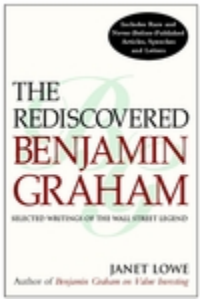
THE REDISCOVERED BENJAMIN GRAHAM *Lectures*

Lecture Number Two

This is a transcript of a lecture from the series ***Current Problems in Security Analysis*** presented by **Benjamin Graham** at the **New York Institute of Finance** from **September 1946 to February 1947**. This content is found in abridged form in *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (Wiley, April 1999) by Janet Lowe. Alternatively, full html versions for all ten lectures are available on the publisher's website.



Those of you who are familiar with our textbook know that we recommend "the comparative balance sheet approach" for various reasons, one of which is to obtain a check on the reported earnings. In the war period just finished that is particularly important because the reported earnings have been affected by a number of abnormal influences, the true nature of which can be understood only by a study of balance sheet developments.

I have put on the blackboard a simple comparative example to illustrate this point. It is not particularly spectacular. It occurred to me because I observed that early this year Transue Williams and Buda Company both sold at the same high price, namely $33 1/2 a share; and in studying the companies' record I could see that buyers could easily have been misled by the ordinary procedure of looking at the reported earnings per share as they appear, let us say, in Standard Statistics reports.

Now, as to procedure: First, the balance sheet comparison is a relatively simple idea. You take the equity for the stock at the end of the period, you subtract the equity at the beginning of the period, and the difference is the gain. That gain should be adjusted for items that do not relate to earnings, and there should be added back the dividends paid. Then you get the earnings for the period as shown by the balance sheet.

. In the case of Transue Williams the final stock equity was $2,979,000, of which $60,000 had come from the sale of stock, so that the adjusted equity would be $2,919,000. The indicated earnings were $430,000, or $3.17 a share. The transfer to a per share basis can be made at any convenient time that you wish. Dividends added back of $9.15 give you earnings per balance sheet of $12.32. But if you look at the figures that I have in the Standard Statistics reports, you would see that they add up to $14.73 for the ten years, so that the company actually lost $2.41 somewhere along the line.

The Buda situation is the opposite. We can take either the July 31, 1945 date or the July 31, 1946 date. It happens that only yesterday the July 31, 1946 figures came in, but it's a little simpler to consider July, 1945 for this purpose. We find there that the equity increased $4,962,000 or $25.54 per share, the dividends were much less liberal -- $4.20; indicated earnings per balance sheet, $29.74, but in the income account only $24.57. So this company did $5.17 better than it showed, if you assume that the reserves as given in the balance sheet are part of the stockholder's equity and do not constitute a liability of the company.

If you ask the reason for the difference in the results in these two companies, you would find it, of course, in the treatment of the reserve items. The Transue & Williams Company reported earnings after allowances for reserves, chiefly for renegotiation, each year (reserves added up to $1,240,000 for 1942-45) and then almost every year they charged their actual payments on account of renegotiation to the reserves. It turned out that the amounts to be charged were greater than the amounts which they provided. The reserves set up by Transue and Williams, consequently, were necessary reserves for charges that they were going to have to meet; not only were they real, but they actually proved insufficient on the whole. I think I should perhaps correct what I said in this one

respect: It may be that Transue and Williams called their reserve a reserve for contingencies, but actually it was a reserve for renegotiation which, as I said, proved insufficient.

. In the case of Buda you have the opposite situation. The Buda Company made very ample provision for renegotiation, which they charged to earnings currently, and in addition to that they set up reserves for contingencies. These apparently did not constitute in any sense real liabilities, because in July 1946 the reserves of a contingency nature remained at about a million dollars.

In the case of Transue, their reserves got up very high but the end of 1945 saw them down to $13,000, which indicated how necessary were the Transue reserves.

Now, let me pause for a moment to see if there is any question in your mind about this explanation as to why you get different earnings on the two bases, and why Buda shows larger earnings than reported and Transue shows smaller earnings that reported. Maybe a question will clarify it.

QUESTION: Does the equity include reserves?
MR. GRAHAM: Yes. That's a good question. By equity we mean common stock plus surplus, plus whatever reserves are regarded as equivalent of surplus. Reserves which are for known liabilities or probable liabilities would, of course, not be part of the equity.
QUESTION: Might not depreciation charges, which make a great deal of difference in what your equity really was, not show up in there?
MR. GRAHAM: That is true. You can very well claim that certain charges for depreciation have created equities for stock which do not appear on the balance sheet, and I will go into that matter later. But that is a separate consideration from this item, in which we deal only with reserves for contingencies and the like. Are there other questions about that?
Now, I have some other examples which I can go through very quickly to indicate more significant differences in the reported earnings, and the actual earnings. They would be found in some of the real "war babies", particularly the aircraft manufacturing companies.

I mentioned last week the case of Curtiss-Wright, particularly because its price was statistically so low in relation to its performance in the past and also by comparison with another small company which I mentioned. Now, in the case of Curtiss-Wright, if you follow this procedure, you will find that on the balance sheet basis in ten years they apparently earned $18.53 per share but the reported earnings were only $12.28. In other words, an average of $1.22 is reported and $1.84 is shown by the balance sheet figures. That's a very considerable difference, -- an increase of 50 per cent. All of those extra earnings of $6.25 in ten years are to be found in the reserves set up during the last five years by the Curtiss Wright Corporation, none of which apparently are needed for specific war purposes, such as renegotiation payments or reconversion expenditures. Actually, the situation is quite the opposite in Curtiss Wright and others of that type. Instead of having to spend a great deal of money on plant in the reconversion period, you

found the opposite has proved true. For in going over from war conditions to peace conditions these companies have turned a great deal of plant account into cash, which we will touch upon later.

In the United Aircraft situation you have somewhat the same picture, not as extreme. The reported earnings for ten years were $14.08 and the indicated earnings per balance sheet were $49.84, -- a difference of about 20 per cent, or $8.77.

. If you look at the balance sheet there you will see that they have set up reserves amounting to $35-million or about $14 a share, and you may ask why the difference in earnings is not equal to the full reserves of $14 per share. Well, if you examine the report in detail you will see that part of those reserves were charged to earnings, and therefore served to decrease the reported earnings, but somewhat less than half, $15-million, was taken out of surplus and transferred to reserve. Restoration of this last amount, of course, would not serve to increase your reported earnings, because it was not deducted before arriving at the reported earnings. I hope you are all familiar with the difference between making a charge to reserves which would appear in the income account before your reported earnings, and a charge on the balance sheet only where it is transferred from surplus to reserves. The latter is purely internal, and a matter of no special significance.

These are the examples that I wanted to give you of comparative balance sheets for the purpose of determining what we might call true earnings, as compared with reported earnings.

*** . You remember in comparative Industrial Analysis we sometimes study the net earnings before taxes and depreciation. For the net before taxes is a useful item, and the deprecation may well be treated separately since it is partly arbitrary. Now I suggest we do the same thing for railroads and find out what that shows us. Well, here are figures for the Denver under 1945 and 1944. What we call the operating revenue or gross was 74.8 million in 1945 as against 70.3 million in 1944. Then first I'll give you the result of a calculation which won't appear in your income account, -- namely, the single figure of net before income taxes and depreciation items. (That is not maintenance, of course; that's depreciation, money for which cash has not been spent.) In 1944 this net was $23,220,000 and in 1945 it was $27,721,000. Hence the much poorer reported earnings for 1945 than in 1944 must be due to the fact that Denver charged off more in 1945 for taxes and depreciation. What are the figures? Depreciation, et cetera -- and that includes an unusual item in Denver called "deferred maintenance," not a large amount -- was $16-million this year, against $6-million the year before. There's $10-million of difference, approximately. Next we have income taxes, and this is really a first-class surprise. You would assume that if Denver charged $16-million for depreciation -- and that's mainly amortization of emergency facilities -- that they would have shown a great benefit in their income taxes. Yet for 1945 they were able to work out an income tax bill of $10,576,000, whereas the year before it was only $5,338,000. Thus in 1945 both depreciation and income taxes were far greater than in 1944.

Now, you will raise two questions, of course. One is, did they really do better in 1945 than in 1944? And if they did, how was it possible for them to appear to have done so very much worse? The depreciation items you can understand readily. All the railroads charged off the full amortization of emergency facilities in 1945, and therefore the charges were higher in 1945 than in 1944. I am not too sure why they all did it, because it seems to me that in some cases they may not have needed that amortization for income tax purposes; and if so, it might have been better for them to have carried it along. But apparently they all decided to make the full charge-off.

. But the main problem is, how can they have paid so much for income taxes when their earnings were apparently so bad? After all, we never heard of a company which had a deficit of $7-million and had to pay $10-million of income taxes. The company's report explains it to you in a rather incomplete way. The first important item is that $7,406,000 of this 1945 tax represents possible tax deficiencies for previous years. Obviously this item has nothing at all to do with the current year's operations. We may hope that there are not really such deficiencies for the past year, but whatever they are they belong to the past years' operations. Also, the depreciation charge of $16-million included $5,300,000 applicable to past years, and consequently the 1945 taxes did not get the benefit of that item, because that was carried back to past years in some rather complicated way. The net of the situation in the 1945 operations include $9-million of amortization and taxes which are applicable to previous years' operations. If these were eliminated, instead of having a loss of $7-million for the year's operations after interest taxes, they would have had a profit of $1,800,000. I can follow that explanation up to one point which isn't clear. The taxes that they calculate as belonging to 1945 still amount to $6,900,000 that they would have to pay. But if their net earnings after taxes were really $1,800,000, this 1945 tax should have been about $1,100,000. So there is still a difference of $5,600,000 not accounted for.

One thing is quite clear now, to get back to the nub of the situation: These items are semi-manipulative, you might say. They have very little to do with the actual operating results of the Denver. Hence if you want to use the 1945 results in an evaluation of the system's earning power, you obviously must give your primary attention to the $27,700,000 earned before taxes and depreciation, as compared with the $23,440,000 in 1944.

In 1946, of course, the Denver is not doing well. Very few roads are doing well. But the Denver is managing to earn money now against losses previously, but they are charging no income tax this year whereas last year they charged this enormous amount.