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No-par discount

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This theory is difficult of practical application, because no one can say with any assurance how long the capital will endure or over what period the expense should be written off. Moreover, this practice raises a question of equity every time new capital comes into the enterprise, profits are capitalized, a stock dividend is declared, etc. Also, the practice results in a false representation with respect to the capital employed in the enterprise.

Return on capital is computed properly with the effective capital as the base. To compute return on capital which, in fact, has not been contributed, results in a fictitious conclusion. The recognition of discount in connection with capital stock having no par value results in a false statement. The balance sheet represents that more capital is being employed in the enterprise than actually was received.

The only amount of capital which may be shown properly in connection with no par shares is the amount of consideration received for such shares. A payment for the purpose of obtaining capital is anything but capital received into the business. As a matter of historical record, there can be no objection to showing both sides of the transaction in the capital account. But when the capital account is used for statements, the balance in the account, representing the effective capital available to the enterprise, is the amount pertinent to the purpose.

This conclusion has no authority to support it other than common sense. So far as is known there have been no legal decisions on the point. To dispute the conclusion seems to show evidence of a desire to cling to a tradition which was born of bad practice made necessary by the fiction concerning par shares. If shares without par value had no other advantages, here would be one for which to be thankful. Capital resulting from the issuance of shares without par value should be shown in an amount equal to the value of the consideration for which the shares were exchanged.

It has been said, of course, in opposition to the suggestion of deducting expense before taking up the proceeds from sales of no-par capital stock, that the practice leads to abuses. To admit such charge is not to admit that the practice is unsound. Unscrupulous and conniving promoters probably always will exist. They may organize corporations having shares without par value, make excessive charges for selling the stock, and turn into the company but a meager residue of the amount for which the stock was sold. But the fact remains that all the capital which the company would receive for the purpose of beginning business would be the amount turned over by the selling agents. The trouble here is with the agents; not with the principle involved. And it may be said, without fear of contradiction, that, in this hypothetical case, if the stock sold had a par value the company would receive no more effective capital, but the fact would be concealed by the fiction of a deferred charge. To so show the discount in the case of shares without par value, it is claimed, would act as a deterrent to large commissions. With this, accounting is not concerned.

Rationalization of accounting procedure is one of the things which capital stock without par value makes possible. Not the least of the advantages is the fact that the capital account may be so stated as to show the capital of an enterprise in its true light. It is so shown when the amount is the effective capital made available to the enterprise by the sale of shares.

The Insurance Man Speaks

"YOU asked me for brief information re: 'sound value as known in the New York Standard Fire Insurance Policy.'

"The meaning of the phrase 'sound value' is 'cash value' as applied to a policy of fire insurance. It is the cash value of the property insured to an owner at the time a fire occurs.

"Because there are many classes of property and many different interests insured, there are of necessity varied phases of what constitutes the actual cash value.

"Often people are under the impression that an amount agreed upon between the Insurance Company or the broker as to the amount of insurance to be carried constitutes the cash value or the sum to be paid by the Insurance Company in case of fire. That is not correct. Some people even overlook the fact that the underlying principle of a fire insurance contract is indemnity.

"It insures the owner against loss by fire. It does not insure against fire nor does it insure the building or the goods.

"The value of the property destroyed, immediately before the fire, is the limit of the assured's claim.

"The beginning of the policy reads:

" 'Does insure............ and legal representatives, to the extent of the actual cash value (ascertained with proper deductions for depreciation) of the property at the time of loss or damage, but not exceeding the amount which it would cost to repair or replace the same with material of like kind and quality within a reasonable time after such loss or damage, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair and without compensation for loss resulting from interruption of business or manufacture.'

"This excludes again, such losses as profits, trade, derangement of business, payment of salaries even though in consequence of the fire, and the effect is to prevent recovery by fire for any sum greater than measured by the actual cash value of the property injured or destroyed. (There is, as you know, use and occupancy fire insurance and profits fire insurance.)

"Without such a limitation clause the policy would not be one of indemnity and we would have to put a specific value on each risk before the issuance of a policy, which would be an expensive procedure.

"Actual cash value in general terms means the sound value of property at the time of fire, or cost to an insured to replace in the same condition as it was immediately preceding the fire.

"To arrive at the actual cash value, the Insurance Company is entitled to any depreciation, however caused, but nothing can be added to the cash value on account of estimated profits, in estimating the amount of loss.

"The basis of indemnity under a fire insurance policy is money value at the time of fire of property destroyed, not the cost of replacement, the insurer being at all times entitled to any depreciation that may exist.

"An insurer always has a right to reinstatement or replacement of damaged or destroyed property, but the privilege is optional with the Company.

"*Buildings:*

"To determine the actual cash value, the usual procedure is to take into consideration the original cost, add cost of improvements subsequently made and as the provision in the policy specifies, 'what it would then cost the insured to replace,' due allowance must be made for increase in cost of material or labor, should any exist.

"The burden of proof in establishing depreciation rests upon the insurer. Appreciation on account of increase of price of material and labor is often greater than the depreciation.

"Depreciation is often on account of age or condition or it may be proper from other causes: 'however caused' is the provision of the policy. A building may have been constructed for some particular purpose, but on account of failure of the enterprise, or unsuitable location, or subsequent change of trade centres, it could not be used for the purpose for which it had been erected, and had become, therefore, in a measure useless. The 'actual cash value,' in the event of fire, of such a building could not be determined upon an original cost, less depreciation for ordinary wear and tear, and neither could the measure of indemnity be based upon an estimate of the cost of replacement or repairing. Then, again, take the case of a dwelling house built in what was once an outlying section of a city. Afterwards streets are cut through and sewers built and other improvements made, making condemnation proceedings necessary, which proceedings have been commenced prior to fire. In such similar cases, the value of the building as it stood on the day of the fire must be predicated upon commercial or intrinsic value, taking into consideration all the circumstances and facts surrounding the case.

"*Personal Property:*

"If the insured be a manufacturer of straw hats and his plant destroyed by fire just prior to the opening of the straw hat season, he could collect market value of his stock, in my opinion, and not merely cost of raw stock materials and labor. In this case you see, provided I am right, that the policy is not one of indemnity only in every single case.

"To sum up, a policy of fire insurance is a contract of indemnity, and when loss occurs it must be given a construction which under ordinary conditions will achieve the object of both parties in an honest manner, and the agreement is made that cash value is the limit of the insurer's liability and cash value means the money value of the thing insured in its condition at the time of the fire.

"What seems to me to be rather a fit description of this is to quote the old standard phrase 'that the cost of construction of a summer hotel at the north pole would not be the amount collectible under a fire insurance policy, as such cost would not be so called sound value.' "

"Verification of Financial Statements"

THE Federal Reserve Board has approved a document which will be issued presently in pamphlet form under the title, "Verification of Financial Statements."

The document supersedes one called "Approved Methods for the Preparation of Balance Sheet Statements," which contained "General Instructions for a Balance Sheet Audit of a Manufacturing or a Merchandising Concern."

The old document contained much valuable audit procedure which often failed of attention and use because it was overshadowed by glaring major inconsistencies. The expression "balance sheet audit" was an unhappy one, and led to misunderstanding and controversy. The stated scope of such procedure limited the work of verification to the assets and liabilities. The instructions relating to the profit and loss accounts provided for little more than the preparation of a profit and loss statement, without verification. There was no authoritative source from which one could discover what was meant by "an examination of the essential features of the accounting." In spite of the fact that the profit and loss accounts were not required to be verified the auditor who signed the form of certificate suggested was asked to say that he had audited the accounts for a "period."

The new document eliminates some of the inconsistencies, makes clearer than formerly what is intended, and leaves no doubt about certain things. The scope of the work indicated in the present instructions covers, "a verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit and loss account for the period under review, and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check."

It is of the essence in this type of audit, for, with *verification* as its basis, such it must be called, that the "extent of the verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In