Journal of Accountancy

Volume 57 | Issue 6 Article 7

6-1934

Correspondence: Accounting Problems of Non-Profit Enterprises, Accounting Principles and the Law, Stated Capital and Treasury Stock

Lloyd Morey

Henry C. Freeman

George S. Hills

Correspondence

ACCOUNTING PROBLEMS OF NON-PROFIT ENTERPRISES

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: Some members of the Institute have raised question concerning statements which I have made to the Institute to the effect that special knowledge concerning the accounting problems of institutions and governmental bodies is necessary in addition to general accounting knowledge and experience to enable a public accountant to do satisfactory work in these particular fields. A well trained accountant who is also experienced in the college and university field has recently written me as follows concerning his experience with the accounting system of a college which he was asked to survey:

"It is my understanding that two years ago the accounting system at ——— college was entirely revamped. This seems to have been done by accountants who were trained in the commercial field, and apparently knew very little about university and college accounting.

"I personally feel that not only are the statements poor, but that the accounting system installed is equally inefficient. It produces and furnishes a lot of figures and information, but I feel that it does not furnish some of the most vital information, and that the reports as set up give misleading information. Nevertheless I occasionally find that men in the public accounting field feel that they know about all there is to know about accounting; and that the people actually connected with universities know little about accounting."

This is an illustration of the reasons why I have felt justified in urging that men in practice inform themselves concerning the special problems of non-profit enterprises. The National Committee on Standard Reports for Institutions of Higher Education has endeavored to set up standards for the accounts and reports of such institutions. These standards will not only meet the needs of the institutions, but conform to the best standards of accounting procedure. Four members of that committee are C.P.A.'s. The recommendations of the committee are available without cost to every public accountant. If accountants will study these proposals and endeavor to carry them out in principle they will not only be rendering an improved service to institutions but also to accountancy.

Yours truly,

LLOYD MOREY

Urbana, Illinois, April, 1934

ACCOUNTING PRINCIPLES AND THE LAW

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: We are becoming so accustomed to having not only our personal notions knocked on the head, but to seeing what we regarded as the amenities, conventions and even traditions of life swept aside that we should perhaps suffer in silence when a few more illusions go by the board. I am not using the first person plural in any of the collective senses referred to by Mark Twain but as an indication of my belief that I speak for others as well as myself.

It had been my preconceived notion that accountants labored more or less under respect for law. It had certainly been my idea that when a member

of the legal profession undertook of his own volition to counsel with us upon the legal implications of some of our practices, we listened to him attentively. I have, in my own experience, been somewhat handicapped by the thought that a corporation was a creation of the law and that its treatment from the point of view of accounting depended necessarily upon certain conventions which the flippant-minded might describe as "legal fictions."

All these fanciful notions, I find, must be abandoned. If the law is a mote in our eye single in the preparation of accounts which shall give a fair and clear presentation of our financial condition, then we must be anarchists. Convention must not in any way govern the preparation of balance-sheets, which must be prepared in such a form as to be all things to all men; and the law which creates corporations must be availed of only to support the illogical results to which it lends itself and not to force us as accountants to adopt an economic result which may prove a temporary embarrassment.

All these unpleasant thoughts result from reading the letter, which appeared in the April issue of THE JOURNAL, addressed to you by my good friend, F. W. Thornton. I must confess to having derived a certain degree of comfort from the reading of George S. Hill's article in the March issue on the treatment of treasury stock. Raymond P. Marple follows a very similar trend of thought in his paper on the same subject appearing in April. Any satisfaction which might have been derived from these articles, however, was entirely swept away by the devastating effect of Mr. Thornton's letter. The feeling I have, after reading this, is that the eternal principles of accounting, whatever they may be, resemble nothing so much as a tank. If any trifling principles of law stand in the way of its progress, the outcome is apt to be disastrous for the law.

I personally have never been able to take this view. I believe that in some matters accountants have taken a more or less unholy delight in setting up laws of accounting which should in some respects be more rigorous and in other respects more lax than the law, and that in either of these circumstances, they are acting at their peril. I think an example of the former class is the treatment of surplus, as to which some distinctions are sought to be made by accountants which the law may not recognize. That, however, is a discussion of another matter which should not be introduced here. In the treatment of treasury stock, that is to say, of reacquired stock, those accountants for whom Mr. Thornton speaks would, as I understand it, disregard the law because the law itself permits the hurdles to be jumped in such a manner as to arrive at somewhat the same conclusion as Mr. Thornton seeks to reach without jumping the hurdles.

I realize that I am exposing myself to the question as to what is the law in this or any other particular case. I shall be told that there are forty-eight state laws and perhaps some federal laws to be reckoned with. I think this is, in some respects, an evasion of the issue. The weight of the law in this country leans heavily towards the principle that capital stock must not be acquired except out of surplus. Since capital stock and surplus both appear on the liability side of our balance-sheets, obviously the one can not be acquired by any application of the other. The meaning and the intent, however, are perfectly clear and thoroughly sound, that is to say, the capital of a corporation can not be reduced except by due process of law, so that if at any time a corporation wishes to acquire its own stock, it must at that time have a surplus of

assets over and above liabilities and capital stock or stated capital at least equal to the amount which it proposes to apply to such a purchase. The exceptions to this principle recently incorporated in the laws of some few states relate, I believe, specifically to stock reacquired for cancellation, and cancellation, of course, solves the accounting problem.

It may appear to be illogical to say that surplus must be reduced by the cost of the stock acquired, for only if and to the extent that the stock has been acquired at a premium over stated value is there any diminution of surplus. There is, however, an application or an appropriation of surplus and this appears to me to be the fact, economic as well as legal, which Mr. Thornton is willing to ignore because of the somewhat illogical result in the economic sense which follows the legal procedure for the retirement of capital stock. A company which has acquired some part of its outstanding capital stock can take steps to reduce its capital. This having been done, the mathematical proposition that surplus was not reduced when the capital stock was reacquired becomes a fact. Therefore, it is argued, reacquired stock in the treasury can and should be deducted from capital stock outstanding even though the capital has not been reduced. This seems to me to smack of embracing altogether too readily one so-called "legal fiction" and ignoring entirely the essential soundness of that other legal requirement (i.e., that stock may be reacquired only out of surplus) which Mr. Thornton undertakes to discard because it is not so spelt out in the statutes of each of the forty-eight states. As a principle, however, this requirement rests upon something much too fundamental in corporation law to be discarded because some states have been negligent or ambiguous in phrasing their statutes. L. L. Briggs' article in the September, 1933, issue of THE JOURNAL OF ACCOUNTANCY may well be referred to in this connection.

It appears to me that a company which has reacquired, but not yet canceled, part of its outstanding capital stock is in the position of having an item representing the disposition of assets which can not properly be charged against either its capital stock account or its surplus account. I incline very strongly to the thought that such an item is properly dealt with only by carrying it as a separate and fully described item on the asset side of the balance-sheet, whence it will be removed after proper legal action has been taken.

I have no sympathy with the thought that a balance-sheet is a statement of affairs. I do not believe it can fairly be claimed that a balance-sheet is not in many respects conventional in character. I do not believe it spells any degree of progress to claim that it should not be conventional. Some elements in a balance-sheet necessarily become misleading, if its conventional character is denied or disguised. In the hands of an ignorant person, a balance-sheet and a doctor's prescription can be equally dangerous. The important thing is to endeavor to maintain conventions which are at the same time respected and respectable. It is surely straining a point to claim that reacquired stock in the treasury is in its very nature an asset. It may be resold and assets in this way obtained for it. Yet there are other items which by convention and from necessity we carry on the asset side of the balance-sheet which not only are not in themselves assets but can not by any means be converted into assets. We are dealing with a conventional form of statement, which is understandable to those who have understanding and is truthful because the conventions according to which it is prepared are understood and essentially true. If,

according to this convention, sanctioned by the practice of many years, reacquired stock is carried as a clearly disclosed item on the asset side of the balance-sheet, it neither deceives nor misleads. The amount of surplus which has not been applied to the reacquisition of stock can be determined without difficulty. The amount of capital stock actually outstanding in the hands of the public can similarly be seen by inspection. No one is misled into the belief that all of the surplus is immediately available for distribution or that the net amount of stock outstanding in the hands of the public may not be increased after the date of the balance-sheet by the sale of the stock in the treasury without an offering to stockholders.

An idea has arisen, particularly in the minds of those who regard accounting as being purely a matter of mathematics, that by removing a sufficient number of items from the asset side of the balance-sheet and deducting them from capital and surplus on the liability side, a resulting figure can be obtained which will represent "net worth." If such a use of the expression "net worth" has been conventionalized to the point of its meaning no more and no less than the words imply, then I have so far not been exposed to the convention. The use of the expression "net worth," as applied to a balancing figure on the balance-sheet, appears to me to be thoroughly misleading. Accounting must proceed along entirely new, and not necessarily more useful, lines, if the balance-sheet is to show net worth in any accepted sense of the term. I come back, therefore, to my thought that the information to be obtained from the balance-sheet is not enhanced in value by transferring reacquired securities from the asset side to any position on the liability side.

Subject to these somewhat querulous remarks, I feel that the form in which Marshall Field & Company set up their capital, surplus and reacquired securities in their balance-sheet at December 31, 1933, is as good a way as any of transferring the item of reacquired securities to the liability side of the balance-sheet if that procedure is regarded as desirable. Their method of treatment is as follows:

CAPITAL STOCK AND SURPLUS:	
Preferred stock—7% cumulative	
$100 par value—callable at $120—	
Authorized 400,000 shares	
Issued and outstanding 296,190 shares	$29,619,000.00
Common stock—no par value—	
Authorized 2,000,000 shares	
Issued 1,400,000 shares, at stated value	14,000,000.00
	$43,619,000.00
Paid-in surplus	5,001,898.65
Earned surplus (of which $226,773.97 is restricted by reason of purchase of treasury stock until such stock is sold or canceled)	16,129,445.02
Capital stock and surplus before deducting treasury stock	$64,750,343.67

Less—treasury common stock:		
15,278 shares, at cost	$226,773.97	
Capital stock and surplus, net		$64,523,569.70

As long as the subject is under discussion, I should like to indicate one direction in which the result of the retirement of capital stock in reëstablishing a previously existing surplus has, in my opinion, been abused.

It is to be assumed that an enterprise is capitalized at its inception at an amount which the organizers regard as reasonable and necessary. Under normal conditions, with a progressive business, the amount of capital required increases and does not diminish. The increased capital found to be necessary is, in part at least, furnished by the withholding from distribution of some part of the earnings of the company.

There may be various reasons for the reacquisition of stock already issued, but it is safe to say that in the great majority of cases common stock is reacquired, not because the management of the company believes that the amount of capital is excessive and should be reduced, but because the price at which the stock can be reacquired appears to be attractive. In the case of the reacquisition of preferred stock, charter provisions frequently require that some proportion of the stock originally issued be retired each year by the company out of surplus earnings. Even in cases where this is not so, the management of a company will frequently buy preferred stock in order to eliminate charges ranking ahead of the common stock.

Where a company has only common stock outstanding, there seems to be no reasonable argument that can be advanced against regarding surplus as unaffected by the purchase of stock once the stock has been canceled. Where preferred stock is outstanding, however, the situation is different. A holder of preferred stock must, even where the charter provides for the gradual retirement of such stock, regard the safety of his investment as depending upon the maintenance of adequate capital by the corporation. He is entitled to assume that the capital provided at the time his stock was issued was regarded by the management as the amount reasonably required for the proper conduct of the business. He is interested in knowing not merely that the company will maintain assets behind each share of his preferred stock to the extent of the amount to which it is entitled on liquidation, but that so long as a single share of preferred stock is outstanding, the capital will be maintained at the full amount required by the company for the proper conduct of its business. It is entirely reasonable for him to insist, therefore, that preferred stock shall be retired only out of surplus, and that when surplus assets represented by the surplus account have been applied to the retirement of preferred stock, the surplus shall not, by the legal process of retiring and canceling the stock, be restored to a condition in which it can be distributed in the form of dividends. That part of surplus which now represents legal surplus but not an excess over and above the capital of the enterprise as it was when he embarked in it, must be definitely earmarked, unless it be capitalized from time to time by the declaration of a common-stock dividend. This is not a question of statute law; it is a question of an agreement, frequently incorporated in the charter but in some cases only implied, which should protect the preferred stockholder against the diminution of the total capital fund until every share of preferred stock has been retired. It is an

agreement, however, which is frequently nullified through the restoration of surplus to divisible form by the retirement of the stock reacquired. Accountants would do well in such cases to stand out for a more rigid observance of the contract, actual or implied, which limits the directors for the time being in their disposition of surplus.

Yours truly,

HERBERT C. FREEMAN

New York, April 16, 1934

STATED CAPITAL AND TREASURY STOCK

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: Mr. Thornton's letter in the April issue of THE JOURNAL attacking my article on stated capital and treasury shares is a striking display of the very attitude of many accountants to which I addressed my critical thesis. His letter may be summarized as follows: The law is a fiction—it is a voluminous, fickle, technical and often unsound nuisance, whereas accountancy, being based on facts alone, is simple and true. Therefore, do not let legal requirements or principles interfere with the practice of accountancy.

But accountants can not avoid the law or be fair to their clients by adopting that attitude. I do not ask that all financial statements be in conformity with the corporation laws of every state in which they may be distributed, but merely that all corporations comply with the laws applicable to them and prepare their statements accordingly.

In particular, I must take issue with Mr. Thornton's contention that a financial statement does not and need not place a legal interpretation on the facts presented. A statement of financial condition which does not properly reflect the legalities surrounding a corporation's assets and operations is a false statement. An overstatement of surplus, an impairment of stated capital, the inclusion of a worthless asset—all these are examples of false statements which may result from a failure to accept legal requirements or from a misinterpretation of the law.

Let it be remembered that a corporation is a creature of the law. True, the laws of all states are different, but each corporation must live in accordance with the particular laws under which it was born. For instance, a New York corporation must accept a provision of the New York penal law which provides that:

"A director of a stock corporation who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended: . . . to apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock . . . is guilty of a misdemeanor."

In plain language that means that no funds, except surplus, can be applied by a New York corporation to the purchase of its own shares of any class, common or preferred. Does that not also mean that all purchases must be made out of surplus and that surplus must be reduced by the amount of the purchase price? And if surplus must be reduced, what authority is there for resorting to counteracting entries for the purpose of nullifying the penal law, such as carrying the purchased shares as an asset or as a deduction from stated capital?

Let us take also the statutes of Delaware, a favorite incorporating state, which prohibit the use of funds for the purchase of common shares, "when such use would cause any impairment of the capital of the corporation", and define "surplus" as the excess of total net assets over the amount of "capital." It follows that common shares must be purchased out of "surplus." Preferred and special shares, however, may be purchased or redeemed out of "capital" by proceedings under another provision of the statutes. The more advanced laws recently adopted by several states have recognized the abuses of treasury shares and forcibly attempted to cure them. Again I say that reference must be made to the laws of the state of incorporation.

Mr. Thornton's definition of surplus as "the excess of assets over all liabilities, including capital stock in the hands of others—after deducting treasury stock" is not correct, as legal "stated capital" and not outstanding capital stock is the basis for determining surplus available for dividends or share purchases. For what other major purpose is it necessary to compute surplus? Accountants as a whole fail to recognize that "capital" or "stated capital"—"legal capital," if you wish—is a dollar amount defined and fixed by statute and not a different name for net worth, proprietary interest or capital stock. As such it can not be reduced except by appropriate corporate action under statutory authority. Legal capital is the rule by which surplus must be measured, and accountants who neglect or refuse to follow a legal course from that rule must take the responsibility of placing their clients and themselves in jeopardy.

Yours truly,

GEORGE S. HILLS

New York, April 23, 1934.