept (all-inclusive concept).

---


9 Earnings Statement for the nine months ended September 30, 1960, American Smelting and Refining Company.
American Institute of Certified Public Accountants has taken a somewhat modified position. The problem of presenting unusual and nonrecurring transactions in interim statements is made more difficult because the members of the profession have not agreed on procedures for the annual statements.

There is one practice that is accepted as being desirable. No matter how the unusual and nonrecurring items are treated, the net income for the year should be set out separately and labeled. Under the current operating performance concept the net income for the year would be the final figure on the income statement. Under the all-inclusive concept the net income for the year is followed by the unusual and nonrecurring items. If the net income per share was computed by dividing the number of shares into the net income for the period it would be possible to compare the per share results of several companies as well as to make a comparison between years for the same company. This practice would provide the reader with historical information on nonrecurring items, and normal operating conditions rather than a comparison of two figures that are not in fact comparable.

Interim reports as progress reports during the year should be presented in the same form as the year-end statement. If a company has adopted the current operating performance concept of reporting at year-end, that concept should be followed in its interim reports.

When the current operating performance concept is used for year-end statements, unusual and nonrecurring items are included in the statement of changes in retained earnings (earned surplus statement). In interim reports income information is presented while the statement of changes in retained earnings is usually omitted. If an unusual or nonrecurring item occurs during an interim period a footnote is required. When the retained earnings statement is not included in the interim report the footnote should be worded in such a way as to indicate that the unusual and nonrecurring item has not been included in the income statement. The footnote should include the amount per share in addition to the nature of the item and the amount.

If the all-inclusive concept is used for the year-end statements, the unusual and nonrecurring items will appear in the income statement after the net income for the period. The per share effect of the unusual and nonrecurring items should be included in a footnote instead of showing the computation on the income statement. This is recommended in
order to avoid combining the per share figure for the net income for the period with the per share amount of the unusual and nonrecurring items.

The American Institute of Certified Public Accountants Committee on Accounting Procedure issued a statement that dealt with "earnings per share." The committee came to several conclusions as follows:

(a) It is, in many cases, undesirable to give major prominence to a single figure of earnings per share;
(b) Any computation of earnings per share for a given period should be related to the amount designated in the income statement as net income for such period; and
(c) Where material extraordinary charges or credits have been excluded from the determination of net income, the per share amount of such charges and credits should be reported separately and simultaneously.\(^{11}\)

While it may be "undesirable to give major prominence to a single figure of earnings per share" every corporation publishes the figure, investment advisors use it, and the investing public seems to require a measure of performance that is in terms they can understand. While the accountant dislikes the use of a single measure, the fact remains, individuals who use accounting information consider it to be useful. By placing data on a per share basis the data become meaningful to the average investor. In order to

impress the small investor with the amount the corporation pays in taxes, many corporations present a figure of tax expense per share in the annual report. For the year ended December 31, 1959, General Electric reported to its stockholders, that the net earnings per share were $3.19 per share, dividends per share were $2.00 and that Federal and Canadian income taxes were $3.09 per share. These figures are much more meaningful than the hundreds of millions of dollars that appear in the income statement for each item.

The interim report of the American Chicle Company, for the nine months ended September 30, 1960, contained a per share column for each time period covered by the report. The third quarter of 1960 was compared with the same period of 1959, and the first nine months of 1960 were compared with the first nine months of 1959. Each statement contained five lines: profit before income taxes; U. S. and Foreign taxes on income; profit after income taxes; dividends from subsidiaries not consolidated; and net income. From the standpoint of analysis, this abbreviated report omits a substantial amount of useful information.

---

From the standpoint of the small investor, the per share information is far more useful and understandable than the actual amounts.

A non-accountant does not appreciate the difference between earnings after unusual and nonrecurring items and net earnings from operations. For this reason the profession should attempt to standardize the reporting practices, for both interim and year-end statements, so that all companies will report earnings per share based on earnings from operations. The effect of unusual and nonrecurring items on the per share figure should be presented, in a footnote, and not added to, or subtracted from the earnings per share from operations. When dividends are increased or decreased because of unusual and nonrecurring items the dividend notice and subsequent financial statements should disclose that fact.

The proponents of the all-inclusive concept argue that, in the long run, the unusual and nonrecurring items do pertain to earnings and should therefore be shown in the income statement. They would also contend that, in the long run, the effect of these items should be included in the per share computations. These are undeniable facts. It is also true that the interim reports, as well as the year-end
statements, are short run analyses and that material items that pertain to periods other than the one at hand should be excluded.

Another variable that must be considered when earnings per share are computed is the number of shares that are to be used. On this matter the Committee on Accounting Procedure has prescribed several procedures that should be followed.

Earnings per share, and particularly comparative statistics covering a period of years, should generally be stated in terms of the common stock position as it existed in the years to which the statistics relate, unless it is clear that the growth or decline of earnings will be more fairly presented, as for example, in the case of a stock split, by dividing prior years' earnings by the current equivalent of the number of shares then outstanding.

In all cases in which there have been significant changes in stock during the period to which the computations relate, an appropriate explanation of the method used should accompany the presentation of earnings per share.\(^\text{14}\)

The rules adopted by the Committee provide the accountant with a basis for determining the number of shares that should be used in a variety of situations. Alternatives are available if the accountant believes that a more accurate per share figure will result. In complex situations the Committee recommends that a footnote accompany

the statement to explain exactly what happened and the basis on which the computation was made.

The situation that occurred in the first quarter of 1960 for The Ohio Oil Company happens occasionally. The net income for the first quarter of 1960 increased slightly over what it had been during the first quarter of 1959. The shares of common stock outstanding also increased. As a result, the earnings per share were less in the first quarter of 1960 than they had been in the first quarter of 1959.¹⁵

The Committee has recommended that the earnings per share for each year, in a comparative statement, should not be changed unless the current conditions are materially different from what they were when the statement for that year was presented originally.¹⁶ A stock dividend, stock split or reverse split would result in a material change in the shares outstanding. In computing earnings per share, all shares outstanding at the end of periods prior to the period in which the dividend or split occurred must be adjusted to reflect stock dividends or stock splits.

A company that issues shares frequently for new acquisitions or under stock option plans might find that the

¹⁵Interim Report to Shareholders, for the first 3 months of 1960, The Ohio Oil Company.

¹⁶American Institute of Certified Public Accountants, loc. cit., p. 80.
number of shares were materially different at the time the report is issued compared to what they were five to ten years ago. When comparative figures are presented for a period of years the accountant may adjust the earnings per share figures for the prior periods. In this case the number of shares outstanding at the close of the current interim period might give the best results.

Year-end adjustments present a problem to the accountant. There are several methods of reporting adjustments of this type. Of the eighty-one answers to the questionnaire about the method of reporting year-end adjustments to stockholders, thirty-two indicated that they did not report the adjustments and forty-nine indicated that they did report the adjustments to the stockholders. Of those reporting the adjustments to their stockholders all but one used the annual report. The other company sent a fourth quarter report to its stockholders. Every attempt should be made to keep year-end adjustments to a minimum. When they are material they should be reported. The advantage of using a fourth quarter report, over that of the annual report, is that the quarterly report would be mailed to the same individuals who receive the other quarterly reports.

17Supra, p. 51.
In addition to the problem of how to notify the readers of the quarterly reports sent that year, the accountant has the problem of how to treat the year-end adjustments the following year. At that time a comparison will be made with the previous year. There are two methods available. First, the adjustments can be apportioned to the periods affected or, secondly they could be left in the fourth quarter. Mercantile Stores Company, Inc. adjusted the statements for each quarter as follows:

The earnings for last year have been restated to reflect the change in handling depreciation which was made at the end of last year. The earnings per share for 1959 were stated at 23 cents in the quarterly report issued a year ago — instead of the 30 cents shown above.18

In this case the adjustment was made to an item that could be readily identified with a specific quarter or quarters. If an adjustment is made to the inventories it would be extremely difficult to determine which quarter, or quarters had been incorrectly stated. To the extent that year-end adjustments can be identified with a particular period of time, adjustments should be recorded so that future comparisons can be made with the best possible information. Depending upon the item, a proration might be made on the basis of the length of time covered by the

18 Three months Earnings Statement, Mercantile Stores Company, Inc. to April 30, 1960.
report. Every attempt should be made to reduce the effect of year-end adjustments on the fourth quarter unless, of course, they apply to that quarter.

It is beyond the scope of this study to question specific accounting principles that are used in determining annual net income. When interim reports are used as the reporting medium for unusual transactions or adjustments this practice falls within the scope of this study and should be considered here.

On September 22, 1960 the General Dynamics Corporation issued a special report to its share owners. This report was in advance of the nine month interim report. It describes the adjustments that were to be made at the end of the third quarter. The board of directors authorized a write-off of nearly 100 million dollars. More important than the amount is the nature of the costs that were charged to that period. "Future research and development expenses; excess of manufacturing costs over proceeds from sales; and write-down to salvage value of used aircraft acquired in connection with sales of jet transports" were the items included in the write-off.19 Several comments by

---

19A Special Report to Share Owners, General Dynamics Corporation, September 22, 1960, p. 2.
Mr. Frank Pace, Jr., Chairman of the Board of Directors, are given below:

Because of this substantial charge against earnings, the Corporation will report a net loss for the nine months ended September 30, 1960 of approximately $26 million. However, with the excess costs of the 880/660 program behind us, the fourth quarter will show profits which will materially reduce this loss.

With these extraordinary costs out of the way, the profitable results of the Corporation's total operations will show more clearly.20

Mr. Pace comments about the future as follows:

Having taken this action, we have placed ourselves in an affirmative position for future growth. We have a substantial backlog that insures larger sales over the next several years which should yield profits unaffected by commercial jet aircraft write-offs.21

The reader is given the impression that without the write-off the company would not grow. By this write-off management has improved the growth potential of the company. To the average investor these statements are very important. Management has taken steps to insure the continued support of the stock on the market and has even improved the growth possibilities. To anyone with a knowledge of business, and in particular accounting, it is obvious that the growth will be the same with or without, the write-off. It is unfortunate that this type of reporting

20 Ibid.
21 Ibid., p. 3.
exists. If interim statements contain false and misleading comments it will only be a matter of time before the government will institute controls to protect the investing public.

Lockheed Aircraft Corporation is another company that used interim reports to disclose substantial write-offs during 1960. In a letter to the stockholders the officers of the corporation reported:

This letter is intended to bring you up to date on developments in the company during the first six months of 1960 and especially to explain important financial decisions that are reflected in our mid-year figures.

In brief, we have written off all losses to date and anticipated losses on the Electra, JetStar, and other transport aircraft programs. At the same time we have also provided for amounts arising from government actions involving cost disallowances, renegotiation, and claims for additional federal income taxes.22

In the statement of consolidated earnings that accompanied the detailed description of the write-offs the company reported a net loss of $55,409,000 for the first six months of 1960. A detailed list of adjustments placed the amount at $67,569,000 all of which was recorded in the first half of 1960.23 While a complete breakdown is given of these adjustments and write-offs the income statement


23Ibid., pp. 3-7.
for the six months is presented in such a way that it is impossible to determine that there is anything unusual included therein.

The management of Lockheed lists six effects of the extraordinary write-offs as follows:

1. We are recording a net loss of $55.4 million after taxes for the six months, due primarily to write-offs on the Electra and JetStar—getting it behind us in one stroke rather than piecemeal, which would prolong the adverse influence upon earnings for the future.

2. With $1.1 billion in unfilled orders on our books, we restore the company to profitable operations from June 26 forward and accelerate the prospect of a return to cash dividend payments.

3. The second half of 1960 taken by itself should be decidedly profitable, although we will show a large net loss for the year.

4. The improving trend in profits should continue in 1961 and thereafter.

5. As the result of tax carrybacks, we will strengthen our cash position.

6. We enhance our ability to sell transport airplanes under favorable conditions. The slate is now clean so far as these programs are concerned. By getting the costs and losses behind us, we make it possible to report a profit on the future sales of these planes.24

These adjustments and write-offs, without doubt, have been made in accordance with generally accepted accounting principles. Inventory valuation principles are well defined. Lower of cost or market valuations may be reduced if the selling price, less estimated cost to complete and sell, is less than either cost or market. A lower limit

24 Ibid., p. 1.
is placed on the inventory as the selling price less estimated cost to complete and sell and a normal profit margin. In the case of Lockheed, market conditions changed during the early months of 1960 to the point that it became apparent that present inventory valuations were excessive. The point of contention here is not the propriety of the write-offs, but rather, the reporting techniques.

In listing the effects of the write-offs the management of Lockheed implied that they would be better able to sell airplanes as a result of the write-offs than they would have been if the write-off had not been made. If the tax refund that resulted from the write-offs and the loss carrybacks provided funds needed to expand the sales effort or otherwise increased the operations of the company it would be possible to increase the sale of airplanes. At the time a write-off is made managements consider it important to soften the impact by describing how the future will be affected by the write-off.

Sperry Rand Corporation included a comment in their first quarter report that the financial information is inaccurate.

Earnings for the first quarter were affected by our heavy investment in preparation for expanded sales and service of Univac electronic data processing equipment. These preparatory costs are being charged against income as incurred, although they really represent an investment to produce increased
future earnings. Looked at in this light, our operations profited more than our records show.25

Traditionally accountants have defined an asset as "any cost that benefits a future period."26 Sperry Rand used the interim report to imply that their accountants have reduced profits by an undisclosed amount that should have been capitalized and charged against future profits.

Certified Public Accountants review the comments that are made in annual reports and often advise the author on the proper technical wording. It appears that many of the interim reports would be improved if the comments were limited to historical facts. Comments about the future should be based upon orders for future delivery that are firm at the time of the report. Even though the Certified Public Accounting firm does not give an opinion on the interim reports it would be advisable to submit the interim report to the accounting firm for review and comment.

Investors and others interested in interim financial information would be interested in management's analysis of the future prospects for the corporation. The accounting profession has prohibited its members from attaching an


opinion to estimates of future earnings. Managements, on the other hand, use budgets for planning programs to be carried out in the future. Some of the interim reports contain estimates of sales and earnings for the next quarter. If these estimates are based on budgets that are being used for management decisions it would be perfectly proper to include that information in the interim reports. If this information is given, the wording should be such as to give the impression that the expectations of future results are contingent upon certain economic conditions. Care should be taken to make the estimates realistic and the best estimate that can be made from the information available from all segments of the corporation at the time the report is issued.

In summary, unusual and nonrecurring transactions should be reported in interim financial statements in the same manner as they are reported at the year-end. Such transactions should not be used in determining earnings per share. Earnings per share should be consistently determined by dividing the net income for the period by the number of shares outstanding.

A non-period adjustment, applicable to a different period of the current year than the one in which it is discovered, should be prorated to the periods to which it
applies. A non-period adjustment that applies to a period other than the current fiscal year should be reported in the same manner as an unusual and nonrecurring transaction described above.

For comparative purposes, prior year statements should be adjusted, if practicable, to include all amounts applicable to that period, even though the item may have been reported originally in another period.
CHAPTER VII
LAST-IN, FIRST-OUT INVENTORIES IN INTERIM STATEMENTS

This chapter will be devoted to problems encountered when last-in, first-out inventories are used in interim financial statements. Alternative methods of determining interim inventory costs will be listed and evaluated. Recommendations will be made that will, if adopted, produce comparable results for companies that use the Lifo inventory method for interim reporting.

The last-in, first-out method of determining inventory costs was first authorized as an acceptable inventory method for tax purposes by the Congress of the United States in the Revenue Act of 1938. This Act permitted a limited number of companies to use Lifo for a portion of their inventories. The Revenue Act of 1939 removed all restrictions and any taxpayer might adopt the Lifo method. Prior to 1939 Lifo was used for reporting purposes by a few industries. Large scale adoptions, however, did not take place until after Lifo was acceptable for tax purposes by all companies.

The procedures for determining year-end inventory costs for the Lifo method are so well established that it is
unnecessary to include an intensive analysis of the procedures in this study. However, certain important and unique features of Lifo inventories are summarized here in order to provide a basis for the discussion of Lifo problems in interim financial statements. A Lifo inventory is made up of a group of cost layers. Each time the inventory increases a new layer is added. When the inventory decreases during a year the last layer added is the first to be removed. Layers are removed until the inventory is reduced to size. Once a layer is removed it is rarely reinstated at the original cost. An exception is made in the case of "involuntary conversions." A new layer is added the next time the inventory increases. The cost of the new layer is either the first purchase costs of the year, last purchase costs or average costs.

The year-end inventory position determines the extent of the annual increase or decrease. An increase or decrease in the inventory during an interim period may be eliminated or reversed by the end of the year. For this reason the interim inventory pricing is dependent upon the year-end inventory position.

If the inventory at an interim date is larger than the inventory at the beginning of the fiscal year the increment will be priced as though the increase existed at the year-end. Unless the first purchase costs are used an
estimate of the costs will have to be made at the interim date. The last purchase costs or average costs for the year cannot be determined until the year-end. Therefore, the interim estimated costs will probably not be the same as the costs determined at the year-end. If the estimated costs are different from the actual costs an adjustment will be required.

The problem that arises when there is an increase in the inventory during an interim period is not as difficult to solve as when there is a decrease. The methods used in practice vary when the inventory on hand at the end of an interim period is less than the inventory at the beginning of the fiscal year. The respondents to the questionnaire were asked to indicate the procedures they follow when the interim inventory was smaller than the previous year-end inventory. Their answers indicated a lack of uniformity between companies. These practices were listed in Chapter III.\(^1\) As a result of different inventory procedures the reported net income is not comparable even though the companies being compared use the same inventory method.

If the inventory is reduced during an interim period one group of controllers would remove inventory layers to the extent of the decrease and transfer that portion of the

\(^1\) *Supra*, p. 62.
inventory to cost of sales. Another group would follow another procedure and include current costs in cost of sales and provide for the subsequent replacement of the inventory at the original cost. A third group combined these methods and used the one that was considered to be appropriate under the circumstances.

Table 16 summarizes the effect on profits of the three methods of accounting for decreases in Lifo inventories at an interim date. The profits of the interim period might be overstated or understated depending upon the year-end inventory position. Several important assumptions have been made in arriving at the conclusions presented in Table 14. It was assumed that there had been an extended period of rising prices and the prices at the year-end were in excess of purchase costs during the year. Another assumption was made that adjustments necessary at the year-end were made to cost of sales and therefore affect profits during the last interim period of the year. It was also assumed that estimates of replacement costs did not differ from actual costs or that the differences were not significant in amount.
### TABLE 16
EFFECT ON PROFITS WHEN ACCOUNTING FOR A DECREASE IN AN INTERIM LIFO INVENTORY

<table>
<thead>
<tr>
<th>Year-end Inventory Position and Accounting Methods</th>
<th>Profits for Interim Periods Ending</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Other Than Year-end</td>
</tr>
<tr>
<td>Interim inventory decrease replaced by year-end.</td>
<td></td>
</tr>
<tr>
<td>1. Cost of sales includes purchases plus inventory decrease at Lifo costs.</td>
<td>Overstated</td>
</tr>
<tr>
<td>2. Cost of sales includes purchases plus inventory decrease at current costs.</td>
<td>Correct</td>
</tr>
<tr>
<td>3. Combination of the above depending upon an estimate of the year-end inventory.</td>
<td>Correct</td>
</tr>
<tr>
<td>Interim inventory decrease not replaced. Year-end inventory is the same or less than interim inventory.</td>
<td></td>
</tr>
<tr>
<td>1. Cost of sales includes purchases plus inventory decrease at Lifo costs.</td>
<td>Correct</td>
</tr>
<tr>
<td>2. Cost of sales includes purchases plus inventory decrease at current costs.</td>
<td>Understated</td>
</tr>
<tr>
<td>3. Combination of the above depending upon an estimate of the year-end inventory.</td>
<td>Correct</td>
</tr>
</tbody>
</table>
The assumption of an extended period of rising prices corresponds with the events of recent economic history. If a period of falling prices had been assumed the effect on profits would be the opposite to what it was for the assumption of rising prices. In Table 16 the single assumption was adopted in order to avoid a complication that would add nothing to the interpretation of the problem. Corporations usually report inventory adjustments in the cost of sales section of the income statement. The effect on profits during the period of adjustment is opposite to the effect on the interim period. The assumption that estimates of replacement costs are accurate is justified because the estimates are made near the time of replacement. These estimates are made with the knowledge of price trends and economic conditions within the industry. For this reason they usually result in insignificant differences.

The companies that include purchases and the inventory decrease at Lifo costs in the cost of sales during the interim period the decrease occurs follow strict Lifo procedures. There is no attempt to estimate the effect of future purchases and sales in either quantity or dollar amount. If the ending inventory is as large or larger than the inventory at the beginning of the year this method fails to match the current costs with the current revenues which is one of the reasons for adopting the Lifo inventory
method. During the interim period when the inventory decreased the current sales dollars are matched with current purchases plus inventory dollars of another period. During the period of replacement the current sales dollars are matched with current purchases plus the excess of replacement cost over the inventory cost for the items replaced.

The companies that include purchases plus the inventory decrease at current costs in the cost of sales establish a reserve for replacement of the inventory. If the interim reduction in inventory is replaced by the end of the fiscal year the companies have succeeded in matching current revenues and costs in each period. On the other hand, if the inventory is not replaced, or replaced only in part, the final period of the year will be more profitable than it should be and the profits of the interim period when the inventory was reduced will be understated. From a conservative point of view this method does understate the profits in the initial interim period and follow that with an overstatement. Accountants have traditionally preferred methods that, if the results are indeterminate at the time, will understate profits initially with the correction producing an overstatement in a later period rather than the reverse. This method would not be the conservative approach during a period of falling prices.
The companies that use a combination of the other two methods will report accurate results for each period assuming that the estimate of the year-end inventory position is accurate. If, for example, a certain material or product was to be removed from the inventory the Lifo costs assigned to the inventory reduction should properly be included in cost of sales. Future plans, such as this, are well known in advance and accounting for interim Lifo inventories can be based on these plans.

Of the three methods used currently the one based on an estimate of the year-end inventory position would produce the most accurate results under all conditions. This method includes the inventory decrease in cost of sales if it is considered to be permanent or provides for replacement at the original costs by including the current costs for the inventory decrease in cost of sales if the inventory reduction is expected to be replaced by the year-end. The other two methods fail to provide reliable interim operating results unless the year-end inventory is the right size for each method.

It is true that the method based on an estimate of the year-end inventory position will produce inaccurate results if the estimates are incorrect. There are several errors that could be made in estimating the year-end position. One error is made if it is estimated that the
decrease in inventory will be replaced and it becomes im-
possible, because of a strike or other unusual occurence,
to purchase sufficient quantities of certain items by the
year-end. This would result in an understatement of profits
in the initial period of decrease and an overstatement of
profits in the period of adjustment. To estimate that the
year-end inventory would be as low or lower than the in-
terim inventory and then have the ending inventory increase
is another error. An estimate of a further decline in the
inventory would be based on an expected reduction because
specific items were being discontinued. In this case a
reversal of the inventory position by the year-end would
probably result from a change in plans. An accountant would
base his estimate of a further decline in the inventory on
sound future plans. Recording profits on inventory changes
and having to reverse them at a later date would be worse
than to defer the recognition and then include the profits
in the period of adjustment.

For these reasons it appears that estimating the year-
end inventory positions and accounting for Lifo inventories
at each interim date on that basis is better than con-
sistently following one of the other two methods. Many of
the decisions made by accountants are based on estimates of
future events and, therefore, a recommendation such as the one above is consistent with many of the accounting practices in use today.

Up to this point it has been assumed that the company determines the inventory position for each item within the inventory. Companies that use the "dollar value Lifo method" are not precluded from estimating the year-end inventory position. They can establish a reserve for replacement or reduce the inventory depending upon the estimate. By computing a price index even though there is a reduction in the inventory the cost of sales can include the current cost equivalent for the amount of the inventory reduction.
CHAPTER VIII
SUMMARY AND CONCLUSIONS

In summarizing the results of this study attention will be devoted first to the users of interim financial statements and then to current interim reporting practices. Following this, conclusions will be given based on findings in specific problem areas. These areas are corporate acquisitions, unusual and nonrecurring items, and Lifo inventories in interim reports. They developed during the course of the research into interim corporate reporting practices. Seasonal variations were included in this study because the Securities and Exchange Commission found that some companies did not want to issue quarterly reports because the reports might be misleading due to the seasonal factor. Following the conclusions a tentative statement of standards for reporting interim financial results will be formulated. This listing of recommended standards will be made in an attempt to formulate the conclusions of this study into a positive statement for further consideration by the accounting profession.

Users of Interim Financial Statements

At the present time the Securities and Exchange Commission does not require companies to file quarterly reports

146
even though there is a demand for them. As stated on page 73 financial analysts requested that quarterly reports be required by the Commission. Large investors, labor union officials, financial analysts and bankers were interested in quarterly reports according to a survey discussed on page 4. This study revealed that the reporting companies are aware of the demand for the reports. This demand places a responsibility on the issuing companies to submit useful reports.

Current Interim Corporate Reporting Practices

The results of the questionnaire indicated that the majority of the companies follow proper accounting practices and procedures as determined by leading theorists and the accounting organizations. There were, however, several areas where the respondents were not in agreement and where current practices and procedures could be improved.

General agreement was found in the timing and content of interim reports. The majority of the companies send quarterly reports. These reports usually contain an income statement, net income per share, and a written statement of the highlights of the operations since the last report. Almost all of the companies send comparative statements with the comparison made with the same period or periods of the preceding year. A majority of the companies report a material adjustment to profits in the period the adjustment
is discovered rather than to include it in the year-to-date column or otherwise indicate that it pertains to another period. Interim reports are prepared following the same policy of consolidation as are the year-end statements. The majority of companies do eliminate or adjust for intercompany profits in inventories, dividends received from subsidiaries that are consolidated, and exclude the minority interest from the net income, in interim financial statements. Interim inventories are usually taken from perpetual records and the inventories that are valued at the lower-of-cost-or-market at year-end are valued the same way at an interim date. As a general rule the companies prorate expenses between interim periods. The expenses specifically included in the questionnaire were: A major expenditure in one period of the year for advertising, vacation pay where most of the vacations are taken during the summer, officers' bonuses, and employee pension plan. A major expenditure in one period of the year for research and development was prorated by approximately half of the companies answering the questionnaire.

In addition to the many answers to questions indicating agreement among the company accountants, there were several questions that were answered indicating very little agreement. Prior year statements would be adjusted when a new subsidiary was acquired during the current year by some
accountants and not by others. Year-end adjustments are reported in a variety of ways without general agreement on any one method of reporting. Lifo inventories are treated differently by different companies when there is a reduction in the inventory during an interim period. A study was made of each of these problem areas.

**Corporate Acquisitions**

Corporate acquisitions of subsidiary companies usually result in an increase in revenues and expenses in the year of acquisition. Unless the financial statements of the prior year are adjusted to include the new acquisition the current statements are not comparable with those of the prior year. From this study it was found that accountants usually adjust the statements for the prior year if the acquisition was considered to be a pooling of interests. Statements of the prior year were not adjusted if the acquisition was in the form of a purchase. The differences between the two forms of acquisition were studied. The significant difference was found to be that the acquired company continues to exist under the pooling of interests form of acquisition while a purchase of a company means an end of one operation and the beginning of another. This is the basis for adjusting statements of the prior year for the pooling of interests and not for the purchase. Comparative statements are used to determine the extent and direction of
changes during the period. By including the new acquisition in one period and not in the previous period the reader is liable to misinterpret the statements. Because comparative statements are useful it was concluded that the statements should be comparable. The form of acquisition should be ignored and the statements for each period should include the financial information for all companies. Specific recommendations were made as follows:

1. Financial information for every period in the report should include the new acquisition. Financial statements for all periods prior to the date of acquisition should be adjusted to include the new company as though it were a part of the operation for the entire time covered by the report.

2. If the above is not practicable, sufficient information should be given so that the financial information for the new acquisition can be removed from the current period and thereby make it possible to produce comparable statements.

**Unusual and Nonrecurring Items**

Unusual and nonrecurring transactions are reported by different companies in different ways and it was found that some companies do not follow the same practices from one year to the next. These transactions should be reported at an interim date in the same manner as they are reported at
the year-end. Earnings per share should be computed from the net income for the period excluding the unusual and nonrecurring transactions that occurred during the period.

Non-period adjustments should be excluded from the period they were discovered and prorated to the periods to which they apply. This procedure relieves the current interim period of items that belong in a different period and permits the reader to judge the operations as they actually were. If the non-period adjustment applies to another fiscal year it should be reported in the statement of retained earnings or in the income statement after the net income for the period. This procedure was recommended for unusual and non-recurring transactions.

**Lifo Inventories**

Two companies using different methods of accounting for a reduction in an interim Lifo inventory would report different operating results, everything else being equal. Of the three methods of accounting for the decrease the one based on an estimate of the year-end inventory position is recommended. If the year-end inventory is expected to be lower than the opening inventory, the interim report should include a profit as the result of the inventory reduction. A profit will result if Lifo inventory costs are lower than current replacement costs. This profit would not be
reported in the interim period if the year-end inventory is expected to be as large or larger than the opening inventory.

The other two methods do not provide for an alternative procedure. One of the methods would include the lower inventory costs in cost of sales and, therefore, increase the profits of the interim period. Should the inventory be replaced by the end of the year this method would overstate the profits of the interim period and understated profits for the period including the year-end adjustments. The other method provides for replacement of the inventory at the original Lifo costs and defers recognition of the profit until the end of the year. If the inventory is replaced this method would properly reflect the profits of both the interim period and the period including the year-end adjustments. If, however, there is a reduction in the inventory for the year this method would understate the profits of the interim period and overstate the profits of the period including the year-end adjustments. The latter two methods are more likely to overstate or understate profits for the various interim periods than is the method based on an estimate of the year-end inventory position.
**Seasonal Variations**

A company subject to seasonal variations should not present an interim report comparing operations of one interim period with another period in a different segment of the seasonal pattern. Usually two consecutive interim periods should not be compared. In actual practice interim reports are presented with one interim period compared with the same period of the preceding year. In this way the effect of seasonal variations is reduced. The objection to such a comparison is that the two interim periods might still not be comparable because they are in a different portion of a cyclical pattern. Seasonal variations can be eliminated by deseasonalizing the operating information. If this is done the results of one interim period may be compared with results for any other interim period. Interim reports containing deseasonalized income statements would provide the reader with information about current trends that cannot be ascertained from the interim reports as they are prepared today.

A tentative statement of standards for reporting interim results follows:

**Standards of Responsibility**

1. It is the responsibility of the controller or chief accounting officer of a corporation to present financial statements that are, in his opinion, in accordance
with generally accepted standards of reporting interim financial results, on a basis consistent with that of the preceding year.

2. A statement should be included and signed by the controller, to the effect that the interim statements have not been audited, but, in his opinion, they properly reflect net income for the period based upon information available at the time of the report.

Standards of Recording

1. Accounting principles used in the preparation of the annual statements should be followed for the interim financial statements.

2. Within the framework of generally accepted accounting principles, on an annual basis, certain procedures should be adopted to prorate expenses between interim periods of the year.

Standards of Reporting

1. Interim reports should be presented to the stockholders of a corporation following the same policy of consolidation as the annual report.

2. Extraordinary and nonrecurring items of revenue and expense should be reported as they would be at the year-end. If the unusual and nonrecurring items are included in the income statement they should be reported after the "net income for the period." If these items are reported in the retained earnings statement at year-end and if the retained earnings statement is not a part of the interim report a footnote should be included in the interim report giving the nature and effect of the unusual and nonrecurring items.

3. The report should include a statement for the same period of the preceding year in comparison with the current statement. Adjustment for seasonal variations, on a statistical basis, is advisable so that an interim statement may be compared with the statement for the period immediately preceding it. Without that adjustment such a comparison should not be made.
4. If a subsidiary is acquired during the current period all financial information in the interim report should be adjusted to include the subsidiary as though it were a part of the operations for the entire period of the report. This should be done if the subsidiary was acquired by either an outright purchase or by a pooling of interests. If it is not possible to adjust the prior period statements, sufficient information should be given so that the financial information for the new subsidiary can be removed from the current period and thereby make it possible to produce comparable statements.

5. Net income per share should be shown and should be computed for every interim period. This computation should be made by using the net operating income for the period. If unusual and nonrecurring items are included after the net operating income for the period they should not be included in the per share computation. The per share effect of unusual and nonrecurring items may be shown in a footnote but should not be combined with the per share figure for net income for the period.
APPENDIX A

Mailing List for Questionnaire

Interim Financial Statements

ACF Industries, Incorporated
Acme Electric Corporation
Acme Steel Company
Air Reduction Company, Inc.
Alco Products, Inc.
Allegheny Ludlum Steel Corporation
Allied Chemical Corporation
Aluminum Company of America
Allison Steel Manufacturing Company
American Art Metals Company
American Brake Shoe Company
American Can Company
American Chain & Cable Company, Inc.
American Cyanamid Company
American Metal Climax, Inc.
American Motors Corp.
American Optical Company
American Radiator & Standard Sanitary Corp.
American Smelting & Refining Company
The American Tobacco Company
Armco Steel Corporation
Armstrong Cork Company
Bell Aircraft Corporation
Bell & Howell Company
Bendix Aviation Corporation
Bethlehem Steel Corporation
Boeing Airplane Company
The Borden Company
Borg-Warner Corporation
Bostitch, Inc.
Bridgeport Brass Company
Capital Airlines, Inc.
The Carborundum Company
Celene Corporation of America
The Chemstrand Corporation
Chrysler Corporation
Commercial Solvents Corporation
Container Corporation of America
Corning Glass Works
Crane Company
Crown Zellerbach Corporation
The Cudahy Packing Company
Cutler-Hammer, Inc.
Dennison Manufacturing Company
Detroit Steel Corporation
Draper Corporation
E. I. du Pont de Nemours and Company
Eagle Pencil Company
Eastman Kodak Company
Encyclopaedia Britannica, Inc.
Ford Motor Company
Fruehauf Trailer Company
Gardner-Denver Company
General Dynamics Corporation
General Electric Company
General Foods Corporation
General Motors Corporation
General Refactories Company
General Telephone & Electronics Corp.
The Gillette Company
Gorham Manufacturing Company
Great Northern Paper Company
Haloid Zerox, Inc.
Harcourt Brace & Company, Inc.
Hathaway Manufacturing Company
Hudson Pulp & Paper Corporation
Ingersoll-Rand Company
Inland Steel Company
International Business Machines Corp.
International Paper Company
Jones & Laughlin Steel Corporation
Joy Manufacturing Company
The Kendall Company
Kennecott Copper Corporation
S. S. Kresge Company
Lehigh Portland Cement Company
Lockheed Aircraft Corporation
Libby, McNeil & Libby
Libby-Owens-Ford Glass Company
Lone Star Cement Corporation
Lone Star Steel Corporation
Ludlow Manufacturing & Sales Co.
Mack Trucks, Inc.
R. H. Macy & Company, Inc.
McCormick & Company
The Mead Corporation
Mead Johnson & Company
Minnesota Mining & Manufacturing Co.
Mohasco Industries, Inc.
Montgomery Ward & Company
Moore Business Forms, Inc.
Motorola, Inc.
Motor Products Corporation
Merck & Company, Inc.
Monsanto Chemical Company
National Cash Register Co.
National Dairy Products Corporation
National Gypsum Company
National Lead Company
The Ohio Oil Company
Olin Mathieson Chemical Corporation
Outboard Marine Corporation
Owens-Illinois Glass Company
F. Lorillard Company
Park, Davis & Company
Penick & Ford, Ltd., Incorporated
Pepperell Manufacturing Company
Pet Milk Company
Charles Pfizer & Company, Inc.
Phelps Dodge Corporation
Philco Corporation
Phillips Petroleum Company
Philip Morris Incorporated
Pitney-Bowes, Inc.
Pittsburgh Plate Glass Company
Pittsburgh Steel Company
The Procter & Gamble Company
The Pure Oil Company
Radio Corporation of America
Ralston Purina Company
Raytheon Manufacturing Company
Republic Steel Corporation
Reynolds Metals Company
Rheem Manufacturing Company
Royal McBee Corporation
Schenley Industries, Inc.
Scripto, Inc.
Sears Roebuck & Co.
Sharon Steel Corporation
Sinclair Oil Corporation
Socony Mobil Oil Company, Inc.
Sperry Rand Corporation
Standard Brands, Incorporated
Standard Oil Company (New Jersey)
The Standard Oil Company (Ohio)
Sun Oil Company
Swank, Inc.
Swift & Company
Twin Coach Company
United Fruit Company
United States Steel Corporation
United States Gypsum Company
Vanadium Corporation of America
The Vellumoid Company
Vick Chemical Company
Westinghouse Air Brake Company
Westinghouse Electric Corporation
West Virginia Pulp & Paper Company
Weyerhaeuser Timber Company
Wildroot Company, Inc.
W. R. Grace & Co.
Zenith Radio Corporation
APPENDIX B
INTERIM FINANCIAL STATEMENTS

1. Is financial information submitted to the stockholders at certain intervals between annual reports?  YES ______: NO ______

If the answer to 1 above is no please return the questionnaire in the enclosed self-addressed envelope.

2. If the answer to 1 above is yes indicate below the frequency of these reports.

   _____ Monthly   _____ Quarterly   _____ Semi-annually   _____ Irregularly

If irregularly, indicate the dates, during the fiscal year ending in 1959 covered by the reports ____________________

3. The information contained in the interim reports in 1959 included:

   _____ A complete income statement, even though condensed
   _____ A complete balance sheet
   _____ Partial income statement information
   _____ Partial balance sheet information
   _____ Net income per share
   _____ A written statement of the highlights of the operations since the last report.
   Other ____________________

4. The interim reports, in 1959, included data for the following periods:

<table>
<thead>
<tr>
<th>Initial Interim Report</th>
<th>Subsequent Interim Reports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current period only</td>
<td></td>
</tr>
<tr>
<td>Current period in comparison with the same period last year</td>
<td></td>
</tr>
<tr>
<td>Current period and the year to date</td>
<td></td>
</tr>
<tr>
<td>Current period and the year to date and the same periods last year</td>
<td></td>
</tr>
<tr>
<td>Year to date only</td>
<td></td>
</tr>
<tr>
<td>Year to date and the year to date last year only</td>
<td></td>
</tr>
<tr>
<td>In addition to one of the combinations above (indicate which) comparative figures for twelve months ending on the date of the report were shown.</td>
<td></td>
</tr>
<tr>
<td>Other ____________________</td>
<td></td>
</tr>
</tbody>
</table>
5. If quarterly statements are sent to the stockholders, do you send a statement for the fourth quarter?  YES____: NO____

6. Please indicate briefly, why interim reports are sent to the stockholders.


7. If, in the second quarter a material adjustment is found that would effect the first quarter profits, this adjustment would be reported as follows:
   ______ Included in the determination of the profit of the second quarter
   ______ Does not effect the second quarter, but is shown in the year-to-date column
   ______ Reported as an adjustment of retained earnings (earned surplus)
   ______ Other (Please explain)


8. Year-end adjustments, when material, are reported to the stockholders.  YES____: NO____

9. If the answer to number eight is yes, what method was used to report the adjustment?


10. If statements are presented for the prior year are they revised to include the results of new subsidiaries consolidated during the current year?  YES____: NO____

11. Are interim statements presented following the same policy of consolidation as the annual statements?  YES____: NO____

12. Are eliminations and adjustments made before presenting consolidated interim statements for the following items?

   YES  NO
   
   a. Intercompany profits in inventories

   
   b. Dividends received by one company, in the consolidation against the dividends paid to it by another company in the consolidation

   
   c. Is the portion of the net income applicable to the minority interest deducted from the net income for the interim period in arriving at the reported net income?


13. Interim inventory quantities, or dollar amounts, are determined by the following method:
   ______ Physical count
   ______ Perpetual inventory records
   ______ Retail inventory method
   ______ Estimated (on the basis of purchases, sales, and gross profit percentage)
   ______ Other (specify)
14. At the end of the fiscal year, cost, for inventory purposes is determined, for the major portion of the inventory, by the following method:

- First-in, first-out
- Last-in, first-out
- Latest invoice price
- Average cost
- Other (Please specify)

15. If the market value (replacement cost) is less than cost are the inventories written down?

Year-end: YES___ : NO___ Interim YES___ : NO___

16. If the inventory cost at year-end is determined by the Last-in, first-out method, and the interim inventory quantity is less than the quantity that was on hand at the beginning of the interim period, indicate the procedure that would be followed to determine the cost of goods sold for the current interim period.

________________________________________________________________________
________________________________________________________________________
________________________________________________________________________

17. Is an attempt made to prorate the following expenses between interim periods of the year?

<table>
<thead>
<tr>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>A major expenditure in one period of the year for advertising</td>
</tr>
<tr>
<td>b.</td>
<td>A major expenditure in one period for research and development</td>
</tr>
<tr>
<td>c.</td>
<td>Vacation pay, where most of the vacations are taken during the summer</td>
</tr>
<tr>
<td>d.</td>
<td>Officers' bonuses</td>
</tr>
<tr>
<td>e.</td>
<td>Employee pension plan</td>
</tr>
</tbody>
</table>

Comments are invited on each of the above. Index each comment to the question to which it relates. Use the back page if necessary.

Signature (Unnecessary if you prefer)_________________________________________

Company______________________________________________________________
BIBLIOGRAPHY

BOOKS


Paton, W. A. and Littleton, A. C. An Introduction to Corporate Accounting Standards. American Accounting Association, 1940.


ARTICLES


I, Robert Doane Neubig, was born in Columbus, Ohio, June 29, 1926. I received my secondary-school education in the public schools of Columbus, Ohio, and my undergraduate training at Ohio State University, which granted me the Bachelor of Science in Business Administration degree in 1948. I was employed by the New York and Caracas Venezuela offices of Price Waterhouse & Co. from 1948 to 1955. I became a Certified Public Accountant in New York in 1953. I returned to Ohio State University in 1955 and received the Master of Business Administration degree in 1956. I was an instructor of Accounting from 1956 through 1960 at Ohio State University and have been an assistant professor of Accounting at Ohio University, Athens, Ohio, since 1960. These positions were held while completing the requirements for the Doctor of Philosophy degree.