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Correspondence: Law and Accounting

Anson Herrick

F. W. Thornton

Henry W. Ballantine

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LAW AND ACCOUNTING

[NOTE:—We have received permission to publish the following letter addressed by Anson Herrick, California, to Henry W. Ballantine, professor of jurisprudence at the University of California. Mr. Ballantine requested accounting assistance in the framing of some of the sections of the new corporation law, and several accountants, of whom Mr. Herrick was one, cooperated with Mr. Ballantine. The letter is self-explanatory.

Supplementing the letter is a communication from F. W. Thornton, commenting upon the matters discussed by Mr. Herrick.

These two letters are presented here in the hope that they will be of interest to readers and may encourage further discussion of the highly important subject with which they deal.—EDITOR.]

HENRY W. BALLANTINE, ESQ.,
Berkeley, California.

My dear Ballantine:

This is a delayed response to your letter of the 17th. I am not entirely in accord with Professor Hatfield's statement that the deduction of the cost of treasury shares from capital stock is simply a recognized convention of accounting and the subtraction does not mean that there is any reduction of the amount of stated capital. In any conflict between the principles of law and accounting (and as far as that goes between the law and the conventions concerning any other professional business) law, sometimes unfortunately, must be recognized as determining. Consequently, regardless of any accounting conventions which might be considered necessary of continuance, its continuance would not change the legal fact, and accordingly, to such extent Professor Hatfield is right. However, I am strongly inclined to think that the majority of deductions of treasury stock from capital is made without due consideration of the legal requirements and I do not think there is any accounting necessity which produces a statement which is inaccurate or may be misunderstood.

I am inclined to think that when treasury shares are carried as an asset it is commonly understood that the amount of such asset account does not reduce the surplus used to make their purchase. Consequently, wherever it is thought advisable to show treasury stock as an asset, surplus should nevertheless be reduced by the same amount and the arithmetical balance of the balance-sheet should be perfected by the insertion of a treasury stock reserve. Such a procedure was my first thought in our discussions of last year, but I now incline to the belief that it will be the rare case in which there is any justification for showing treasury shares as an asset.

I recently had occasion to issue a balance-sheet in the case of a corporation—having both preferred and common stock—which had purchased, and retained in treasury without formal retirement, certain preferred shares and certain common shares. The corporation held a Delaware charter. After consider-

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able study I finally presented the capital and surplus on the balance-sheet as follows:

1. Capital	\$1,200,000.00
Preferred—100,000 shares, par \$10.00— including 1,000 shares held in treasury	\$1,000,000.00
Common—200,000 shares—par \$1.00— including 18,000 shares in treasury...	200,000.00
Earned surplus	224,000.00
Balance 1/1/32	\$300,000.00
Less loss 1932	\$50,000.00
Cost of 1,000 shs. pfd.	5,000.00
Cost of 18,000 " com.	21,000.00
	76,000.00
Total capital and surplus	\$1,424,000.00

From a perfectly practical standpoint the liability (as against common stockholders) upon preferred stock had truly been reduced to \$990,000.00 and the accountability of the directors to common stockholders had also been reduced to \$182,000.00. Accordingly, in point of fact, and in accord with what might be termed ordinary accounting procedure, the showing might have been as follows:

2. Capital	\$1,172,000.00
Preferred— 99,000 shs. at \$10 par	\$990,000.00
Common—182,000 " at \$1 par	182,000.00
Earned surplus	250,000.00
Balance Jan. 1, 1932	\$300,000.00
Less loss 1932	50,000.00
Capital surplus	2,000.00
Discount on purchases 1,000 shs. pfd.	\$5,000.00
Premium on purchases 18,000 " com.	3,000.00
	76,000.00
Total capital and surplus	\$1,424,000.00

In the foregoing, however, there is no statement of the amount of stated capital and the earned surplus is incorrectly shown inasmuch as there was an actual distribution of earnings in connection with the purchase of the common stock at a price in excess of the capital attributable thereto. The matter might have been shown as follows:

3. Capital	\$1,200,000.00
Preferred— 99,000 shs. at \$10 par	\$ 990,000.00
Common—182,000 " at \$1 par	182,000.00
Capital stock acquired out of surplus	28,000.00
Earned surplus	224,000.00
Balance Jan. 1, 1932	\$ 300,000.00
Less loss 1932	\$50,000.00
Cost of 18,000 shs. com.	21,000.00
Cost of 1,000 " pfd.	5,000.00
	76,000.00
Total capital and surplus	\$1,424,000.00

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In the foregoing the liability and accountability for preferred and common shares outstanding is correctly shown and in addition the legal capital is correctly stated. The earned surplus is correctly shown from a legal standpoint in that there has been deducted the entire cost of the shares repurchased. Again the matter might have been shown as follows:

4. Capital				\$1,174,000.00
Preferred—100,000 shs. at \$10		\$1,000,000.00		
Common—200,000 " at \$1		200,000.00		
Total stated capital		\$1,200,000.00		
Less cost of 1,000 shs. pfd. and 18,000 shs. com.		26,000.00		
Earned surplus				250,000.00
				\$1,424,000.00

In the foregoing the total legal capital is shown and the entire cost of the shares repurchased has then been deducted on the theory that the cost was paid out of capital.

In the last two illustrations, while the stated capital is correct, I think the showing of earned surplus is incorrect. In the former the earned surplus has been charged for all of the cost of the stock repurchased. In the case of the common stock this cost includes both earnings and original capital contribution, the last of which is not, for practical purposes, a deduction from undistributed earnings. Also the charge for \$5,000.00, being the cost of preferred stock repurchased, is inaccurate from a practical standpoint because it represents in effect a return of contributed capital. In the latter of the two last cases, earned surplus is again wrong because it does not recognize the distribution of earnings in connection with the repurchase of common.

The matter might also be shown as follows:

5. Capital				\$1,172,000.00
Preferred—100,000 shs. at \$10		\$1,000,000.00		
Common—200,000 " at \$1		200,000.00		
Total stated capital		\$1,200,000.00		
Less par value of 1,000 shs. pfd. and 18,000 com.		28,000.00		
Earned surplus				247,000.00
Balance 1/1/32		\$ 300,000.00		
Less loss 1932	\$50,000.00			
Earned surplus distrib- uted on pchs. 18,000 com. stock	3,000.00	53,000.00		
Capital surplus				5,000.00
Discount on purchase 1,000 shs. pfd. at \$5				\$1,424,000.00

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In the foregoing the total legal stated capital is shown correctly and also there is correctly shown the total of the residual liability or accountability. The earned surplus is correct in that there has been deducted only that proportion of the amount disbursed for the purchase of shares which reflects distribution of earnings; i. e. the premium on the common stock. The discount on the purchase of the preferred stock is correctly shown as capital surplus; i. e. that part of the total surplus which is not representative of undistributed earnings. However, although stated capital is correctly shown the statement is still open to the objection that it produces a surplus total of \$252,000.00 which is in excess of the legal surplus.

I think that any one of the foregoing illustrations may be defended and also criticized. The third illustration might be modified further by reducing the earned surplus to \$219,000.00 and adding a capital surplus item of \$5,000.00, and if so modified I now incline to the thought that it would be the most accurate showing, but it would unquestionably be confusing to many.

In another somewhat similar case in which I have had occasion to issue a balance-sheet, the preferred stock upon being repurchased was formally retired and the company's counsel advised that the par value was properly deductible from stated capital. Accordingly, in the preparation of the balance-sheet the preferred stock is stated at the par value of the shares which remain outstanding. In the case of the common stock, however, the entire cost was charged to surplus notwithstanding that it also was formally retired.

In connection with your question as to whether balance-sheets are frequently prepared so as to mislead the management and investors as to the true amount of surplus, I think that this is very frequently the case. However, your thought of misleading the management and investors is from the standpoint of an erroneous showing of the amount of legal surplus. While I realize it is a matter that probably can not be reached by statute, I think the greatest misleading of both investor and management arises through a statement of surplus with the inference that it measures the dividend capacity (and it may from a legal standpoint) when such inference is wholly incorrect. As I have so frequently pointed out, dividends depend not only upon an accumulation of earnings but upon the existence of sufficient working capital to enable the actual payment of the dividends. Consequently, the statement of an amount of earned surplus in face of a practical situation which prevents the use of any part of it for dividend is definitely misleading. I have always believed that a showing of earned surplus should be segregated as between that which is available for dividend and that which has been reinvested in fixed assets. This is easier said than done, however, because that proportion of undistributed earnings which really is subject to distribution and that proportion which is not is in many instances a matter of opinion or is dependent upon varying corporate policies.

Faithfully yours,

ANSON HERRICK

San Francisco, March 25, 1933.

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: Mr. Anson Herrick, seems to be exercised over what he thinks are requirements of "the law" with respect to purchase by a corporation of its own stock, to be observed in the preparation of balance-sheets.

What law? The corporation law of New York provides that a corporation may purchase its own stock out of surplus and that capital or capital stock may not be reduced "if the effect of such reduction or of any distribution of assets made pursuant thereto will be to reduce the actual value of its assets to an amount less than the total amount of its debts and liabilities plus the amount, *as reduced*, of its capital or issued capital stock as the case may be." In brief, a deficit must not be produced upon stating assets at "actual value."

The New Jersey statute expressly permits purchase of stock for retirement.

The Nevada law permits purchase of stock out of "capital, capital surplus, surplus, or other property or funds." The fifty-two states and territories have fifty-two different laws on the subject.

These statutes prescribe what a corporation legally may do; they do not prescribe the manner in which it shall state what it already has done. Accountants' balance-sheets are intended to show what transactions have taken place and the present financial position; they are financial, not legal, exhibits.

If corporation statutes should govern the form of balance-sheet these statements would vary according to the state of incorporation; what is legally right in one state may be a criminal offense in another. But accounting ethics are not defined by geographical limits; what is fair presentation in New York is fair presentation in Laputa.

Balance-sheets are prepared for lay readers; can they interpret these statements in harmony with imaginary requirements read into state statutes? Can we do it? Can the courts? Court interpretations of these laws, cited by Professor Briggs in his exhaustive articles in this JOURNAL, are a very Bedlam of contradictions. If there were a single federal statute it might perhaps be possible to produce a form of balance-sheet reconciling legal and accounting principles and generally understood; the best we can do now is to use a form that is generally understood because it is based on good accounting.

I know of no state law that purports to govern the form of balance-sheets. Speaking of their preparation Mr. Herrick says that "law must be recognized as determining" in any conflict between the principles of law and those of accounting. I reject that theory utterly. Our duty is to give statements showing the financial position as clearly and as correctly as we can; some of the specimens in the letter of Mr. Herrick are unnecessary attempts to prove that the corporation has complied with alleged legal requirements, a work of super-erogation to the injury of the clarity of the statement of financial position.

Although there are no laws that I know of prescribing the form of presentation in balance-sheets of corporations that have acquired some of their own stock the United States treasury does give a form for that purpose in the tax report blank. The form is:

Capital stock (less stock in treasury)	Amount of stock in hands of stockholders
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No reference here to the fifty-seven varieties of state statutes; the federal government wants informative financial statements and ignores local legal provisions that are made for quite other purposes, and do not even nominally apply to the preparation of accounts.

It would be unbecoming for an accountant to presume to instruct or criticize law makers or lawyers as such; if a lawyer tells me that each of the varying

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state statutes is good and useful for some legal purpose I might laugh but I could not deny it; even were there inclination to criticize another profession consideration of criticisms by another profession directed at accountants would deter. I do advise accountants to recognize that financial statements are not legal documents nor intended to set forth the legal position, and to prepare them so as to set forth the financial position in accordance with what they believe to be the best accounting practice, which is not affected by territorial boundaries.

If there were any statutory requirement exceeding the requirements of good accounting it should be observed; if there were in any statute applicable to a given case even the implication of a higher standard the implication should govern. I do not know of any such statute in any state. The object of statutes is not to prescribe honorable standards but to fix minimum standards below which penalties are provided. One who is satisfied to live just outside prison doors will naturally adapt his accounting to the lower standard.

Lawyers have their field, in which they should be respected and not encroached upon; we have our field, a different one. Trespassing is undesirable and unwelcome.

F. W. THORNTON.

New York, June 20, 1933.