Accounting Historians Journal

Volume 9
Issue 2 *Fall 1982*

Article 1

1982

Reporting treasury stock as an asset: Law, logic, and economic substance

Terry K. Sheldahl

Follow this and additional works at: https://egrove.olemiss.edu/aah_journal

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

Sheldahl, Terry K. (1982) "Reporting treasury stock as an asset: Law, logic, and economic substance," *Accounting Historians Journal*: Vol. 9 : Iss. 2 , Article 1.
Available at: https://egrove.olemiss.edu/aah_journal/vol9/iss2/1

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Accounting Historians Journal by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

The Accounting Historians Journal
Vol. 9, No. 2
Fall 1982

Terry K. Sheldahl
MILLSAPS COLLEGE

REPORTING TREASURY STOCK AS AN ASSET: LAW, LOGIC, AND ECONOMIC SUBSTANCE

Abstract: This paper traces development in the accounting literature, circa 1909-1933, of dominant support for contra-equity presentation of treasury stock, and relates this overview to prominent current arguments for selective asset treatment. Classic "logical" objection to asset analysis is found to be compelling. Contemporary challenges to prevailing doctrine in terms of "economic substance," enjoying distinguished lineage from the earlier era, are recast as attractive recording and disclosure proposals. An auxiliary theme is the changing nature of relevant objection of "legalism." Sources include Hatfield, Esquerré, Montgomery, Paton, Kohler, and (of particular note) Sunley, and current analysts Allan Young and Beatrice Melcher.

The recording of treasury stock transactions is a relatively flexible area, aside from any applicable legal requirements. There are alternative basic methods, the "par value" and "cost" approaches, each permitting varied treatment of pertinent "loss," in particular. In accounting terms, however, neither gain nor loss may be recognized in reacquisition, reissuance, or retirement of stock.[1]

The corresponding reporting doctrine is that treasury stock is a negative "equity" item, not an "asset." For fully half a century this position has enjoyed overwhelming support among accounting writers; in slightly qualified form it has since 1934 had "authoritative" professional endorsement;[a] and, reinforced by SEC provisions

Beyond the specific reference in note c, indebtedness is gratefully acknowledged to the two anonymous reviewers for their constructive comments and suggestions. An earlier version of this paper, entitled "An Historical Perspective on Asset Presentation of Treasury Stock," was presented at the 1979 Annual Meeting of the American Accounting Association—Northeast Region.

[a]The reference is to a 1934 AI(CP)A statement, still accepted as authoritative, which allows that "it is *perhaps in some circumstances permissible* to show stock of a corporation held in its own treasury as an asset, if adequately disclosed" (emphasis added). Without qualification, the Committee on Accounting Procedure in 1938 rejected both recognition of gain or loss on treasury stock transactions, and direct adjustment of retained earnings in lieu of gain recognition. Financial Accounting Standards Board, pp. 9 (citation), 10 (*Accounting Research Bulletin 43*, Chapter 1, Sections A, paragraph 4, and B).

and (since 1954) federal income tax law, it has for nearly as long prevailed decisively in practice.[2] During the years 1974-78 only 1.9% of companies surveyed by *Accounting Trends and Techniques* which held their own stock (as did 72.1% of all firms covered) carried such holdings as assets, or at least noncurrent ones.[3]

Within the past generation, however, treasury stock activity has changed markedly in nature and increased immensely in volume. In this context it has been argued that "economic substance," as opposed to "legal form," can sometimes be expressed only through asset treatment. One prominent analyst favors such presentation whenever reissuance of stock is clearly "intended" at the time of acquisition, while another one is more restrictive.

These challenges to accounting orthodoxy invite review of emergence over the first third of this century of the prevailing consensus among accounting writers. Besides development of a consensus position, two points warrant particular notice: original "legalistic" argument for uniform *asset* presentation of treasury stock; and assertion or anticipation by early authorities of a leading intermediate position taken today. Principal sources include Hatfield, Esquerré, Montgomery, Paton, and Kohler. The less celebrated author William T. Sunley, however, most incisively stated the case against asset presentation.

Confining attention to treasury "common" stock, his argument is found to express a compelling "logical" point which presupposes no distinctive economic context, beyond incorporation itself, and hence poses no obstacle to economic "realism." Even so, useful contributions are credited to current selective asset advocates Allan Young, a finance professor, and Beatrice Melcher, a research associate of the American Institute of Certified Public Accountants (AICPA), by recasting their respective positions as specific *recording* and *disclosure* proposals.

Establishment of Treasury Stock Orthodoxy, Circa 1909-1933

Early in this century treasury stock was normally carried as an asset, and as late as 1932 nearly one-half of relevant companies listed by the New York Stock Exchange followed this practice.[4] By then, there was strong consensus in the accounting literature that asset presentation is unsound *in principle*. A sophisticated minority viewpoint called for such treatment in certain instances.

Following identification of the two basic sources of reacquisition, and relevant objectives, emergence of the consensus position is documented, and argument for selective asset treatment is traced

back to 1909. Finally, a concise summation from 1933 invites clarification of the prevailing analysis relative to the "entity" theory of financial reporting.

Sources of Reacquisition, and Relevant Objectives

The basic sources of stock reacquisition, discussed in terms of pertinent *objectives* of the earlier period, are (1) *donation* by shareholders, and (2) *purchase* therefrom. *Forfeiture sale* upon subscriber default, a potential third source at the time given (contrary to present practice) prior stock certificate issuance,[5] is disregarded due to relative unimportance.

Donation

Donation, a particularly prominent source of share reacquisition in the earlier era, may serve either of two main purposes: (a) elimination of a deficit, or (b) generation of working capital.

Elimination of a Deficit

Capital stock may be donated for purposes of eliminating a deficit, as a condition of dividend payment. Such donation would today require formal retirement of the stock, as a basis for recording "additional paid-in capital" against which the deficit could be written off.[6] Early practice, however, sanctioned immediate recognition of "donated capital," at the par value of the shares.[7] The stock could then be held in the treasury for other purposes, including the raising of working capital.

Generation of Working Capital

The objective of raising working capital is uniquely significant and controversial, historically. Focus is placed upon donation subsequent to incorporation through exchange of stock wholly or principally for nonmonetary assets, such as patents, plant facilities, or mineral properties. These assets would be stated at the par value of the stock, rendering it "fully paid." Shareholders would then on a pro rata basis donate shares to the firm, possibly representing up to one-half their holdings.

The stock could then be reissued for cash at less than par, without imposing a contingent liability (to creditors) upon shareholders. A major obstacle to attraction of investment by an untested enterprise would thus be removed.

Early writers sometimes noted that inability to attract working capital at par value would not in itself imply *overvaluation* of initial assets. Original owners legitimately having strong faith in a new company might recognize need by other potential investors for special inducements.[8]

Nonetheless, the writers did not doubt prevalence of the "treasury stock subterfuge," by which the nonmonetary properties *were* clearly overvalued to avert contingent liability on sale of stock at a discount. Relevant court protection for creditors was often at best problematic.[9] Concern about this abuse may well have encouraged ready endorsement of contra-equity treatment of treasury stock, as well as advent of no-par (and low-par-value) stock.

Purchase

A prominent textbook of 1931[b] listed eight objectives of common stock "repurchase" (to use later terminology):

1. Relieving a retiring stockholder of his interest in a close corporation
2. Replacing a retiring stockholder in such a firm
3. Accommodating a stockholder
4. Eliminating a "dissident" stockholder
5. Securing shares for distribution to employees
6. Investing surplus funds
7. Taking advantage of an expected rise in market value
8. Simply reducing outstanding stock.[10]

This listing seems particularly relevant to "close" corporations. Items 1 and 2 are defined in terms of such companies, while numbers 3 and 4 are apt to be particularly asociated with them. Objectives 5 and 7 relate wholly or primarily to "public" firms.

More direct evidence that reacquisition through purchase was not prevalent among publicly held corporations in the earlier era is provided by a contemporary study identifying 1932 as a year of *unusually heavy* treasury activity. In that year twenty-six companies listed on the New York Exchange repurchased shares (aver-

[b]Through national balloting among both academic and practicing accountants, Sunley and Pinkerton's text was nominated for Beta Alpha Psi's "Most Notable Contribution to the Accounting Literature Award" for the twelve months ended May 1, 1931. Also nominated, among twenty-five books listed, were works by Roy Kester; A. H. Church, a noted cost accounting writer; historian Wilmer Green; and W. B. Castenholz, like Sunley a prominent accounting author, practitioner, and correspondence educator. The award ultimately went to Castenholz's book. Sheldahl, pp. 480-495.

aging approximately five percent of total stock outstanding), compared with eight in 1931 and six in 1933. The study concluded that "investment," in a sense embracing items 6 and 7 together, was the primary motive of such activity.[11]

These references tend to support a critic's assertion that when the orthodox reporting doctrine arose reacquisition was generally insignificant to ongoing corporate financial planning.[12] Centrality of "defensive" considerations in an era of severe *depression* must, however, be acknowledged.

"Legalistic" Arguments for Asset Treatment

Given the widespread early practice of carrying debit and credit items, as such, respectively on the asset and equity sides of the balance sheet,[13] it is not surprising that treasury stock initially was widely reported as an asset. Prominent authorities supported such practice on two narrowly "legalistic" grounds, the second of which calls to mind the virtual prohibition of treasury holdings in Great Britain.

Establishment of Monetary Value

Harry C. Bentley, in 1911, and Robert H. Montgomery, in 1912 and 1916, advocated asset presentation because stock repurchase, like purchase in general, establishes a "monetary value." Consideration rendered reflects value acquired.[14] Presumably interpreting donation through analogy, these authors viewed treasury stock as a "commodity, to be held or sold according to the wishes of management."[15]

While in essence it merely notes that reacquisition is normally a market transaction involving outflow of funds, this argument is important historically as the original rationale for recording treasury stock at cost.

Maintenance of Legal Capital, and a Related Reference to British Law

Writing in 1914, Paul-Joseph Esquerré supported asset treatment because under governing laws reacquisition generally did not reduce "legal capital."[16] Basically, the par or stated value of reacquired stock was assumed to represent continuing capitalization in accounting terms. A like position perhaps lay behind the statement of a 1922 corporate law text that "with some logical correctness" reacquired "full-paid stock" would be reported as an asset.[17]

This legalistic argument conflicts with the first one, by implying that treasury stock should be recorded at par or stated value (as holdings thereafter reported as assets often were at the time[18]). It is no more persuasive logically, in its invitation to extreme relativism through statutory variation. However, Esquerré's position draws attention to a most basic objective of legal regulation in the area, and, in turn, traditional prohibition of treasury stock in Britain.[c]

State laws by which reacquisition without retirement leaves legal capital intact serve to protect creditors, and shareholders themselves, from excessive distribution of funds. Confining repurchase to the amount of retained earnings, or retained earnings and "additional paid-in capital," they effect a trade-off between such action and dividend payout. Related protection is provided by statutory regulation of legitimate reacquisition purposes and, in individual cases, bond covenant restrictions in the area.[19]

In British law concern for possible (1) harm to creditors, (2) manipulation of stock prices by companies "trafficking" in their own shares, and (3) abuse of any formal voting rights which might be recognized led very early to outright prohibition of treasury stock.[20] The principle that a company cannot be its own shareholder was established in 1887, in the case *Trevor v. Whitworth,* and later made statutory. It was relaxed negligibly by the Companies Act of 1948, providing in specified cases for *court-ordered* share reacquisition from "oppressed" stockholders (in a clause repealed in 1980), and also forfeiture by defaulting subscribers without court involvement; and otherwise stipulating strict conditions for reduction in capital under court supervision.[21]

British corporate law also forbids a company to finance acquisition of its shares by another party, in any measure, or, if controlled by another company, to acquire an interest in that firm. The very restrictive overall policy is compromised somewhat, however, by provision for acquisition of a company's stock, or that of its parent, by *trustees* or other "nominees."[22] Also, a subsidiary having obtained an interest in another corporation *before* takeover by that firm may apparently retain it, although one authoritative source recommends divestiture or arrangement for stock cancellation.[23]

British accounting treatments have not been investigated in the present research. However, a subsidiary holding shares in its

---

[c]Gratitude is expressed to the anonymous reviewer who suggested making reference at this point to British law. It may be noted further that the European Economic Community has adopted stringent regulations concerning share reacquisition within member countries. Schmitthoff, vol. 3, secs. L-633—L-639.

parent company would presumably report them as an asset, although voting rights might be highly problematic. More pertinently, within the (hostile) British legal environment it would be particularly meaningful in *consolidated* statements to report such holdings as treasury stock, analyzed as an equity deduction item. This "treasury stock method" enjoys considerable support in the United States.[24]

Fleeting Influence of Legalism

The influence of early legalistic cases for asset presentation was short-lived. Montgomery himself would soon advocate *selective* asset presentation, while more generally support for uniform contra-equity treatment was becoming well entrenched.

In part such developments simply reflected an expanding sophistication in accounting thought, including assertion for accounting of greater autonomy from the legal realm. Additionally, legalistic arguments could only seem particularly unpersuasive in the light of the troublesome area of donation. While one writer suggested that donated stock might be listed at zero valuation, at the foot of the asset section,[25] it was commonly assumed that donation had immediate accounting effect. Under asset treatment, the result could only be to *increase* total asset valuation over a level perhaps already highly inflated. Reissuance at a discount would then paradoxically *decrease* total valuation.

Legalistic advocacy of asset treatment for treasury stock was promptly eclipsed by the basic argument for contra-equity presentation, ironically itself considered legalistic by present critics of conventional analysis.

The Classic Logical Case Against Asset Presentation, and Supporting Arguments

The classic logical case against asset presentation, that the idea of "self-ownership" by a corporation has no content, was advanced by William T. Sunley in 1915. Several of his contemporaries added useful supporting points.

Sunley's Classic Statement

Sunley asserted simply that the "corporate" shareholder *could* in no meaningful sense possess three capacities or rights fundamental to corporate ownership. They are participation in (a) election of the board of directors, (b) distribution of periodic dividends, and (c) distribution of assets in liquidation. Formal participation in these

areas by the company itself would in substance be proportionate assignment to holders of outstanding stock of additional votes, dividends, or assets.[26]

This point is self-evident relative to liquidating distribution. Further, while sometimes legally permitted in the earlier era, through transfer from retained earnings to dividend income,[27] formal participation in dividends clearly would have no content. Moreover, the argument is equally strong as to voting rights. Proportionate representation of either operating management or the sitting corporate directorate would contradict their basic rationale, while any other approach would be fully as arbitrary as designation of recipients of the "corporate".share upon liquidation.

Sunley could easily have extended his argument to the "preemptive right," a characteristic feature of ownership in his time. A corporation could not meaningfully *exercise* "rights" relative to itself. Any pretense in that regard could only imply their proportional increase for holders of stock still outstanding, or exclusion from issuance of the relevant percentage of shares.

Almost the only ownership entitlement available to the "corporate" shareholders is transfer of reacquired shares to other parties for value, and even it involves special legal restriction.[28]

Supporting References

It is useful to note selected supporting points, or statements, made in the earlier period for contra-equity analysis of treasury stock. In 1909 Henry Rand Hatfield stated that "In a certain sense any return of capital stock to the issuing company may be considered as a virtual cancellation of that amount of the previously issued stock,"[29] without yet (as noted below) accepting the apparent reporting implications of this interpretation. Some years later, however, in essentially a revised edition of the 1909 text, Hatfield would endorse uniform contra-equity treatment.[30]

Also writing before Sunley, Arthur Lowes Dickinson stated that capital stock "represents the manner in which its property and assets are distributed among those who constitute the corporation," and continued as follows:

> If one of those owners disposes of his shares to the corporation, he withdraws therefrom, taking with him what he considers his fair proportion of the asset value, and leaving the rest to be divided among the remaining owners.[31]

William A. Paton, just beginning his career, likewise insisted upon contra-equity treatment. Responding to the objection that "fully

paid" treasury stock would tend to be *more marketable* than unissued shares, he remarked that this difference no more warranted asset presentation than would the value to a bank of its right to issue currency justify recognition of a pertinent asset. He further advanced two *"reductio ad absurdum"* arguments effective against undiscriminating recognition of treasury stock as an asset: first, that formal retirement of shares could not intelligibly be interpreted as asset destruction; and second, that asset treatment implies that a firm could reacquire virtually all its stock outstanding without contracting its capital base.[32]

Other prominent proponents of contra-equity analysis included Hastings Lyon, Roy Kester, and R. J. Bennett and Paul Pinkerton (although, as noted presently, Pinkerton took another position in a subsequent collaboration).[33]

Early Argument for "Selective" Asset Presentation

In 1909 Hatfield introduced argument for "selective" asset presentation, despite the reference just made to his early thought, by suggesting that *management purposes* should govern reporting of reacquired stock:

> If it [reacquisition] is done with the intention of reducing the Capital Stock, certainly the stock . . . should be deducted from the amount of the outstanding stock . . . . But if the stock is not acquired with the intent of reducing the capitalization, and is not canceled, accounting practice in this country certainly justifies and, indeed, requires that it be shown among the assets.[34]

Only stock reacquired with retirement intent would on this approach be reported as a deduction item. Like his early successors in the tradition he initiated, Hatfield expressed only implicitly the basic premise of his position: that in certain cases reacquisition can reduce capital only in *form,* not *substance.*

Montgomery refined the analysis in the 1920s, in the third (1921) and fourth (1927) editions of the auditing text in which he had earlier advanced his form of legalism.[35] His new position was stated most clearly, however, in a 1923 abridgement prepared with the aid of one of his partners.

Montgomery asserted that stock "purchased for resale" (or, clearly other reissuance) should be reported as an asset at cost,[d]

[d]In his fourth edition Montgomery expressly favored reduction to "market" given a price decline regarded as permanent. Montgomery, 1927, p. 245.

while shares reacquired "without specific intention to resell" should be presented "as a deduction from the capital stock issued," at par.[36] Due to pertinent abuse, however, he called for presentation of *donated* shares as equity deduction items, at par, balanced by reduction of relevant nonmonetary asset items.[37]

Montgomery's approach differs from Hatfield's 1909 position primarily in analyzing reacquisition without clear intention in either direction, retirement or reissuance, as a decrease in capital. A secondary difference is that Hatfield had made no special provision for donation, perhaps because conspicuous abuse in the area did not yet exist.

Montgomery's position on repurchase (at least) drew support in 1931 from a most unlikely source: Sunley himself, in collaboration with Pinkerton, another early advocate of contra-equity analysis.[e] Referring to their listing of basic reacquisition objectives, Sunley and Pinkerton observed that, while only speculation and employee distribution entail reissuance intent, only reduction in capital excludes it. Varied *contextual* features, including evidence of established company policy, might indicate such intent. Even reacquisition to accommodate a stockholder or eliminate a dissident would warrant asset treatment if a buyer were secured in advance.[38]

While Hatfield wrote in 1927 that "accounting practice occasionally" followed Montgomery's approach to selective asset treatment,[39] no explicit commentary on it has been found. The closest implicit reply was Paton's negative reference to "marketability" of treasury shares as a basis for asset analysis.

The most direct rebuttal, however, is that a purpose requiring ultimate maintenance of capital might be sought through a strategy involving *temporary* contraction. Another potentially telling objection is that the position is *unworkable,* because "intention" may manipulatively be disguised. These points are of particular interest in that Montgomery's position has of late been revived, as discussed below.

Kohler's Summation: Treasury Stock Orthodoxy and the Entity Theory

With no more than minor overstatement, Eric Kohler in 1933 characterized accounting texts of the time as "well-nigh unanimous"

---

[e]Sunley reverted to his original position in the revised edition of his text, involving a different coauthor. Sunley and Carter, pp. 90-91.

Sheldahl: Reporting treasury stock as an asset: Law, logic, and economic substance

in supporting contra-equity analysis of treasury stock. He regarded this position as "unassailable," *if* the corporation were genuinely a "separate organism."[40]

This reference relates the consensus viewpoint to the "entity" theory of the corporation. Its essence is simply that a corporation cannot intelligibly be regarded as a partial owner *of itself.* On a "proprietorship" outlook, by comparison, the full shareholder group might be viewed as collective owner of treasury holdings, hardly a clearer interpretation.

Kohler's interpretation may prompt a contemporary objection of "legalism" against treasury stock orthodoxy, but only misguidedly. First, any meaningful analysis must presuppose the basic *concepts* of property ownership and corporate structure.

Second, it is not assumed that corporations are "real" entities, on the order of observable physical objects. Effort is invited to "pierce the corporate veil," by way of reconstructing Sunley's 1915 argument in terms of one or more standard logical fallacies, such as circularity or infinite regression. The following argument, formulated as if treasury stock *were* an asset, might serve as a first approximation:

1. Ownership of common stock constitutes "indirect" partial ownership of an evolving body of financial resources, constrained in their management by an evolving body of financial obligations
2. Ownership of common stock in a company whose resources include treasury common stock constitutes "indirect" partial ownership of that item itself, among the other resources
3. The treasury stock itself represents "indirect'" partial ownership of the body of resources within which it is included
4. Hence, ownership of common stock in a company whose resources include treasury common stock constitutes "indirect" partial ownership of that item (among the other holdings), which in turn constitutes "indirect" partial ownership of that item (among other holdings), . . . , and so on, *ad infinitum.*

While adequate clarification of "indirect" ownership would be a challenging task, it should be possible to restate the case against asset presentation in line with analysis of the corporation as a "legal fiction." Before submitting final judgment, however, current argument for selective asset treatment must be considered.

Contemporary Heterodoxy, in Two Formulations

While it has prevailed decisively at the levels of both theory and practice, uniform contra-equity analysis has recently been challenged by Allan Young and Beatrice Melcher. They have in turn revived Montgomery's position, and taken a less subjective approach to selective asset treatment, representing only modest advance in sophistication.

The new "heterodoxy" is very noteworthy, however, in view of qualitative and quantitative changes having greatly enhanced significance of treasury stock activity. In the early era stock repurchase was relatively rare, and usually required contra-equity presentation in any case. Today, in significant quantities, it is commonplace, and purposes viewed by current critics as requiring asset treatment have gained prominence.

Changes in Scope and Objectives of Treasury Stock Activity

Share reacquisition, by purchase, has expanded remarkably during the past generation. From 1954 to 1969 annual repurchase by companies listed on the New York Exchange increased from 5.8 million to 64.0 million shares, representing respectively 1.02%[f] and 2.02% of total shares traded. After a brief period of decline it rose abruptly to 143.8 million shares, or 3.32% of overall trading, in 1973. In that "bear-market" year 219 companies, approximately one-seventh of the listed corporations, reacquired at least one hundred thousand common shares.[41]

A survey conducted among the chief financial executives of those companies identified the following objectives, in the order listed, as having been the most prevalent bases for reacquisition:

1. Obtaining shares for executive stock options, other incentive compensation programs, and employee stock purchase plans
2. Obtaining shares for corporate acquisition (business combination) programs
3. Improving earnings per share[g]
4. Obtaining shares for conversions of bonds or preferred stock
5. Temporarily investing surplus cash

[f]This first figure (only) is biased upward, by exclusion from the base of shares traded prior to stock dividends or stock splits, although the reduction is offset in part by inclusion of preferred shares. "New York Stock Exchange Stocks," p. 28.

[g]The SEC in 1979 adopted a requirement by which registrants must disclose impact of stock repurchase upon earnings per share. Beresford and Neary, p. 6.

6. Supporting the market price of common stock
7. Increasing the debt/equity ratio.[42]

This listing is not fully comparable to the one cited for the earlier period, which was nonranked in form, basically impressionistic, and scarcely confined to public corporations. Even so, the lists imply that reacquisition was generally much less significant to overall *financial planning* in the earlier period. Only two of the eight early objectives appear in the current list, namely, obtaining shares for distribution to employees, and investing surplus funds.[h] Further, the former one is immensely more important in the present day.

Against this background, Young and Melcher have called for reexamination of the traditional reporting doctrine.

Young's Revival of Montgomery's Analysis

Young takes the position represented by Montgomery in the 1920s, omitting, as had Sunley and Pinkerton, reference to donation. Characterizing assets as "uses of funds which still retain a service potential to the firm,"[43] he would so present all shares repurchased with clear "intention" of reissuance, for *any* recognizable management purpose.[44] Formal commitment to reissuance is considered unnecessary. Valuation would be at cost or the lower of cost or market, depending upon whether classification were "noncurrent" or (inadmissibly for Montgomery) "current."[45]

In support of this position, three contexts are cited in which management purposes are commonly accepted as central to accounting analysis: distinction between current and noncurrent assets; operating and financial leases; and stock dividends and stock splits.[46] In the latter two instances the alternative would be strict control by legal form.

Terminologically, it would be preferable to speak of "expectation" of reissuance as the condition for asset treatment, since initiative may rest with parties other than management, as in conversion of other securities to common stock. Substantively, Young's criterion invites the objection of undue subjectivity, and encouragement thereby of accounting manipulation by management.

The latter objection arises from the direct implication, largely ignored by Young, that reissuance may yield "gain" or "loss." While speculative purposes may give pause in this regard, linkage of re-

[h]Two of the other objectives cited in the prior listing, numbers 6 and 8, were cited by the contemporary financial executives surveyed, but by fewer than 10 of the 113 respondents in each case. Walsh, p. 6.

acquisition with the earnings process seems generally implausible. For example, the standard criticism of accounting for conversion of bonds at market price of either security is provision of such treatment for gain or loss.[47] Such objection can hardly be dismissed out of hand.

There is risk of severe paradox in Young's position, in any case, For example, if "economic substance" is to govern accounting treatment of reacquired stock, should not *unissued* shares be carried as an asset if they are to be placed on the market in lieu of reissuance of treasury holdings? Since "gain" on reissuance was taxable for two decades, 1934-54,[48] this case historically is realistic.

Melcher's Case for Narrower Asset Treatment

Melcher's relatively complex approach yields much narrower advocacy of asset presentation. She would require both that (1) reacquisition serve on explicit *requirement* that the company acquire its own shares, and (2) the specified purpose be of an "operating" nature rather than a "financing" one.[49] More concisely, treasury stock should be reported as an asset if it is acquired relative to an express commitment, to serve particular operating objectives. Donated stock would almost as such fail the test.

"Operating" objectives are illustrated mainly in terms of *compensation* plans, notably stock option and purchase programs, profit-sharing and bonus provisions, and deferred compensation contracts. Treasury shares may also be used for pension plan costs, sales commissions, and charitable donations.[50]

Stock reacquisition for "financing" purposes directly concerns equity interests. Objectives include (a) investment of excess funds, (b) revision in financing sources, (c) anticipation of conversions and exercise of warrants, (d) distribution of stock dividends, and (e) implementation of business combinations. Melcher disallows asset treatment in such cases on the premise that change in ownership interests alone cannot yield gain or loss.[51]

Melcher advocates asset treatment, and attendant recognition of gain or loss (as applicable), for reacquisitions "specifically *required* for a designated operating purpose,"[52] because "distributing stock to satisfy liabilities does not change the underlying nature and purpose of incurring costs."[53] Since only action by the board of directors is specifically cited, it is perhaps assumed that *contractual* commitment to stock reacquisition would ordinarily require prior board approval.

Such limitation of asset treatment is no doubt intended to forestall income manipulation through treasury stock activity. Shares acquired prior to origination of a need for treasury shares would not qualify, nor would stock acquired with the idea of discretionary reissuance in fulfillment of a given obligation, in preference either to issuance of new shares, or to distribution of cash or marketable securities.[54]

Unlike Young's, this position has some affinity with official authoritative tradition. The cryptic 1934 AI(CP)A statement on treasury stock cited in note (a) contemplated that asset analysis might on occasion be "permissible," without citing instances. The SEC, however, has approved asset reporting of shares reacquired expressly for prompt use in employee bonus or stock purchase plans, for example,[55] and otherwise orthodox analysts have tentatively accepted such treatment.[i] Melcher has gone further, endorsing *mandatory* asset presentation in these cases.

Overall, the distinction between two classes of objectives seems pertinent *if* treasury stock activity indeed relates to the earnings process. Further, the condition that reissuance be required would clearly support objectivity. At the same time, it seems a bit paradoxical to recognize gain or loss on transactions relating to compensation plans, but not ones involving reissuance of shares acquired as an "investment."

Broader appraisal of the views of Young and Melcher than has as yet been made awaits final evaluation of the basic case against asset treatment.

Reaffirmation of Orthodoxy, Accommodating Dissident Analyses

By way of conclusion, the classic argument against asset presentation of treasury stock is reaffirmed, while means are identified for deriving substantial contributions nonetheless from both Young and Melcher.

Unsuccessful Efforts to Refute Sunley's Classic Argument

Sunley's contention that a corporation cannot be an owner of itself seems generally compelling, on its own terms. Proponents of asset treatment may still submit, however, that it mainly addresses

[i]Finney and Miller, pp. 122-123. The authors cited themselves take a strictly orthodox reporting position, however.

features unimportant to modern share ownership, or that it subordinates basic objectives of financial reporting to empty logical abstractions. Failure of each rebuttal effort leaves such analysts only the bleak option of "heroic denial" that their positions *do* imply self-ownership.

Analytical Approach: Alleged Conceptual Distortion

The basic "analytical" response to Sunley's argument would be that the primary features of modern stock ownership are storage of value and eligibility for periodic dividends, and that they are respectively ignored and approached misleadingly by the argument. Treasury stock could be viewed as conferring a counterpart to participation in cash or property dividends, through "saving" dividend payout. The other features considered by the classic argument, as discussed above, might be dismissed as follows:

1. Voting privileges are generally a mere formality
2. Emphasis upon participation in liquidating dividends conflicts with the "going concern" premise of accounting
3. As indicated by declining incidence,[56] preemptive rights are relatively insignificant in the present day.

Allusion to storage of value recalls Paton's response to assertion of asset status based on "marketability" of treasury shares, at a time in which they often were more attractive to investors than newly authorized stock. The references made to other features are equally misleading. Delay in issuance of new shares likewise "saves" dividend distributions. Further, voting is *not* a formality within close corporations, although they may for example reacquire shares with reissuance intent. Moreover, assesment of liquidation prospects may properly affect decisions on retention or acquisition of stock, and their residual equity interest is the prime concern of a company's "final" shareholders. Finally, while the preemptive right has declined in overall importance, it is hardly an irrelevant or incidental feature of common stock, where it exists.

Methodological Approach: Alleged "Formalism"

"Methodologically," a selective asset advocate may insist that a purely conceptual argument making no reference to management objectives, economic implications, or other behavioral bearings must not control accounting treatments. This objection of "formalism" is a contemporary allegation of accounting legalism.

While it is an accounting truism that ultimately substance must prevail over form, the classic argument for contra-equity analysis cannot be dismissed on this basis. Two relevant points have already been made: that substantive likenesses between treasury stock and unissued shares could in no event justify asset recognition in the latter case; and that management purposes not involving reduction in capital might be approached through temporary contraction.

The decisive rebuttal, however, is that if there *are* relevant material differences between different contexts of share reacquisition, it should be possible to represent them in accounting/reporting terms without inviting logical paradox. The remaining task is to illustrate this point relative to the positions of Young and Melcher, having concluded that the orthodox doctrine on treasury stock reporting is correct.

Accommodation of the Heterodox Positions

Three possible approaches remain for giving accounting recognition to different contexts of stock reacquisition: (1) differential *recording* of transactions; (2) supplemental *disclosure;* and (3) a combination of courses 1 and 2. In an effort to salvage significant contributions from both critics of orthodox accounting treatment, the third alternative is adopted. Young's position is recast as a "recording" doctrine, while Melcher's variation is expressed at the "disclosure" level.

Basic Treasury Stock Recording Methods: A Complementary Interpretation

Practice has followed theory relative to *presentation* of treasury stock. However, accounting writers have predominantly favored the "par value" approach to *recording* of relevant transactions, while practice has generally favored the "cost" method. The two alternatives may be reconciled by recognizing them as suited to different contexts of stock reacquisition.

Historical Divergence Between Theory and Practice

In the earlier period a strong consensus developed in favor of the "par value" recording method, by which reacquisition is recorded essentially as retirement of stock, and reissuance as an independent transaction. Representative advocates of recording treasury stock at par or stated value included Paton, Kester, Hatfield, and Harry A. Finney.[57] Apparently the "cost" method, by which treasury shares

are recorded at cost and their reissuance is accounted for as a follow-up transaction, was associated too closely with the discredited reporting doctrine of asset treatment to be attractive.

The par value approach was endorsed in 1957 by the American Accounting Association Committee on Concepts and Standards,[58] and may yet today enjoy more support than the cost method among accounting writers. It was recently commended by Melcher, for nonasset contexts, and also by two parties linking the other recording procedure to asset presentation of reacquired shares, Norlin Rueschhoff and textbook collaborators D. E. Kieso and J. J. Weygandt.[59]

Even so, the cost method has dominated practice. During the years 1974-78, 86.7% of surveyed companies which reported treasury stock in the equity section did so at cost, of which 97.1% treated it as a final deduction item.[60] Classification by reacquisition context is, however, unavailable.

Proposed Complementarity of the Methods

It is submitted that recognition of the two recording methods as mutual competitors is misguided, and only forestalls effective response to advocates of selective asset presentation. A complementary interpretation advanced by Eldon Hendriksen,[61] and in a modified form having official support as well,[j] is adopted instead. Specifically, the cost method should be used whenever reacquisition occurs with clear intention or expectation of *reissuance,* whether or not a formal requirement exists, and the par value method otherwise. In the latter case, "'constructive retirement" is assumed.

The position taken parallels Young's approach to selective asset treatment, because the distinctive features of Melcher's analysis seem rather arbitrary outside such a context. First, since gain or loss would not be recognized in any case, the rationale for differential recording of reacquisition for "operating" and "financing" objectives is removed. Second, the strictures as to "requirement" of reacquisition presuppose opportunity, otherwise, for income manipulation, whereas any subjectivity within the dualistic approach adopted would affect presentation only of the equity accounts themselves. Any incentive provided in this context to manipulate

[j]In paragraph 12b of *Opinion No. 6,* the Accounting Principles Board recommended use of a "cost" basis "When a corporation's stock is acquired for purposes other than retirement (formal or constructive), or when ultimate disposition has not yet been decided." In the latter regard it differs from Hendriksen's position, supported in this study. Financial Accounting Standards Board, p. 139.

reported *accounting numbers,* themselves, is assumed to be minimal.

To leave matters at this point, however, would invite concern as to undue subjectivity in reporting, relative to management purposes themselves. A relevant requirement of *disclosure* should thus accompany the dualistic doctrine governing recording of treasury stock activity.

A Proposal as to Supplemental Disclosure

It is suggested, then, that through supplemental disclosure distinction should be drawn between shares reacquired subject to formal "requirement" of reissuance, and other holdings recorded at cost. Inclusion of such information would not only accommodate Melcher's viewpoint, but also ease the burden upon the independent auditor in attesting to the equity section of the balance sheet.

While the appropriate level of detail is debatable, in the absence of relevant empirical study of reader needs, additional information regarding treasury stock holdings might be provided in this connection. For example, a distinction could be drawn between "current" and "noncurrent" items, based upon time frame of anticipated reissuance. Such a disclosure would capture still another dimension of *Young's* position.

In summary, the area of supplemental disclosure is likely to be highly important in developing standards for treasury stock reporting.

Concluding Comment

The historical overview developed above has both recognized an enduring contribution on the part of early work relative to treasury stock reporting, and provided an invitation to contemporary research concerning specific recording and disclosure issues arising in the area. In particular, the force of the classic logical argument against asset presentation has been reaffirmed, without general dismissal of the views of heterodox analysts, past or present.

By sorting out the principal legal, logical, and economic issues whose interplay is involved, the study has identified treasury stock accounting as an area more intriguing than the volume of scholarly attention to date directed towards it might suggest.

FOOTNOTES

[1]Hendriksen, pp. 527-530.
[2]Rosenfeld, p. 767. Rueschhoff, pp. 4-5.

[3]Dick and Rickert, p. 234. Shohet and Rikert, p. 216.
[4]Rueschhoff, p. 2.
[5]Sunley and Pinkerton, p. 99.
[6]Simon, p. 706.
[7]Sunley and Pinkerton, pp. 138-139.
[8]Cole, p. 259. Cook, p. 152.
[9]Bennett and Pinkerton, p. 1107. Cole, p. 259. Conyngton, pp. 105-107. Cook, pp. 148-152. Hatfield, 1927, pp. 217-219. Paton, 1922, pp. 387-389. Sunley and Pinkerton, p. 133.
[10]Sunley and Pinkerton, p. 96.
[11]Holt and Morris, pp. 505-507.
[12]Young, p. 220.
[13]Hatfield, 1927, p. 9.
[14]Bentley, pp. 173-174. Montgomery, 1912, p. 138. Montgomery, c1916, pp. 133-134.
[15]Bentley, p. 174.
[16]Esquerré, p. 332.
[17]Conyngton, p. 104.
[18]Paton, 1922, p. 382.
[19]Simon, pp. 698-699, 698n.
[20]Boyle, sec. 13-5; Dickinson, p. 133. Schmitthoff, vol. 1, sec. 48-09.
[21]Boyle, secs. 13-5, 15-15. Schmitthoff, vol. 2, secs. A-066, A-221, A-478.
[22]Boyle, secs. 13-7, 13-8. Schmitthoff, vol. 1, secs. 48-09, 48-10. Schmitthoff, vol. 2, secs. A-027, A-054, A-165.
[23]Boyle, sec. 13-8 (recommendation). Schmitthoff, vol. 1, sec. 48-09.
[24]Cameron, Woelfel, and Pattillo, pp. 297-301.
[25]Lyon, p. 11.
[26]Sunley, p. 426.
[27]Paton, 1919, p. 334.
[28]Rueschhoff, pp. 5-6.
[29]Hatfield, 1909, p. 151.
[30]Hatfield, 1927, p. 182.
[31]Dickinson, p. 130.
[32]Paton, 1922, pp. 383-386.
[33]Bennett and Pinkerton, p. 1101. Kester, 1918, pp. 247-248. Kester, 1925, p. 181. Lyon, pp. 11-12, 14.
[34]Hatfield, 1909, pp. 151-152.
[35]Montgomery, c1921, pp. 206-208. Montgomery, 1927, pp. 244-246.
[36]Montgomery, 1923, p. 216.
[37]Montgomery, 1923, p. 217.
[38]Sunley and Pinkerton, pp. 95-97.
[39]Hatfield, 1927, pp. 181-182.
[40]Kohler, p. 336.
[41]"New York Stock Exchange Stocks," p. 15. Walsh, p. 4.
[42]Walsh, p. 6.
[43]Young, p. 224.
[44]Young, p. 223.
[45]Montgomery, 1927, p. 245. Young, pp. 225-226.
[46]Young, pp. 222-223. Young and Horwitz, p. 31.
[47]Kieso and Weygandt, p. 716.
[48]Reuschhoff, p. 4.
[49]Melcher, p. 251.

[50]Melcher, p. 250.
[51]Melcher, p. 237.
[52]Melcher, p. 251 (emphasis added).
[53]Melcher, p. 250.
[54]Melcher, pp. 252-254.
[55]Rappaport, ch. 16, p. 19.
[56]Kieso and Weygandt, p. 646.
[57]Finney, ch. 8, pp. 16-17. Hatfield, 1927, p. 183. Kester, 1918, pp. 18-19. Paton, 1922, pp. 381-382. Paton, 1919, pp. 333-334.
[58]American Accounting Association, p. 7.
[59]Kieso and Weygandt, p. 661. Melcher, pp. 242-244. Rueschhoff, p. 6.
[60]Dick and Rickert, p. 234. Shohet and Rikert, p. 216.
[61]Hendriksen, p. 529.

BIBLIOGRAPHY

American Accounting Association, Committee on Concepts and Standards. *Accounting and Reporting Standards for Corporate Financial Statements, and Preceding Statements and Supplements.* Madison, Wis.: AAA, 1957.

Bennett, R. J. and Pinkerton, Paul W. "Corporation Accounting." In *Corporation Procedure,* pp. 1031-1421. Edited by Hugh Conyngton. New York: Ronald Press Co., 1922.

Bentley, Harry C. *The Science of Accounts.* New York: Ronald Press Co., 1911.

Beresford, Dennis R. and Neary, Robert D. "Financial Reporting Briefs." *Financial Executive,* Vol. 47 (June 1979), pp. 6, 8, 10.

Boyle, A. J., gen. ed. *Gore-Browne on Companies.* 43rd ed. Richard Sykes, consultant ed. London: Jordan & Sons Ltd., 1977.

Cameron, James B.; Woelfel, Charles J.; and Pattillo, James W. *Advanced Accounting: Theory and Practice.* Boston: Houghton Mifflin Co., 1979.

Cole, William Morse. *The Fundamentals of Accounting.* Boston: Houghton Mifflin Co., 1921.

Conyngton, Thomas. "Corporate Law." In *Corporation Procedure,* pp. 1-551. Edited by Hugh Conyngton. New York: Ronald Press Co., 1922.

Cook, William W. *The Principles of Corporation Law.* Ann Arbor: Lawyers Club of the University of Michigan, 1925.

Dick, George and Rickert, Richard. *Accounting Trends and Techniques.* 32nd ed. New York: American Institute of Certified Public Accountants (AICPA), 1978.

Dickinson, Arthur Lowes. *Accounting Practice and Procedure.* New York: Ronald Press Co., 1914 (c1913); reprint ed., Houston, Texas: Scholars Book Co., 1975.

Esquerré, Paul Joseph. *Applied Theory of Accounts.* New York: Ronald Press Co., 1914.

Financial Accounting Standards Board. *Financial Accounting Standards:* Original *Pronouncements as of June 1, 1981.* Chicago: Commerce Clearing House, 1981.

Finney, Harry A. *Principles of Accounting.* Vol. 1. New York: Prentice Hall, 1923.

__________ and Miller, Herbert E. *Principles of Accounting: Intermediate.* 6th ed. Englewood Cliffs, N. J.: Prentice-Hall, 1965.

Hatfield, Henry Rand. *Accounting: Its Principles and Problems.* New York: D. Appleton & Co., 1927; reprint ed., Lawrence, Kansas: Scholars Book Co., 1971.

__________. *Modern Accounting: Its Principles and Some of Its Problems.* New York: D. Appleton & Co., 1909.

Hendriksen, Eldon S. *Accounting Theory.* 3rd ed. Homewood, Ill.: Richard D. Irwin, 1977.

Holt, Walter A. and Morris, Edwin L. "Some Aspects of Reacquired Stock, 1931-1933." *Harvard Business Review*, Vol. 12 (July 1934), pp. 505-510.

Kester, Roy B. *Accounting: Theory and Practice*. Vol. 2. New York: Ronald Press Co., 1918.

__________. *Accounting: Theory and Practice*. 2nd ed., rev. Vol. 2. New York: Ronald Press Co., 1925.

Kieso, Donald E. and Weygandt, Jerry J. *Intermediate Accounting*. 3rd ed. New York: John Wiley & Sons, 1980.

[Kohler, Eric L.,] "Treasury Stock." *The Accounting Review*, Vol. 8 (December 1933), pp. 336-339.

Lyon, Hastings. *Corporation Finance*. Part (Vol.) 2: *Distributing Securities, Reorganization*. Cambridge, Mass.: Riverside Press, 1916.

Melcher, Beatrice. *Stockholders' Equity*. Accounting Research Study No. 15. New York: AICPA, 1973.

Montgomery, Robert H. *Auditing: Theory and Practice*. New York: Ronald Press Co., 1912.

__________. *Auditing: Theory and Practice*. 2nd ed., rev. & enl. New York: Ronald Press Co., 1919 (c1916).

__________. *Auditing: Theory and Practice*. 3rd ed., rev. & enl. New York: Ronald Press Co., 1922 (c1921).

__________. *Auditing: Theory and Practice*. 4th ed., rev. & enl. New York: Ronald Press Co., 1927.

__________, assisted by Walter A. Staub. *Auditing Principles*. New York: Ronald Press Co., 1923.

"New York Stock Exchange Stocks." *Bank and Quotation Record*, Vol. 28 (January 1955), pp. 15-28.

Paton, William A. *Accounting Theory: With Special Reference to the Corporate Enterprise*. New York: Ronald Press Co., 1922; reprint eds., Accounting Studies Press, 1962; Lawrence, Kansas: Scholars Book Co., 1973.

__________. "Some Phases of Capital Stock." *The Journal of Accountancy*, Vol. 27 (May 1919), pp. 321-335.

Rappaport, Louis A. *SEC Accounting Practice and Procedure*, 3rd ed. New York: Ronald Press Co., 1972.

Rosenfeld, Eugene. "Uniformity in Accounting for Treasury Stock and Its Disposition." *The CPA Journal*, Vol. 43 (September 1973), pp. 763-769.

Rueschhoff, Norlin G. "The Evolution of Accounting for Corporate Treasury Stock in the United States." *The Accounting Historians Journal*, Vol. 5 (Spring 1978), pp. 1-7.

Schmitthoff, C. M., with M. Kay and R. K. Morse. *Palmer's Company Law*. 22nd ed. Vol. 1: *The Treatise*; Vol. 2: *The Companies Acts and Other Company Measures*; Vol. 3: *Company Measures*. London: Stevens & Sons, 1976 (updated to April 16, 1980).

Sheldahl, Terry K. *Beta Alpha Psi, from Alpha to Omega: Pursuing a Vision of Professional Education for Accountants, 1919-45*. Accounting in Transition series, edited by Richard P. Brief (advis. ed.). New York: Garland Publishing, 1982.

Shohet, Jack and Rickert, Richard. *Accounting Trends and Techniques*. 33rd ed. New York: AICPA, 1979.

Simons, Harry. *Intermediate Accounting: Comprehensive Volume*. 5th ed. Jay A. Smith, consulting ed. Cincinnati: South-Western Publishing Co., 1972.

Sunley, William T. "Treasury Stock." *The Journal of Accountancy*, Vol. 20 (December 1915), pp. 424-429.

——————— and Carter, William J. *Corporation Accounting.* Rev. ed. New York: Ronald Press Co., 1944.

——————— and Pinkerton, Paul W. *Corporation Accounting.* New York: Ronald Press Co., 1931.

Walsh, Francis J., Jr. *Repurchasing Common Stock.* New York: Conference Board, 1975.

Young, Allan E. "Accounting for Treasury Stock." *Journal of Accounting, Auditing and Finance,* Vol. 1 (April 1978), pp. 217-230.

——————— and Horwitz, Bertrand. "The Case for Asset Disclosure of Treasury Stock." *The CPA Journal,* Vol. 45 (March 1975), pp. 31-33.