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Classification of Surplus

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Accountancy is concerned primarily with two broad classifications. The first of these is called assets and includes all property legally owned and controlled, legally enforceable rights to property and to service and certain other items occasionally included with the assets for specific reasons, such as deferred charges, goodwill and other similar items. The second class consists of the various rights of persons to these assets. This class again divides into two groups, the rights of creditors, known as liabilities, and the rights of proprietors. Incidentally, it is gratifying to note the increasing frequency with which this differentiation between liabilities and proprietorship is definitely displayed upon a balance-sheet.

Proprietors of corporations first aquire such rights because of a contribution of property or of services the value of which is presumably measured by the stock issued therefor. If the assets of a corporation at any time exceed the sum of the amount obtained from creditors and the amount measured by the outstanding capital stock, there must evidently be some credit account to measure such excess. Also there should be some accepted terminology whereby this excess may be designated without fear of misunderstanding. It is in this sense that I am using the term surplus.

It is unfortunate that in accountancy, as in many other subjects, words have been burdened with so many varying meanings. In case of many accounting terms there is no generally accepted usage which can invariably be associated with them. To one man they mean one thing, to another man they mean an entirely different thing. To a certain extent this confusion of usage applies to the term surplus. In this paper I am using it in its widest sense, that is, to measure any excess of asset value which a corporation may have over the sum of its liabilities and outstanding capital stock.

Also I am considering surplus only from the standpoint of accountancy principles, disregarding certain methods of classification and treatment which are of interest only for invested capital purposes. Our present-day excess-profits-tax law has required certain differentiations in the handling of surplus, such

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as those arising from revaluations as of March 1, 1913, which would not otherwise have been necessary or desirable. As it now appears that this law will be eliminated after January 1, 1922, I have excluded from this discussion any such classification for tax purposes.

With regard to surplus the accountant is primarily interested in its source, its measurement and its display.

Source

It is desirable that accounting reports shall so classify and display corporate surplus that its source may be readily determinable.

Since surplus forms a part of the proprietorship, it was either contributed to the organization by the proprietors themselves or has accrued to their credit within the organization.

Surplus may come from four sources:

1. From contributions by the proprietorship.
2. From gifts, awards or contributions from others than proprietors, where no corresponding service or value is rendered or liability created. These are so infrequent as to be negligible in our discussion.
3. From the sale of capital assets.
4. From profits or income earned in the operations of the business.

A fifth classification as to source is sometimes made by applying the term surplus to the amount created by writing up or appreciating the book value of certain assets the ownership of which is still retained. For purposes of completeness I will discuss this so-called surplus arising from appreciations, though I think it is more conservative and more correct to give it some designation other than surplus so that interested parties may not be deceived as to its real significance.

Paid-in Surplus

A balance-sheet should display as a separate item any paid-in surplus as distinct from surplus accruing within the organization. This paid-in surplus may have been contributed by the stockholders at the time of acquiring stock if the stock was issued to them at a premium. If the tangible assets turned in for stock have a value which is unquestionably greater than the par value of the stock issued for them there is created a paid-in surplus. With regard to intangible assets, however, it is very doubtful if the accountant is ever justified in allowing a paid-in surplus account to be created. If any intangibles are taken at a value in excess of the stock issued therefor the accountant will have to write down the value of these assets or set up the excess as a reserve which shall be used to reduce the assets for balance-sheet purposes and will form no part of the corporate surplus.

If a corporation reacquire its own stock at a discount a paid-in surplus is thereby created. The corporation pays out for the stock a less amount than was originally paid in therefor. These excess assets did not come from creditors nor from the operation of the business. They therefore constitute true paid-in surplus the same as any other surplus contributed by stockholders.

Capital Surplus

Surplus arising from the disposal of a capital asset is of sufficient significance to justify a special designation. This may properly be called capital surplus. At least such terminology is frequently so applied. It is a true surplus like paid-in surplus. It is desirable that it shall be kept separate from the surplus arising from the ordinary operations of the business. Both paid-in surplus and capital surplus are legally available for dividends except in certain cases where such disposal of them may be limited by statute or contract.

Earned Surplus

As to the surplus arising from earnings several differing usages prevail. Some organizations carry to the surplus account each period the net amount of profit or income as shown by the operating statement. From this surplus deductions are then made for any amounts disposed of, such as for dividends. Other organizations carry such profits in an account called "undivided profits," limiting the term surplus to an account to which certain sums are transferred periodically from the first account. This method merely subdivides the earned surplus into two accounts more or less arbitrarily. Some organizations in their annual balance-sheets use the term "undivided profits" to display that portion of the net earnings of the preceding period which has not been appropriated, transferring the undivided profits of other periods to the surplus account.

Portions of earned surplus may be set aside under many distinctive headings to show the purposes for which they are appropriated, such as "reserve for sinking fund," "reserve for betterments," "reserve for new factory." Any reserve set aside for the purpose of acquiring additional assets or for the purpose of liquidating liabilities is probably true surplus and should be grouped accordingly in the balance-sheet.

Display of Surplus

The accountant in his balance-sheet will probably desire to show separately each such subdivision of earned surplus, especially if it be a subdivision authorized either by contract or by formal action of the board of directors. However, it is desirable that such subdivisions should be so grouped either by indention or otherwise that the total of earned surplus at the date of the balance-sheet may be displayed as a specific item or at least be readily ascertained.

It is also desirable that in the balance-sheet the accountant should display surplus in such manner that the amount available for dividends may be readily ascertainable. All surplus which has been paid in or earned or has resulted from the sale of capital assets is presumably available for distribution as dividends unless it has been definitely appropriated for some other purposes. That which is not available would include any balance of surplus resulting from appreciation of assets and all items of surplus which had been impounded by action of the board of directors.

So far as reserves are concerned, there are only three possible places upon the balance-sheet for them to appear: first, as a direct deduction from assets to which they definitely apply; second, as part of the analysis of the surplus portion of proprietorship; third, as liabilities. If such an item measures a true liability, it is questionable whether or not the term "reserve" should apply to it. One justification might be that such use of the word indicates that while the element was recognized as a true liability, the amount used was an estimate only, as in the case of a reserve for federal income taxes set up on a balance-sheet before the amount of this liability could be definitely ascertained.

Earlier in this paper, I called attention to the fact that there is an increasing tendency on the part of accountants to make a marked differentiation in the display of liabilities as distinct from proprietorship interest. The old-fashioned balance-sheet in which all credit amounts were tabulated one after the other upon the right hand side without marked grouping or classification has given way to the modern balance-sheet wherein the attempt is made to display definitely all those totals of classifications which are of interest to the business world. Liabilities are subdivided so as to show the total of those of a current nature as distinct from those which are of a more permanent nature. The inclusion of capital stock obligations with the permanent liabilities is giving place to the method wherein all proprietorship measurements are grouped together, cumulating in a total which displays in one amount the net excess of all assets over liabilities.

In the case of par-value stock this total will usually consist of the items representing capital stock plus the surplus items, or minus deficits, if there be any. The total proprietorship item above referred to is sometimes given a definite designation such as "book value of capital stock" or "net worth." Influenced by a no-doubt-praiseworthy idea of giving his client full money's worth, the accountant has frequently gone farther than this, and has parenthetically shown what he alleges to be the "book value per share" which he obtains by dividing this total amount by the number of shares of stock. If the stock is all common, this result probably is correct, but no doubt all of us have seen such display made in balance-sheets which contained both common and preferred stock. Where there are two or more classes of stock differing in their rights and privileges, the calculation of the book value of each share may become a complicated procedure. Careful consideration must be given to the relative interests of each group of stockholders in each classification of surplus. For instance, preferred stockholders may have no dividend rights whatsoever in paid-in surplus, if such surplus came from the common stockholders only. The amount of earned surplus applicable to preferred stockholders will depend entirely upon the character and amount of the preference, whether cumulative or non-cumulative, whether participating or non-participating, and the amount which has already been paid to them in dividends since their preference became effective. Unless the question is one specifically applicable, I doubt the value of the effort such a display, to be correct, would necessitate.

APPROPRIATED SURPLUS

Surplus fundamentally represents a fund which is under the direct control of the board of directors of a corporation save in certain instances, such as corporations of a financial character, where this authority is limited to some extent by statute. At times this authority may be further limited by contractual relations, such as bond issues wherein sinking funds are required to be set aside out of earnings. Aside from these limitations the boards of directors have practically free control over the surplus. By vote they may set aside certain portions of it for certain purposes, such as reserves for new equipment, reserves for contingencies and other reserves of a similar nature, thus impounding that amount of surplus and rendering it non-available for dividend purposes. This impounding is often more apparent than real. Usually by vote of the board they may reverse any previous action unless other persons are definitely a party thereto. Because a board of directors has set aside a certain amount as a reserve for improvements is no guaranty that this reserve will be continued, for at a later date the board may again by vote turn this reserve back into the general surplus fund.

I think that this point is worthy of emphasis, as it is frequently overlooked by business men. In fact one occasionally finds business men who are under the impression that the very term "surplus" involves a certain impounding or limitation of distribution. Many business men who separate earned surplus into two accounts, one being called undivided profits or a similar name and the other designated as surplus, intend to convey the idea that the account called surplus includes amounts which it is their intention to retain in the business and that the giving of that name surplus serves notice to all concerned of such intention. At the present time the term surplus is used in such a variety of ways that it may or may not give to the observer any such idea as the one intended by these men.

The question naturally arises as to whether or not it is desirable to indicate any such impounding. If a corporation on December 31st displays a balance-sheet showing a very large surplus and on the strength of this balance-sheet borrows certain sums, there is in reality nothing to keep it from immediately thereafter greatly reducing this surplus through dividends. If the directors should take such action it might be held that they have in a sense deceived the lenders of this money even though they remain technically within their rights, both as to law and accounting. Because of this it might seem desirable to adopt a certain terminology for the funds which were intended to be withheld from dividends so that the mere use of such terminology would be more or less definitely a pledge on their part to retain these funds for the use of the business and for the protection of creditors.

Such a definite impounding of surplus might at times prove undesirable, as occasion might arise when their credit would be greatly impaired and therefore their creditors' rights be imperiled, unless dividends should continue to be paid regularly, and it might be that such dividends could not be paid without using some of this surplus, which, though rightfully available for such purposes, had been arbitrarily impounded at some preceding date. I feel that this matter is one which deserves much study and consideration on the part of accountants.

Surplus From Appreciation

Many organizations owning certain capital assets whose market value has greatly increased since they were acquired seem unable to resist the temptation to add this appreciated value to the book figures representing these assets. The credit amount thus created should not be merged with items of a different source but should be credited to an account called "surplus from appreciation." If this be properly displayed upon the balance-sheet and be definitely separated from other classes of surplus, there is no reason why anyone should be deceived by it. A very important point in connection with this item is frequently overlooked. Accountants find that many clients in depreciating such appreciated assets treat the whole amount of this depreciation as a deduction from income. Unfortunately accountants have frequently failed to correct this error. Such depreciation must be divided into two parts. So much of it as applies to the cost of the asset may be properly considered as a debit to income, but the portion of it which applies to the appreciated value must be deducted from the amount of surplus from appreciation.

A certain corporation as a result of an appraisal wrote up its assets several million dollars. Because of the circumstances this writing up was tolerated by the accountant. However, if the proper amount of depreciation of this increased figure based upon the estimated remaining life of the assets had been charged against income it would have displayed a result which would have greatly injured the credit of this organization. Such result would have been incorrect also, as it is contrary to accounting to withhold from profits for purposes of replacement amounts in excess of the cost of the items replaced. The amount of this annual depreciation was divided into two portions bearing the same ratio as the excess of the assets bore to the amount of the appreciation. The first of these portions being debited to income was sufficient to extinguish the cost value of the asset at the expiration of its period of usefulness. The other portion being applied annually to the surplus created from appreciation reduced that amount to zero at the same date. Not only was this correct but it was logical. It withheld from profits for purposes of replacement an amount exactly equivalent to the cost of the assets. It allowed the assets to stand upon the balance-sheet at their appraised value during their usefulness, and it amortized the surplus created from the appreciation over the period of the useful life of the assets so appreciated.

Donated Stock

One frequently finds, especially on the balance-sheet of a certain type of organization, surplus arising from the donation of capital stock. This account may be strictly correct, but one frequently finds that it appears at an overstated amount, due to the fact that it has not been reduced by the discounts resulting from the sale of this stock, or that it is of such a character that instead of appearing as a surplus item, it should have been used to write down the book value of the assets which were received for the original issue of capital stock. Usually it may be assumed that the donation of capital stock, if it follows immediately after the issue of such stock, is itself an indication of the fact that the assets for which the capital stock was originally issued were taken in at an inflated value. Such donated stock being listed as an additional asset results in a credit account carried under the name of stock donation or some similar terminology. As the donated stock account is converted into cash or other equivalent assets, any difference because of discount should ultimately be applied to reducing the amount of the stock donation account. When the stock is finally disposed of, the adjusted balance upon this stock donation account will presumably measure the net asset value resulting from this donation. If at this time it is evident that the original assets were inflated, this inflation should be eliminated by a proper reduction on the one hand of the book value of such assets and, on the other hand, of the stock donation account. If this is not done, all or a part of this stock donation account will measure, not true assets, but a mere book inflation of assets, which would be contrary to sound accounting and to conservative business policy.

However, if the deflation above referred to has been properly accomplished and the original assets have been written down to their correct value, there may still remain a balance in the stock donation account. If so, this balance is true paid-in surplus, as it represents a contribution by the stockholders of actual asset value in excess of the capital stock issued therefor.

Non-par Stock

The stock which is issued without par value is still so new in the business world that very few definite principles regarding the handling of the accounts which represent it have been evolved. This is especially true with regard to the element of surplus in its relation to non-par stock.

It is quite generally accepted that the amount paid in for such stock shall be credited to the non-par stock account, and that undistributed earnings applicable thereto shall be carried in surplus accounts the same as for stock of a par value; but beyond this we find very little uniformity in practice. It has been held by some that any surplus attaching to non-par stock might be credited at once to the capital account, on the theory that the very purpose of the non-par stock is to show unit ownership only, without differentiation as to contributed value and earned value. Such treatment, however, would be questioned by an accountant. He would hold that such differentiation is essential for statistical purposes at least and would retain the capital stock account as the measure of the value of the contributed assets.

Stock of no par value, just as par-value stock, may be reacquired by the organization at a price differing from its original issue. In such case, there is created an element affecting surplus. The re-purchase of such stock at an amount in excess of the assets received for its issue reduces surplus accordingly. In like manner, surplus is increased by the re-acquiring of stock at a price below that of its issue. Such surplus becomes a paid-in surplus, even though it applies to a stock which has no par value.

If non-par stock is issued for a variety of prices, as may readily be true where its issue covers a long period of time during which developments have taken place that justify a constantly increasing price for the stock, the capital account at any time divided by the number of shares then outstanding gives the average value for all stock issued. Whether such average value should be used in the determination of the premium or discount on re-acquired stock or whether for this purpose one should use the price at which the particular shares re-acquired were issued is a debatable point to which accountants will probably give further consideration before any definite rule will be adopted.

Consolidated Surplus

In consolidating the balance-sheets of affiliated or subsidiary corporations the asset item of investment representing the purchase of stock in subsidiaries must be eliminated, and in its place will appear the actual assets and liabilities of the company whose stock was purchased. The amounts so substituted may not agree with the purchase price. In fact they seldom do agree. Any difference must necessarily affect the consolidated surplus. If, in lieu of the investment asset, net assets of a greater book value are brought into the balance-sheet, the surplus account will be increased by the amount of this excess. In like manner it would be decreased if the substituted net assets were less than the investment asset.

This change in surplus represents the net earnings or loss applicable to the investment and accumulated since the date of its purchase. For, presumably, any difference between the purchase price and the book value of the net assets so acquired at that date is covered by an adjustment of the consolidated goodwill account. This latter adjustment was discussed very thoroughly by Mr. Webster in his paper before this institute a year or two ago.

Also in consolidating balance-sheets, surplus may possibly be affected by adjustment of intercompany items and the elimination of intercompany profit in the inventory.

Measurement

While it is theoretically true that the accountant should analyze all surplus as to its source and so display it, yet, questions frequently arise as to whether or not such classification is accurate. For instance, if a capital asset is sold for more than its book value is this excess a capital surplus? May it not be that this excess was due to the fact that too high a depreciation had been taken in the past? If so, the earned surplus has suffered to that extent. May it not be that all or a part of this so-called capital surplus is nothing more than an adjustment of the earned surplus account?

Again if the asset sold was one that had been contributed for stock originally, might not this excess really be paid-in surplus which the organization failed to recognize as such at the time of its contribution? Is it not true then that few, if any, of our classifications or our measurements are absolute? Is it not rather the fact that we are striving continually toward the truth rather than that we have been able exactly to reach the truth? There are very few statements of absolute facts in accountancy reports. In most cases the best that we can hope to do is to come as near to the truth as we are able, recognizing the fact that this is a progression which has no stopping place.

No matter how completely the sources of surplus have been traced by the accountant, and no matter how intelligently he has displayed these classifications, there remains the vital fact that the value of his classification and display depends upon the accuracy of his measurement. What is the measurement of surplus? We have indicated that surplus is the excess of assets over the combined liability and outstanding stock of a corporation. The measurement is then determined by the measurements of these other elements upon which the surplus depends. Surplus is not an element in a business the amount of which can be measured within itself or measured independently of the other elements of the business. One may perhaps determine the amount of cash of an organization or perchance the amount of a certain class of liabilities without consideration of the other balance-sheet elements. This is not true of surplus. Surplus then is not an element distinct within itself, but instead its value depends upon the combined measurements of all the other balance-sheet factors. The valuation of surplus therefore carries one back immediately to the valuation of assets. If a business man should ask any of the members of this institute to advise him as to this base of asset measurement the answer would no doubt be very definite. He would be told that any chose-in-action should be valued at its face value less a reasonable reserve for non-collectibility; that inventory items should be valued at cost less any market depreciation that may apply to individual items. He would be told that fixed assets should be valued at cost less reasonable depreciation. These bases sound very logical and conclusive, but every one of us who practises accountancy has faced numerous problems where it has seriously stretched our sense of justice and of accuracy to apply these rules. There are many points constantly arising which do not seem to be fully covered by them.

In Chicago a certain organization bought a tract of land many years ago for a price which now seems ridiculously small. Today this land is unquestionably worth a million dollars instead of the one hundred thousand paid for it. The directors desire to build an office building on that site and to float bonds to provide the funds. They call upon you for a balance-sheet. How are you going to display that real estate? Shall you accept the valuation of the real-estate experts and record it at a million dollars, thus dumping $900,000 into surplus, or shall you insist upon valuation at cost? If you record it at cost are you displaying with any degree of accuracy the real asset value of this corporation? Of course, they may form a new corporation and sell the real estate to this new corporation for a million dollars. In auditing the new corporation we would unhesitatingly value the real estate at cost, that is, at one million dollars. In reality are the assets of the new corporation worth one penny more than the assets of the old corporation? Have they by the juggling feat of establishing a new legal entity actually increased the valuation of their assets by 900%?

On the other hand if we accept appraisal instead of cost as a basis of valuing our assets, then what is there left in accounting that would be dependable? Every man's assets would then be listed at as much as some alleged expert might estimate that they were worth. Balance-sheets would cease to have any dependability. Some might perchance hold that we were justified in tabulating that Chicago real estate at its present value because it had been purchased say fifty years ago but would not consent to such appreciation if it had been bought say last year. With such a theory the question naturally arises if it is correct to accept a revaluation after fifty years but not after one year, at just what point between those two dates does the dividing line apply? After just how many years does an illegitimate procedure become legitimate?

Let us take another illustration. An organization which has developed many patents and processes may through their operation make a very large income, yet carry very few tangible assets. There are many such organizations whose annual income is several times their total tangible assets. Such an organization desires to borrow money at the bank, and asks you to prepare a balance-sheet. You list only the tangible assets but the directors say, "Here are our patents, our goodwill, what about them? They are worth millions to us." The accountant says "You can list them only at what they cost you. You may capitalize the expenditures for obtaining patents, for advertising, etc., but that is all." It is difficult to convince that organization of the logic of the accountant's position. Usually before he is through convincing his client the accountant himself begins to doubt the logic of his own position. He realizes that he is illogical in valuing at cost assets in one organization which may have very little real earning power or usefulness to anyone and refusing to give any value to the accumulated results of the creative efforts of the organization just discussed. But he solaces himself by the thought that if we leave cost as the base of our valuation of assets, then where shall we stop? Cost seems to be the only landing place amid the hills and forests of commercial activities where we can make a safe descent. Leave it, and the sky is the limit, and there seems to be no place for us to rest without wrecking our whole scheme of value. These illustrations could be multiplied indefinitely but perhaps these are sufficient to indicate the fact that we have not as yet reached a perfect basis of valuation. The accountant is the last man who should drop conservatism and the last man who should become radical and depart from an essential procedure until he has discovered one which is better. But on the other hand he should also be the last man to be content to accept any basis as final. The accounting profession must devote much thought to the developing of greater flexibility in the rules of asset value without sacrificing fundamental principles. Don't ask me how this can be done. It is not a matter for any one of us or two of us to solve, but it is a question to which the accumulative efforts of the profession should find a satisfactory answer.

The measurement of surplus then depends upon the measurement of the elements which create it. Every adjustment in the valuation of any element affects surplus. Every change in the method of determining the book worth of an asset affects surplus. Every variation in the accumulating of nominal elements or of policy in carrying a deferred charge affects surplus. Properly to determine the amount of surplus of a complicated organization involves a knowledge and a practical application of nearly every rule and principle of accountancy, and many of these are as yet indefinite or indeterminate.

A study of any phase of surplus such as earned surplus makes us wonder whether or not we really know its characteristics. Earned surplus presumably is composed of profits that have been withheld from distribution. Why were they withheld? Were they withheld merely through choice or through necessity? Every accountant and every business man knows organizations in which the withholding was compulsory if the organization was to continue. If this withholding is compulsory then is it profit? We have been recording profit as the earnings of an organization which may be paid to the proprietors. Now if these amounts which we display upon our statements as earnings can not be paid to the stockholders without damaging the business, are they really classifiable as profits? How many organizations do you know which pay out in dividends all that the accountant shows as net income? Very few. They usually state that it is conservative to withhold a portion of this net income for one or the other of well-established reasons.

It is not my intention to announce that I am ready to discard our definition of net profit or that I advise an organization to pay out all of its net profits as dividends. Instead I am trying again to emphasize the fact that even such elements as net profit which we are sometimes prone to regard as well defined in the accounting world—even to these, we as accountants must give constant consideration, must study them carefully, if we would aid in bringing our profession a little nearer to the true and correct presentation of the essential elements of business activities and to fulfil as accurately as we can the function which the business world expects us to fulfil.