Journal of Accountancy

Volume 58 | Issue 2 Article 5

8-1934

When Lawyers and Accountants Disagree

E. E. Wakefield

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

Part of the Accounting Commons

Recommended Citation
Wakefield, E. E. (1934) "When Lawyers and Accountants Disagree," *Journal of Accountancy*: Vol. 58 : Iss. 2 , Article 5.
Available at: https://egrove.olemiss.edu/jofa/vol58/iss2/5

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 Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

When Lawyers and Accountants Disagree

By E. E. Wakefield

Study of recent new general corporation laws—for example, the Illinois law adopted in 1933—provokes discussion of certain questions as to which there seems to be a decided difference of opinion between experienced and able lawyers on the one hand and experienced and able accountants on the other hand. The underlying reasons for these differences of opinion are, of course, in part different training and different professional background. To me, the reasons for differences seem in part also to be due to failure of each profession to think through to a clear understanding of the views of the other. Another source of differing views is in the failure to recognize sufficiently the fact that accounting terminology can not be an entirely exact medium of expression. It is not like the formulæ of chemistry.

Two questions which illustrate the sources of these differences in views between lawyers and accountants are: (1) as to treatment of treasury stock as affecting surplus available for dividends, and (2) as to the propriety of charging dividends and operating losses to capital surplus.

With reference to treasury stock, the lawyers say, quite correctly, that purchase of treasury stock does not of itself reduce capital. Hence, since the only other thing it can be taken to reduce is surplus, a balance-sheet which shows treasury stock deducted from capital must overstate surplus. Under the Illinois business corporation act, 1933, by implication (section 6), such a statement of treasury stock is forbidden. Ought accountants then to say, "We have erred when we made balance-sheets showing treasury stock deducted from capital. Let us repent!"? Apparently able lawyers think so. But if they so think, have they quite realized what the accountants are trying to do when they make balance-sheets with treasury stock deducted from capital? It is certainly true that mere purchase of treasury stock does not reduce capital, in the statutory sense. Corporation laws specifically provide the methods by which capital can be reduced, and corporations, being creatures of statute, can do things in a way that is technically correct only if they adhere to statutory requirements. Yet there is really a more fundamental fact to be taken

into consideration. Once stock has been acquired by the corporation it need not be issued again unless the corporation sees fit. Certain stockholders, who, previous to such acquisition, had a claim to share in the corporate assets, have no longer such a claim. Hence, those stockholders who remain will in fact have a right to an increased amount in excess of the capital which their stock represents. The source of this excess may be entirely earnings of the corporation. To tell these remaining stockholders, through a balance-sheet, that earned surplus is only $100,000, made up of $150,000 net earnings, less $50,000 paid for treasury stock of $50,000 par value, is only to require them to make a mental adjustment of the figures to reconcile them with what the stockholders know to be the fact, viz., that the company has earned $150,000 and still has that amount plus enough to cover all the capital represented by stock outside the treasury. If a state corporation law requires that purchases of treasury stock be charged to earned surplus, of course the only way to make a balance-sheet under such a law is to follow the statute and to show purchased treasury stock as a reduction of earned surplus. If there is no such requirement in the state law—and the laws of most of the states have as yet no such provision—then the problem is not one of absolutely right expression one way and absolutely wrong expression the other. The question is how best to express by accounting terminology the facts which should be indicated, with as little explanatory description as a proper statement will require. The problem may well be viewed, therefore, as one in which the best the accountant can do, short of using long, explanatory phrases, is to select the form of statement which will most readily give the fundamentally important information which the reader may be expected to want, adding, if it seems advisable in a particular case, a direct statement that statutory capital has not been reduced.

Both the lawyers and the accountants may be right in their views, and the really important thing may not be to argue which is the more nearly right but to appreciate that in any given case the accountant must suit his form of statement to the situation, having mastered the legal principles, as the lawyers understand them, and the problems of practical expression in accounting terminology, as the accountants understand them.

Similarly, with regard to capital surplus and charges to it for dividends and for losses, undoubtedly the lawyers are right when

they say that if the law of the state permits dividends and losses to be charged to capital surplus the bookkeeping is in accordance with the law if it so shows such charges. But again the question of the capacity of accounting terminology to express facts becomes the thing of paramount importance. Neither the form of the statute nor the terminology of accounting can change the fact as to whether the corporation has or has not increased its investment by operations. If it hasn't, it hasn't, no matter how, as a mere question of law, the results may be legally shown in the accounts. But the meaning of words and phrases used in accounting must be sufficiently generally accepted that readers may be expected to understand the terms used as they were intended to be understood. Surplus is, vaguely, excess of something over something else. Earned surplus may reasonably be assumed to mean such an excess which arose from operations. Hence, the minute some part of the result of operations, such as a loss, is charged to what has not been earned but has been contributed, as capital surplus, the natural meaning of the term earned surplus is obscured. It, then, has to mean such part of net worth as came from operations if parts of the results of operations are excluded and charged or credited somewhere else. Now, if anybody knows that this is so and is given enough information so that he may make his own corrections and find out how much earned surplus there would have been if all the results of operations had been charged or credited to earned surplus, he is of course not misinformed. But if the purpose of a statement is to try to show results in terms of investment and increases or decreases thereof by operations, why make the reader figure it out for himself, when for many years we have had in earned surplus a term which at least in a general way indicates results of operations?

A change of familiar accounting terminology by statutory provision, such as permission to charge dividends to capital surplus as in the Illinois law (section 41 (b) with reference to preferred dividends) easily leads to the perversion of results which the framers of the statute probably wanted to avoid.

A corporation has capital of $100,000, half preferred and half common, and capital surplus of $50,000. It proceeds to lose $25,000, which is charged to capital surplus. It then pays $3,000 preferred dividends, charged to capital surplus. Next it earns $25,000, which is credited to earned surplus. Its net progress, through operations, beyond the amount invested, is zero. But if

it wishes to pay a dividend on common stock it seems to be free to do so, and the total result is really that common stock gets a dividend in effect out of contributed and not out of earned resources of the corporation. If the $25,000 loss had been charged to deficit, doubtless the legal position would have been the same, but at least creditors and preferred stockholders would have had what was really happening more clearly indicated to them and the probability of payment of what was really a dividend to the common stock out of capital, in the broader sense of the term, might have been lessened. It is true that preferred-stock agreements may limit dividends on common stock, whatever the statute provides, but if they do, it is no doubt on the supposition that the procedure ought in principle to be as the preferred-stock agreement indicates and ought not to be obscured by the accounting.

It seems clear to me that lawyers and accountants must strive to understand each other better as to the possibilities in the use of accounting terminology even when they come into agreement as to the facts and the law involved.