1928

# Profit, dividends, and appreciation

John Raymond Wildman



Recommended Citation
Haskins & Sells Bulletin, Vol. 11, no. 03 (1928 March), p. 21-23

# Profit, Dividends and Appreciation

By John R. Wildman

PROFITS arise from the establishment of an enforceable right to receive an amount in excess of cost.

Profits have been established when a right to receive an amount in excess of cost is represented by accounts, notes, or similar receivables, which can be converted readily into cash.

Profits have been realized when assets comprehending the profit have been converted into cash.

The theory that there must be something to divide before a dividend may be declared, while eminently sound, may require some explanation. It is a condition precedent to the declaration of a dividend payable in cash that profits equivalent to the proposed dividend shall have been established. Neither business practice nor law has required that the specific assets in which the profits rest shall have been converted into cash before the dividend can be paid. But sound business procedure does require that the assets which comprehend the profits shall be on their way into cash, and moving in that direction so sharply that the use of a corresponding amount of cash for the payment of the dividend will not interfere with the prompt payment of claims maturing in favor of current creditors.

Dividends may be declared when profits have been established. They may be paid when the necessary cash can be extracted from the business. Thus, the controversial question of whether a corporation may borrow funds with which to pay a cash dividend, is not one of legality, but one of business judgment and credit.

Profits, if not distributed, represent a part of surplus. Until the profits have been realized they must be in current assets, that is, in accounts receivable, or notes receivable, or, in some instances, securities taken in settlement of accounts. After realization their location is a matter of fine-spun theory. The profits may be in cash, or they may have been reinvested in merchandise, plant property, securities, or applied in the reduction of liabilities which is equivalent to reinvestment.

Surplus is the excess of assets over liabilities (including reserves) and capital. All surplus is not profit any more than all profit is cash. Surplus may be derived from profit, from adjustments of asset values, from adjustments of liabilities, or of reserves, or from the consideration received in exchange for capital stock disposed of at a premium.

Any surplus may be partitioned by means of a stock dividend. Only earned surplus, or surplus resulting from established profits, may be distributed in cash. This statement is subject to certain qualifications. Where surplus is derived from the reduction of a liability, or from a reserve previously created out of earned surplus, or from an apportionment of the consideration received for capital stock with the purpose of equalizing the rights of shareholders to future dividends, it may be made the basis of cash dividends.

Exception to the statement that an increase in the value of an asset increases surplus, is found in the case of appreciation resulting from revaluation of depreciating property. Such increase in value, due to appraisal of property, frequently is found in surplus, and frequently is described in such cases as capital surplus. Such surplus frequently is made the subject of charge for losses resulting from operations, or for adjustments in the value of assets other than property.

The effect of subjecting capital surplus to such procedure is to ignore the fact that future depreciation of property must be based on appraised values and that the amount of the increase in value over cost will be required subsequently to absorb the depreciation on the increase in value. This statement is unalterable unless the full measure of depreciation, or in other words depreciation on appraised values, is to be recovered out of future earnings.

One reaches the conclusion by the foregoing reasoning that the difference between appraised value and cost should be credited to a reserve, and not to capital surplus. If full depreciation is recovered out of future earnings, an amount corresponding to the depreciation on appreciation passes periodically from the reserve for appreciation to earned surplus. The reserve for depreciation takes care of the property at the time of its extinction. In the meantime the appreciation reserve provides the appropriate proportion for excess depreciation on property included in the appraisal in case of extraordinary loss due to abandonment or other causes.

Probably it may be said with impunity that surplus does not arise from appreciation of depreciating property. The amount of appreciation resulting from an upward revaluation of a depreciating asset should be credited to a reserve. If subsequently the periodic charge for depreciation is apportioned on the basis of cost and appreciation, so that the part relating to cost only is charged to operations, the reserve will be required to absorb the remainder corresponding to appreciation and the reserve should not be disturbed further. If all the depreciation is charged to operations, the reserve may be reduced by periodic transfers to earned surplus.

Appreciation of non-depreciating assets properly may be credited to surplus, but not to earned surplus. Appreciation in no way establishes a profit. It is an adjustment of asset values reflecting an increase, which increase may or may not be realized at some future time. Quite consistent though it may be to argue that surplus represents the net of, and fluctuations in, values in excess of liabilities and capital, it is inconsistent to argue that all surplus is profit.

While any surplus may be partitioned by means of a stock dividend, the effect of declaring a stock dividend out of capital surplus is to fix such surplus in the capital account on the basis of an estimate which may or may not be proved by future developments to have been justified. The action of partitioning capital surplus by means of a stock dividend forever removes such surplus from the possibility of making it absorb an operating deficit. While the soundness of applying an operating deficit against capital surplus is in question, at times it is done. Apparently, however, it may not be done legally under the present Ohio statute. Likewise, the partitioning of surplus, erroneously set up on the theory that appreciation on depreciating property creates surplus, prevents the amount involved from being used subsequently for the purpose of absorbing depreciation on appreciation in value, or from being transferred to earned surplus as the appreciation is realized out of earnings.

Summing up the foregoing, it appears:

(1) That appreciation of depreciating property should be credited to a reserve account and not to capital surplus.

(2) That appreciation on non-depreciating property may be credited to capital surplus.

(3) That capital surplus should not be made to absorb a profit and loss deficit.

(4) That capital surplus preferably should not be partitioned.

(5) That stock dividends should be used to partition only such capital surplus as has been realized, or established, which surplus in effect becomes earned surplus.

(6) That cash dividends should be declared only out of earned surplus.

(7) That in the case of any balance sheet involving the foregoing matters the

surplus should be set forth so as to show its component parts and their respective origins.

(8) That in any case where statutes permit procedure to the contrary, the departure, of course, must be countenanced, but, by the same token, the facts must be shown clearly. It would not seem amiss to show also the statutory authority for the anomaly.

## Investment Trust Trends

WHEN investment trusts were first introduced in the United States there was a tendency to operate along strict trust lines by selling participating certificates or trust shares in a trust fund which was invested in a diversified group of securities and deposited with a trustee. The holder of a participating certificate had a proportionate interest in the total value of, and income from, the fund. However, the trend is now away from the strict investment trust type of organization and toward the investing company type. Most of the so-called investment trusts today issue their own bonds or debentures, which bear a fixed rate of interest, and invest the proceeds in a variety of outside securities. Any profit made on the securities over and above the annual interest charges on the bonds and debentures belongs to the corporation.

Despite the present trend, there are still many points peculiar to an investment trust which the auditor should investigate while making an audit of such a company.

Perhaps the most important phase of the so-called investment trust organization which the auditor should investigate is whether the company's investments conform with the standards of value and standards of diversification prescribed in the articles of incorporation. The standards of value usually permit investments only in securities having a certain earning power, issued by companies established for a certain length of time, and which conform to other similar requirements. Standards of diversification prescribe the proportion of the funds which may be invested in any one security, company, country, type of industry, or type of security.

The matter of earned surplus available for dividends also requires the attention of the accountant. He should assure himself that the company is not taking into earned surplus available for cash dividends any increase in the market value of the securities in which its funds are invested. The accruals for the period also should be tested rather thoroughly.

The manner in which the management is compensated for its services should be investigated and the correctness of such compensation verified. It is desirable also that the auditor determine if any of the officers or directors of the company are connected with any other financial organization which issues and sells securities. If so, it is possible that unsound securities which the issuing company was unable to move may have been "unloaded" onto the investment trust.

While in the case of a company organized upon a purely investment trust basis it is probably best to show the company's accountability for the participating certificates as a deduction from the trust investments on the asset side of the balance sheet, there appears to be no reason for varying the form and arrangement of the balance sheet of an investing company from that ordinarily used by corporations generally. Of course, all contingent liabilities should be shown in the balance sheet.

No matter what the trend of investment trusts may be, the fundamental principle of diversified investment in marketable securities still remains, and the accountant should bear that in mind while auditing such companies.