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Primary Accounting Concepts

A SPECULATION IN THE INTEREST OF CLARITY

By Lewis A. Carman

There is in accountancy a curious absence of any pronounced tendency toward research and scientific development. Unlike the medical and engineering professions, where laboratory work frequently precedes the practical application, accountancy has been shaped almost entirely by outward circumstances. Accounting thought has lain dormant for generations at a time, arousing itself sluggishly for self-improvement only after it has been kicked awake.

It is scarcely too much to say that in scientific development accountancy is not far beyond the empty profundities of the medical profession of a few centuries ago, with its four humors, blood, phlegm, choler and melancholy, or greatly in advance of the limited concepts of the ancients with their four elements, earth, water, air and fire. The basic concepts of accounting have never been completely unfolded and presented as a consistent system. It has been said—and I think truly—that no one has yet framed an adequate definition of the terms "debit" and "credit."

The confusion of today is made worse confounded by a frontal collision between two schools of accounting thought, each heaving large sections of the pavé at the other without much regard for the by-stander or for the wheels of progress. For want of better terms the two schools may be called the legalistic and the die-hard schools.

To the legalistic school the law is the fount of all knowledge. In particular, the belief is held that inasmuch as the corporation is the creature of the law the accounting for its operations is solely a function of the law. Personal opinion contrary to statute has no standing in court and, therefore, has none in fact. The die-hard school derives its conclusions from certain tenets imparted to it by its forefathers (perhaps on their death-beds) and regards a law contrary to these much as a chemist would regard a law "altering" the composition of water. (The *Atlantic Monthly* for July, 1935, cites an act of the Indiana legislature changing the ratio of the circumference of a circle to its diameter from 3.14159265 . . . to something more convenient.)

Much of the difference of opinion between the schools centers about the presentation of the capital structure in accounting statements, particularly that which is called "surplus." Shall this be a figure obtained by the application of a statutory formula or shall it be an amount equivalent to the excess of earnings over dividends? Both schools may lay down their brickbats, for their dispute lies in their failure to discriminate between different aspects of the same thing.

In explaining what this "same thing" is, I shall need a number of new terms which I must state and define as I go along. To begin with, we lack an acceptable term for the financial magnitude of a business entity. We can speak of the length of a pipe, the area of a field, the volume of a tank, the weight of a truck, the temperature of a room, and so on. For all these magnitudes we have units of measurement, feet, acres, gallons, pounds, and degrees. In accountancy we have the unit of measurement, the dollar (or other monetary unit), but we do not have a proper term for the financial magnitude measured by it.

The words customarily used—"capital" and "net worth"—must be rejected. "Capital," from the Latin caput, head, is a sadly overworked word. We speak of capital letters, capital cities, the capital of a column, capital punishment, a capital time, an investment of capital, the conflict of capital and labor, and so on. Even in the narrower limits of our profession the word has a variety of meanings, for we have capital expenditures, capital stock, capital surplus, stated capital and many others. The connotations of the word are so many and so ambiguous that it can not be used in any really scientific development of accounting concepts. It will here be employed only in the sense of wealth, money, etc. "Net worth" is objectionable because it is a phrase and not a single word, and because to many accountants "worth" implies current market value.

What we need is a word for the sum of the positive and negative values in a business entity or, in other words, the excess of asset values over liabilities. When I say values I mean simply the figures shown in the balance-sheet. These may represent values to which we heartily subscribe, values that are suspect and values that are qualified as untenable. Good, bad or indifferently exact, figures are the bricks without which balance-sheets can not be constructed. The term we seek, then, is simply the algebraic sum of the positive and negative values displayed in any given

balance-sheet. It is obtained by a mathematical process and no representation other than that of clerical accuracy is made for it.

It is difficult to select or to coin a word that will strike the ear aright, but I must have one before I can go on. With some diffidence I submit the word "quantum" from the Latin quantus (how much?), the root of our word "quantity." The trouble with "quantum" is that it sounds like something tangible that can be taken out of the safe and looked at, whereas it is an abstraction like length, area, weight, etc. I should like a word expressing better the idea of a sum or total. The Latin summa valorum (sum of the values) expresses the idea exactly, but it is hardly acceptable. Some concoction like "valusum" from value-sum, "totoval" from total-value, or even "capitotal" might be better if it did not grate so harshly on the ear. Undoubtedly a term similar to "magnitude" or "amplitude" (might we say "valitude?") would give better the idea of an abstraction, and I very nearly did select "amplitude." The word itself is not so important as long as it is clearly understood; and for our purposes "quantum" will have to serve.

The quantum, then, is defined simply as the sum of the positive and negative values (assets and liabilities) of a business entity, whether it be a corporation, partnership or sole proprietorship. We can then say that the length of this pipe is so many feet, the area of this field so many acres, the volume of this tank so many gallons and the quantum of this business is so many dollars. Quantum is a word for financial magnitude corresponding in use and meaning to those of physical magnitude with which we are already familiar. It should be emphasized that it is an abstraction, like all such terms, and not something concrete or tangible. When a piece is cut from a pipe, the length is decreased but not taken away. When a river overflows its banks and carries away the corner of a field, soil goes down stream but not area, which is merely reduced. A cash dividend, then, will reduce the quantum but is not "paid out" of it.

You must forgive me the time I have devoted to the selection and definition of this word, but it is essential to an understanding of what I am about to present, for, generally speaking, all accounting is the expression of one or more aspects of the quantum! What is meant by aspect? Suppose that we were making a sociological survey of a city of 100,000 inhabitants. We might classify the population by age, sex, race, nationality, marital

status, religious affiliations, political affiliations, property holdings, income levels, and so on. Each of these analyses could be submitted in the form of a summary whose total was 100,000, and each would present a different aspect of the same thing, the population (or magnitude) of the city.

Similarly, in accounting we seek to present certain fundamental aspects of the quantum (or financial magnitude) of a business entity. What are the principal aspects of the quantum? They are four, and may be mnemonically termed the "what" aspect, the "whence" aspect, the "whether" aspect and the "who" aspect, for of the quantum at any given date there may be asked these four questions:

1. By what is the quantum represented?
   This is answered by a statement of positive and negative items—or of assets and liabilities.
2. Whence came the quantum?
   This is answered by a statement displaying the positive and negative increments of value during the life of the enterprise—or a list of origins and dispositions of value. This is a statement now wanting in accountancy.
3. Whether and (if so) to what extent may the quantum legally be reduced by withdrawals?
   This is answered by a statement applying to factual elements whatever statutory formula is established as the measure of the amount that may be distributed.
4. Who owns how much of the quantum?
   This is answered by a statement of the rights, preferences and equities of each class of proprietors.

These four fundamental statements may be supplemented by two subordinate statements showing how the assets and liabilities and how the origins and dispositions varied during a given period (usually a year).

At present it is not unusual to see attempts made to present all four of these primary aspects in a single statement, with results that are little short of ludicrous. Now the commingling of unlike elements is the cardinal sin of every classificatory science, and accounting leans heavily on logical classification. Suppose, then, that in the interest of consistency we were to enunciate the following basic theorem:

One, and only one, aspect of the quantum may be presented in any accounting statement.

There is no catch in such a theorem. We recognize a similar postulate every time we draw up a chart of accounts. We fail to be consistent, however, when we present our accounting statements. What would be the form of our statements were we to enlarge our notion of consistency to include the above theorem?

It is not feasible to present here a full set of accounting statements, but the salient peculiarities of such a set may be fully described. If we denote the four fundamental exhibits by letters and the two subordinate statements by numbers, we shall have the following group that answers the questions posed above:

A. Statement of assets and liabilities (balance-sheet)
   1. Statement of value movements (flow sheet)
B. Statement of value origins and dispositions
   2. Statement of income and other increment
C. Statement of statutory corpus and surplus
D. Statement of corporate structure and owners' equities.

In these statements the inner workings of a business are displayed much as are those of a frog on a dissecting board. Now whether or not such a state of openness is the best of all possible states for a frog is a matter for argument—much depends upon whether one adopts the viewpoint of the frog or of the interested observer. And, similarly, it does not follow that the statements here outlined are the best of all possible statements in all circumstances, but they will (it is hoped) serve to clarify the primary accounting concepts in the mind of the observer.

The relation of these statements to the central concept of the quantum and to one another is displayed in the accompanying diagram. The statements are described individually in the following:

EXHIBIT A

The "what" aspect of the quantum is presented in exhibit A, the statement of assets and liabilities or balance-sheet. Such a statement is no more nor less than a list of the positive and negative values whose sum is by definition the quantum. It does not differ in any respect from the conventional balance-sheet in the presentation of the assets and liabilities. The one and only difference lies in the presentation of the sum of the values. This is presented logically as a single amount and is not broken up into a number of sub-items as is now the common practice. A com-

parative balance-sheet, for example, would have directly following the liability items a caption such as this:

	December 31.		
	1935	1934	Increase
Quantum (sum of the values)........	$1,381,642	$1,299,431	$82,211

But where, one may ask, are our old friends "capital stock," "surplus," and possibly other related accounts? Are not these essential items shown on your balance-sheet? How can you tell whether the business entity is a corporation, a partnership or a sole proprietorship?

The answer is simple. One, and only one, aspect of the quantum is presented in the balance-sheet and that is the "what" aspect. The sources from which values were derived, the amount that may legally be distributed in dividends and the relations with the proprietors are all aspects foreign to this statement and will be presented where logically they belong. Much of the lack of clarity in our accounting thought of today may be attributed to this confusion of categories. When we encounter "preferred stock," "common stock," "capital surplus," "earned surplus," etc., on a balance-sheet, we find a disordered and abortive attempt to present conjunctively concepts that are logically distinct.

The fact that the balance-sheets of corporations, partnerships, and sole proprietorships will all have the same appearance under our theorem is logically as it should be, for the essential differences between these lie solely in the proprietorship relation and should not have the slightest effect on a statement of constituent elements, or of "what" aspects. A statement of assets and liabilities is (as its name implies) essentially an inventory. A ton of pig iron is a ton of pig iron on any balance-sheet, cash is cash anywhere, an account receivable is an account receivable, a building is a building, and so on. The possessions of a business entity and the amounts owed by it are attributes entirely independent of the ownership form. They are elemental facts of the business considered solely as an operating unit. A truck, for example, may be owned by a corporation, a partnership or a one-legged Chinaman without affecting in any manner its characteristics as an operating unit. In any of these three cases, the make, the cost, the depreciation, the weight, the state of the engine, brakes and tires, the maximum load, the miles-per-gallon, the speed, the horse-power,

and so on, are properties of the truck completely independent of the ownership aspects. Similarly, a statement of assets and liabilities of a business entity should logically present only the "what" attributes common to any operating unit and these are the positive and negative values that constitute its magnitude—or quantum. Proprietorship relations are quite beyond the scope of such a statement and are logically presented as a separate aspect.

As the quantum is defined as the algebraic sum of the positive and negative values displayed in the balance-sheet, it follows that all possible light should be thrown on these values. The balance-sheet should furnish, either by direct statement or by unambiguous implication, the basis of valuation of each item (cost, market, appraisal, realization, etc.) and should be supplemented by comments that will enable a reader to form his own conclusions. The comments should show the composition, age and maturity of the receivables, the nature of the investments, the general characteristics of the inventories, the rates of depreciation and the reserves applicable to each asset, and so on. An ideal balance-sheet would show these details on its face, but too much detail tends to obscure general relationships and for that reason must be relegated to the comments.

Balance-sheets frequently display the assets and liabilities at the end of two successive years, with a comparison. Of course, such a statement may show the assets and liabilities at a single date or at as many dates as may be desired. A complete analysis might call for balance-sheets at intervals of not less than a year, commencing with the inception of the business.

Statement 1

Statement 1 is an exhibit designed to show "how" the assets and liabilities changed during a given period. When this statement supplements and supports a comparative balance-sheet it will show the details of the amounts in the "increase-decrease" column. It will do more than this, however, for it is in effect a journalization of the transactions for the period and as such affords a bird's-eye view of the value movements.

It is difficult to present such a statement in a small compass, for it must be confessed that the great drawback of the statement is its unwieldy size. It usually requires from ten to twenty columns for a proper presentation of the value movements. The following is an extremely condensed outline of such a statement

wherein the letters "d" (debit) and "c" (credit) are used in place of black and red figures:

	Incoming values	Accounts receivable	Cash	Accounts payable	Inventory	Outgoing values	Quantum
Sales	c	d	d				
Collections		c	d				
Discounts allowed		c				d	
Accounts written off		c				d	
Disbursements			c	d		d	
Discounts earned	c			d			
Purchases, payroll, etc.				c	d	d	
Cost of goods sold					c	d	
Net income for period	d					c	c
Total		d	c	d	d		c
Balances at beginning of period		d	d	c	d		c
Balances at end of period		d	d	c	d		c

Note that with the proper columnar arrangement each line begins with a credit. An exception to this is usually a departure from the normal (e.g., returned sales, returned purchases, etc.). Of course, the above is the sketchiest sort of outline. A complete presentation is usually something like this (the numbers indicate the order of the columns):

Incoming values:

1. From equity owners (proceeds of stock issues, assessments, etc.)
2. From operations (sales, revenues, income, etc.)

Receivables:

3. Accounts receivable
4. Notes receivable
5. Reserve for doubtful accounts

6. Cash

Borrowings:

7. Bonds
8. Notes payable

9. Accounts payable (including payrolls and accrued items)
10. Investments

Property assets:

11. Gross book value
12. Reserve for depreciation

13. Deferred charges

Inventories:
14. Raw
15. In process
16. Finished

Outgoing Values:
17. Operations (costs, expenses, charges, etc.)
18. Equity owners (dividends, payments to acquire stock, etc.)

19. Quantum

The arrangement of the columns follows the natural flow of values through the business, and the statement might well be called a "flow sheet."

It is surprising that statements of this character are not more often found in accountants' reports, for they answer a multitude of questions all too frequently ignored. In such statements the character of the sales (credit or cash), the provision for credit losses, the accounts written off, the recoveries, the notes accepted in settlement of accounts, the cash receipts and disbursements, the property and equipment acquisitions, the write-offs and the provision for depreciation, the borrowings and liquidations of loans, the movement of goods from the raw to the finished state, the distribution of the payroll, the charges direct to operations from cash, and so on, are all shown. Statements 1 and 2 complement each other. Statement 1 shows the effect of the operations for the period on the assets and liabilities, while statement 2 (the income statement) analyses and classifies the incoming and outgoing values in the first and next to last columns of statement 1. Together the two statements afford a complete view of the operations for a given period.

An analysis similar to statement 1 is extremely valuable to an auditor for it serves as a basis for applying tests.

Exhibit B

The "whence" aspect of the quantum is displayed in the accompanying exhibit B. The degree to which our accounting statements are conventionalized is revealed by the fact that the vital information given in exhibit B is never found in our present-day reports. Accounting reports are supposed to be historical documents, but most of them are very much like a history of the United States that might begin with the inauguration of the present administration. They are correct enough as far as they go, but they don't go far enough. Exhibit B supplies the missing link as it

yields a picture of the financial history of the business enterprise for its entire life.

Exhibit B shows, on the one hand, how much has come into the business and whence it came and, on the other, how much has gone out of the business and whither it went. It explains the existence of the values now in the business or (as we have defined it) the quantum. It presents a summary of value increments and decrements that is entirely independent of the capital structure. Only through differences in nomenclature can the summary of value origins and dispositions of a corporation be distinguished from that of a partnership or sole proprietorship.

As the statement shows only increments and decrements of value and is independent of capital structure it does not—and should not—reflect such changes as the issuance of a stock dividend and the reduction of the "stated value" of capital stock. These changes are not increments or decrements of value, and they leave the quantum unchanged. If the capital stock were issued for more or less than the par value, only the amount actually received would appear in exhibit B. Like exhibit A, this exhibit answers questions that may be asked of any operating unit quite regardless of ownership relations.

Note, too, that the increments and decrements of value are entirely independent of each other—that is, no decrement is applied against an increment or vice versa. (Net income is, of course, a net amount and so is the net appreciation figure.) Everything received from an equity owner as consideration for the issuance of capital stock increases the quantum and is, therefore, an increment of value. Conversely, every withdrawal by an equity owner, whether for the relinquishment of his equity or as a cash dividend, decreases the quantum and is, therefore, a decrement of value. Note particularly that cash dividends are not applied against the net income, for there is no direct relation between the two! It is true that the *amount* legally distributable is usually based, in part at least, on the amount of the net income, but the latter is merely the measure of the former. It is as absurd to say that earnings, income or profits are distributed as it would be to say that a football victory was distributed to the student body. "Profit," "loss," etc., like "victory" and "defeat," "success" and "failure," are shorthand abstractions indicating the outcome of a train of events.

It is the major asininity of current accounting thought that abstractions are employed as though they were tangible and concrete. Both accounting and legal literature make ridiculous reading in this respect. What we should say in speaking of dividends is that cash equal in amount to the increment through earnings (i. e., a series of transactions) was distributed. Cash is material and tangible and is distributable; earnings, income, etc., are immaterial and abstract, and are not distributable. Cash dividends are simply withdrawals by equity owners and have no connection with income other than that in the long run decrements are limited by increments just as the amount of water that may be taken from a bucket is limited by the amount put in.

In exhibit B the increase through net income (i. e., successful operations) is placed under the increment heading and the cash dividends under the decrement heading. To have applied the cash dividends against the net income (as is the common practice in presenting "surplus") would have misstated the history of the enterprise. We should have a similar misstatement were an historian to argue that inasmuch as Austerlitz was a victory for Napoleon and Waterloo a defeat, the one offset the other and neither took place.

We need better generic terms for the funds advanced to and withdrawn from an enterprise by equity owners. "Withdrawals" might pass muster (though a bit pompous) but we have no good term for the converse— "contributions" sounds too much like an act of benevolence. Perhaps we might borrow from our engineering brethren and say simply "in-put" and "out-take." The consideration for the issuance of capital stock, assessments levied on stockholders, and so forth, then may be called in-puts of value, and the amounts paid by a corporation in acquisition of its own stock, cash dividends to stockholders, etc., are out-takes. Incidentally, the term "dividend" is misused, though it is no doubt beyond hope of correction. Strictly speaking, "dividend" means that which is to be divided. In accounting we use the word both in this sense and to denote the individual parts of the whole after division has been made.

The exhibit B or "whence" statement presented here is a relatively simple one. If there is more than one class of capital stock there will be columns under the "increment" heading for each class and under the "decrement" heading for dividends thereon. Usually sundry columns are necessary under

both the increment and decrement sections in order to show unusual items (fire losses, life-insurance collections, judgments, etc.). These may be keyed by means of reference marks to explanations at the bottom of the page.

The column totals in exhibit B might be summarized for clearer reading, but as such a summary is presented in exhibit C it is unnecessary here.

Statement 2

Statement 2 will show "how" the increments and decrements varied during a given period, usually a year. It corresponds closely to the conventional income statement. What is now customarily presented as a major accounting exhibit is seen to be logically subordinate to a non-existent basic exhibit. This statement usually supports or amplifies the details for one or more of the years summarized in exhibit B. While this statement is not greatly different from its conventional counterpart, it is so arranged that the figures for the various columns in exhibit B are brought out distinctly. For example, a comparative statement might end as follows:

	Year Ended December 31st		
	1935	1934	Increase
Net income for year	$ 120,037	$ 38,349	$81,688
Less depreciation based on appreciation	2,826	2,826	
Remainder	$ 117,211	$ 35,523	$81,688
Other increments:			
Proceeds of stock issues	12,250	1,840	10,410
Gross increment	$ 129,461	$ 37,363	$92,098
Decrements:			
Dividends	$ 45,000	$ 37,000	$ 8,000
Payments to acquire stock	2,250		2,250
Total	$ 47,250	$ 37,000	$10,250
Net increment for year	$ 82,211	$ 363	$81,848
Quantum at beginning of year	1,299,431	1,299,068	363
Quantum at end of year	$1,381,642	$1,299,431	$82,211

A complete list of captions for a statement of this sort would be something like the following:

1. Sales
2. Cost of sales
3. Gross profit
4. Selling expenses
5. Net profit on sales
6. General and administrative expenses
7. Profit from operations
8. Other income credits
9. Gross income
10. Income charges
11. Net income for period
12. Other profit-and-loss credits
13. Gross profit-and-loss
14. Profit-and-loss charges
15. Profit-and-loss for period
16. Other increments
17. Gross increment
18. Decrements
19. Net increment for period
20. Quantum at beginning of period
21. Quantum at end of period

Obviously, as many years as are desired can be presented in a statement of this character. A complete analysis of the operations might call for at least annual statements for the entire life of the enterprise.

Exhibit C

Exhibit C is a statement designed to show "whether" or not cash distributions may legally be made to equity owners and, if so, to what extent. Before presenting it, let us consider further the relation of statutory requirements to accounting.

A considerable portion of the regulatory legislation directed at corporations concerns itself with the limitation of cash distributions to equity owners. There have been two distinct attitudes of legislators toward the matter of cash dividends. The original idea was that dividends should not exceed the amount of the earnings. This, while still the fundamental notion, has been modified somewhat and may now be expressed as the generally held belief that the sum of the dividends and the amounts disbursed by a corporation in acquisition of its own stock should not exceed the amount of the earnings.

The idea that dividends should be limited (in whole or in part) by the amount of the earnings is based on the naïve assumption that the affairs of an enterprise are static. It is argued that if so much capital is needed to start a business, the initial amount should never be reduced by distributions. Little thought seems to have been given to the danger of permitting the investment to be reduced to or maintained at this initial figure should the business expand. Many—perhaps most—successful corporations would commit suicide were they to pay dividends to the extent legally permissible.

The basing of the dividend limitation upon earnings is erroneous to the point of stupidity, as it causes distributions to be regulated by historic rather than by material factors. The advisability of a cash distribution depends logically upon two, and only two, factors, namely:

1. The current financial status.
2. The probable future requirements of the business.

The first is always determinable; the second must be estimated—and the estimating requires the exercise of judgment and is subject to the errors of the fallible human mind.

Consider three corporations with similar assets and liabilities but with their capital structures set forth in the conventional manner as follows:

	A	B	C
Capital stock....................	$ 100,000	$ 980,000	$1,200,000
Surplus..........................	900,000	20,000	200,000*
Total.......................	$1,000,000	$1,000,000	$1,000,000

* Deficit.

One can legally declare a very large dividend, one a very small dividend and the third none at all—yet the financial status of each is the same as that of the others. Why the discrimination? You may say appearances seem to indicate that A is a highly prosperous enterprise, that B is barely holding its own and that C is a failure. If these assumptions are correct they throw light on the future requirements of the business and are the factors to be considered—not historical data. On the other hand, perhaps A is fifty years old and has slowly accumulated its present capital over a long period, B is three months old and "going strong," while C, five years old, has recovered from a disastrous beginning in hard times, is now well stabilized on its present set-up and is the most profitable of the three.

It is obvious, then, that no intelligent idea as to the advisability of a cash dividend may be obtained without an analysis of the current financial condition (with full regard to the rights of creditors) and an estimate of the future needs of the business. The progress of a business enterprise is like that of a man rowing against a variable current. Either he forges ahead or is borne down stream. Only for brief periods is he apt to maintain a stationary position. It is rare that a business proceeds at the same rate for any great length of time, and its needs for fixed and

operating capital vary. It is paradoxical but true that a successful business may not only be unable to pay dividends but must have more capital in order to maintain its place in industry. How absurd it is, then, to regulate dividends by the origins and dispositions of values. Under current legislation the expanding business is graciously given permission to cut its own throat, while the declining business or the business founded on a wasting asset (mine, oil well, timber tract, etc.) must keep useless funds impounded.

The so-called stock dividend is a clumsy and ludicrous expedient to correct the first ill. When it is apparent that a corporation requires permanently more capital than originally invested by the shareholders, more certificates of stock are solemnly issued, and "surplus" is reduced and "capital stock" is increased. It seems to have occurred to no one that the issuance of more shares and the raising of the amount to be retained permanently in the business are two entirely dissociated acts, either of which may be performed without the other.

The only legitimate reason for the issuance of more shares is convenience. When the value per share increases beyond a convenient amount, additional shares may be issued in order to reduce the value per share. This issuance of new shares should not be misnamed a "stock dividend" but should be called a more fitting term, possibly a "share augmentation."

If it becomes desirable to raise formally the limit below which the quantum may not be reduced by cash withdrawals, let an appropriate resolution fixing the amount be voted by the shareholders and registered with the corporation department of the state. It should be as simple as that. No additional stock need be issued; none of the lumbering, creaking machinery of the present day need be set in motion. It does not reflect credit upon the analytic faculties of accountants that the "stock dividend" has been accepted as the sole and unquestioned means of restricting cash dividends in an expanding business. The sooner it is recognized that share augmentation and dividend restriction are two azygous acts, the sooner will our concepts be clarified.

We need terms for the amount that may legally be distributed to shareholders and the amount below which the quantum may not be reduced by distributions. The latter might be called the "retain" or something similar, but it is difficult to find a corresponding term for the distributable amount. As both these amounts depend upon statute, they may be called "statutory

corpus" and "statutory surplus" for want of better terms. The statutory corpus is simply a minimum quantum for the enterprise. As long as the actual quantum is greater than this minimum, distributions may be made to the extent of the excess, or statutory surplus. The statutory corpus, then, is no more nor less than a reverse Plimsoll mark, indicating the point beyond which the "unloading" may not proceed.

Again it must be emphasized that these terms are abstractions or magnitudes. The abstract quality of the concepts would be more evident if we said "corpus amount" and "surplus amount." The loose and absurd expressions in common use ("The dividend was paid out of surplus," "The reserve was created out of surplus," etc., etc.) are reflections upon the intelligence of accountants. A dividend is paid out of cash. The reduction of the asset reduces the total values in the enterprise (quantum) to an amount not less than the legal limit (statutory corpus) leaving, usually, an amount (statutory surplus) in excess thereof, indicative of the extent to which further distributions are legally permissible.

The corpus amount and the surplus amount depend solely upon statute. That statutory formulas for the computation of the surplus amount now are based upon earnings is merely incidental. The measure of dividends need not be earnings at all but could be anything legislators might care to designate. Historic factors —origins and dispositions—are absurd guides for the determination of anything so dependent upon financial status as dividends and should be abandoned in favor of material factors. The elements now employed in our computations of statutory surplus are found in exhibit B, whereas logically they should be derived from exhibit A.

Exhibit C, setting forth the computation of statutory corpus and surplus as of December 31, 1935, in accordance with prevailing ideas, may be presented as follows:

EXHIBIT C

	Total	Computation	
		Corpus	Surplus
Increments, per exhibit B:			
Equity owners:			
Proceeds of stock issues:			
Original	$1,100,000	$1,100,000	
Reissues	14,090	14,090	
Assessment	45,000	45,000	
Total	$1,159,090	$1,159,090	

Net income from operations......	$ 827,004		$827,004
Appreciation of property assets less depreciation based thereon.	36,738	$ 36,738	
Total increments...........	$2,022,832	$1,195,828	$827,004
Decrements, per exhibit B:			
Equity owners:			
Cash dividends..............	$ 523,500		$523,500
Payments to acquire stock.....	117,690		117,690
Total decrements...........	$ 641,190		$641,190
Net increments.................	$1,381,642	$1,195,828	$185,814
Statutory transfers:			
By stock dividend (1,000 shares).		100,000	100,000*
By reduction of capital stock from 11,000 to 7,500 shares.........		350,000*	350,000
Quantum.......................	$1,381,642		
Statutory corpus................		$ 945,828	
Statutory surplus			$435,814

* In red.

It should be emphasized that the allocation of the elements of exhibit B between the corpus and surplus columns of exhibit C is simply a computation. The "net income" is not "put into" surplus nor are dividends "paid out" of surplus. The surplus is merely an amount equal to the algebraic sum of the positive and negative amounts employed in the computation.

It is instructive to compare this formula for computing the surplus amount with one based on the current financial status and the probable future requirements of the business. I have not here presented an exhibit A or balance-sheet, but let us say that it reflects the figures employed in the following computation:

	Total	Corpus amount	Surplus amount
Property, less depreciation..........	$ 577,023	$ 577,023	
Patents, less amortization...........	127,315	127,315	
Securities.........................	177,912	177,912	
Working capital (excess of current assets and deferred charges over current liabilities)	649,392	625,000	$24,392
Total.........................	$1,531,642	$1,507,250	$24,392

Bonds	$ 150,000	$ 120,000	$30,000
Remainder	$1,381,642	$1,387,250	$ 5,608*
Estimated effective accretions from future earnings		52,250*	52,250
Total	$1,381,642	$1,335,000	$46,642

* In red.

In exhibit C the statutory surplus, or the amount distributable, is computed in accordance with a legalistic formula, and the excess over the amount so obtained is the corpus amount. In the computation above, the corpus, or the amount that must be retained, is computed and the excess is the surplus amount. The two methods of approach are diametrically opposed. The first is academic; the second realistic.

Under the method of computation illustrated above, the balance-sheet values of the so-called "fixed assets" are always included in the corpus column. It is a matter of indifference in making the computation whether the property assets are written down to a dollar or raised to an appraised value of a billion dollars, as long as the value of these assets is one of the positive elements upon which the quantum figure is based. Except in extraordinary circumstances, property values are obviously not in distributable form and the same principle holds true for patent rights and other intangibles.

The company whose statement is presented above has been in business for eleven years and is now faced with the prospect of heavy machinery replacements. In anticipation of such replacements, a considerable sum has been invested in readily marketable securities, and the directors believe that the funds so invested are not available for distributions. (In other circumstances these securities might not be included in the computation of the corpus.)

The officers estimate that not less than $625,000 of working capital will be needed. The ratio of working capital to the anticipated sales has been greater in the past, but by economies incident to greater volume, by a quicker turnover and by the reduction of inventories bought in anticipation of a rising market, the officers expect to operate on $625,000. This much of the working capital, then, is clearly not distributable and should be included in the corpus computation.

This leaves only $24,392 of working capital available for distributions, but this amount is insufficient by $5,608 to cover the bond instalment of $30,000 maturing during the coming year. However, allowance is made for the effect of accretions to working capital during the ensuing year (the computation of the adjustment need not be given here) and it is estimated that the surplus amount may safely be increased by $52,250, making this amount $46,642.

The corpus amount is reduced by the deferred bond instalments, $120,000, as there is every reason to believe that the increment through earnings in future years will be more than adequate to cover the annual instalments of $30,000 each.

The comparison of this computation with that in exhibit C is instructive. In the latter the statutory surplus has been computed in accordance with prevailing ideas, that is, the amount has been derived from a consideration of historic factors. The application of this academic formula indicates that $435,814 was legally distributable at December 31, 1935. Needless to point out, were the corporation to distribute this amount it would either commit suicide or reduce its operating capacity to a point below that warranted by its investment in plant and patents. A consideration of factual elements indicates that the company can not distribute much in excess of $45,000; and even that amount is defensible only upon the assumption that additional funds from operations will become available during the ensuing year. This is a typical illustration, and only conscientious and intelligent direction by officers saves many corporations from fatal dividend policies. Some day, perhaps not in your time or mine, legislators, state controlling agencies, executives and even accountants will actually be obliged to think about this question of dividends. The days of formula application will be over.

Any taxation of "surplus" based on an historic formula will be a monument to the ignorance and asininity of this our age. To tax a "surplus" determined from historic factors is to kill the goose that lays the egg. For example, let us say that $1,000,000 of capital is needed for the operation of a certain business. A corporation is formed, the equity owners put in $600,000, and $400,000 is obtained by issuing bonds. The company prospers and the bonds are liquidated. But the company still needs $1,000,000 to operate and it must, therefore, reflect on its books an historic "surplus" of not less than $400,000. It could not

distribute the amount of this falsely termed surplus without committing suicide! If its business has expanded so that capital of $1,500,000 is now needed, its books must show an historic "surplus" of not less than $900,000, and so on. To call any portion of the essential capital of an enterprise "surplus" is as silly as to term the engine or wheels of a truck "spare parts"! It must be realized that the historic origins of capital have no bearing whatever on a material status.

Exhibit D

Exhibit D is designed to display the "who" aspect of the quantum. Here the relations between the business and its owners are set forth in detail and here the interests of each class of owners in the quantum, or total value of the enterprise, are shown. This exhibit is the least conventional of all as to form, and in simple cases the information usually set forth therein may be less formally presented in the comments.

In complex cases, particularly where there are several classes of equity owners, the statement deserves a place among the primary exhibits. It will show rights, preferences, equities, the annual earnings per share of stock, the dividends per share, the effect of issuing large blocks of stock for considerations at variance with book values, and so on. In short, it will display to owners and prospective owners the rights and book value of any equity unit.

The form of the statement will vary so much with individual cases that no attempt is made here to do more than to outline the salient features of a typical exhibit D. Such an exhibit should show at least the following:

I. Incorporation data.
  a. Date of incorporation
  b. State
  c. Period covered by the charter
  d. Principal purpose of incorporation

II. Description of capital stock
  a. Number of shares authorized and par value (if any)
  b. Number of shares outstanding at balance-sheet date
  c. Dividend rates
  d. Retirement provisions
  e. Assessment liability
  f. Dissolution rights
  g. Voting rights
  h. Other significant features

III. Equities of each class of stockholder
 a. Total value of each class of stock
 b. Value per share of each class of stock
IV. Chronological table of issues, acquisitions, reissues and retirements
V. Other data.

The incorporation data may be covered briefly in two or three sentences, as "The company was incorporated on January 16, 1925, under the laws of the state of Delavania for the principal purpose of manufacturing and selling gadgets. The corporate charter covers a period of fifty years."

The appropriate descriptions of each of the several classes of stock should follow the sub-headings under II, as, for example:

Authorized (par value, $100.00 a share):
 Preferred, 7,500 shares
 Common, class A, 6,000 shares
 Common, class B, 1,500 shares
Outstanding at December 31, 1935:
 Preferred, 5,000 shares
 Common, class A, 2,000 shares
 Common, class B, 500 shares

and so on. In this manner the rights and preferences of the various classes of stock may be readily compared.

The equities of each class of owner may be shown somewhat as follows (the same quantum amount is employed for illustration as in exhibits B and C although the corporate structure is different):

	Quantum	Non-distributable amount (Corpus)	Distributable amount (Surplus)
Preferred	$ 525,000	$525,000	
Common, class A	685,314	336,663	$348,651
Common, class B	171,328	84,165	87,163
Total	$1,381,642	$945,828	$435,814
Value per share:			
Preferred	$105.00	$105.00	
Common, class A	342.65	168.33	$174.32
Common, class B	342.65	168.33	174.32

The preferred stock is stated above at the retirement and dissolution value of $105 a share. The excess is the book value of the common stock. Both classes of common stock share ratably in the event of dissolution. As no preferred dividends were in arrears, the statutory surplus is applicable entirely to the common stock.

A chronological summary shows briefly the changes in the equity units, for example:

			Common	
		Preferred	Class A	Class B
1925–26	Issued for cash at $100 a share.....	6,000	4,000	1,000
1927–28	Retired at $105 a share...........	1,000*		
1929	Stock dividend (statutory corpus increased and statutory surplus decreased $100,000).............		800	200
1932	Common shares reduced ratably from 6,000 to 2,500 shares with consequent transfer of $350,000 from statutory corpus to statutory surplus.........................		2,800*	700*
1933–35	Common shares acquired at average price of $87.52 per share.........		145*	
1934–35	Common shares reissued at average price of $97.17 per share.........		145	
	Total......................	5,000	2,000	500

* In red.

Further data as to dividends per share, earnings per share, the effect on equities of issuing or retiring large blocks of stock at figures markedly different from book values, and so on, may be added to this exhibit.

Accounting phraseology would be clarified considerably if we refrained from speaking of capital stock as "sold" by the issuing corporation. A stock certificate is simply an evidence of ownership issued as a receipt for the contribution of something of value by the owner. It is not "sold" by the issuing corporation any more than a warehouse receipt, a hat check or a pawn ticket is "sold" when issued. It is, no doubt, legitimate to speak of the sale of stock by an owner to another person as this is a transfer of ownership from one person to another, but a corporation does not "sell" or "buy" its own stock. It issues certificates as evidences of "in-puts" and receives them for "out-takes" involving the relinquishment of equities by erstwhile owners.

A corporation can not "own" its own stock, and there is logically no such thing as "treasury stock"—unless this term be used purely in a legal sense to denote a number of shares that may be reissued. No amount designated "treasury stock" should ever appear on a balance-sheet. Every disbursement to an equity owner for the relinquishment of his equity decreases the quantum

and should be shown under the caption of decrements in exhibit B. Any other treatment falsifies the quantum amount.

Résumé

Reference to the accompanying diagram shows that exhibits A and B are classified as "independent" statements. The data reflected by these exhibits are common to all business enterprises and are entirely independent of ownership relations. They reflect the present status and past history of the entity considered solely as an operating unit. All statutory and proprietorship aspects are foreign to these exhibits and are displayed elsewhere. Only by technical differences in nomenclature may the exhibits of this nature for a corporation be distinguished from those for a partnership or sole proprietorship. Exhibit A shows by what the total value (quantum) of the enterprise is represented and exhibit B shows whence it was derived—and these are the basic factual elements of any enterprise. It follows that exhibit A does not show "capital stock," "surplus" or any similar items, for these relate to other aspects of the quantum. Exhibit B states separately all increments and decrements of value and does not apply dividends against earnings or offer other similar follies. It shows a summary of the operations from the inception of the business, a statement now wanting in accounting reports.

Exhibits C and D are on the dependent side of the diagram, for the data reflected by them are not common to all enterprises but are derived from statutes or from contractual arrangements with equity owners. The purpose of exhibit C is to show the amount that may legally be distributed to equity owners, and the computation rests solely upon statute. At present the statutory formulas are universally based on historic factors and not on material factors. The elements used in the computation are derived from exhibit B, whereas logically they should be derived from exhibit A and viewed in the light of the probable future requirements of the business. Exhibit D displays compactly the rights, privileges and equities of the various classes of shareholders.

In viewing these statements one is at first a little uneasy at not finding in the balance-sheet his old friends, "capital stock," "capital surplus," "earned surplus" and their ilk. They are absent simply because logically they do not belong there. Of course, there is no law of God or man that says one may not mix categories, just as there is none against mixing drinks, but in either

case one is apt to get weird results. It would be perfectly feasible to incorporate an entire income statement in a balance-sheet—all one need do in the conventional arrangement is to indent sufficiently under the caption of "surplus" and write in the items. We don't do this because such an arrangement would be an obvious confusion of categories. Yet in a half-baked sort of way we attempt something similar when we include "capital stock," "surplus," et al.

But we lose sight of the fact that to do even this we must subscribe to the tenets of some school or other. For example, one of the die-hard school might wind up his balance-sheet as follows for the corporation whose accounts appear in exhibit C:

Capital stock—7,500 shares of $100.00 each	$ 750,000
Assessment on common stock	45,000
Surplus arising from appreciation	36,738
Capital surplus (reduction of common stock)	350,000
Earned surplus	199,904
Total	$1,381,642

This man may believe in crediting "earned surplus" with the profit on stock acquisitions and charging it with the premium on the stock retired. Other brethren might have different ideas—it does not matter for our illustration. If the above is intended to give an idea of origins—and obviously it is—it fails pitifully. The amount, either gross or net, received for the issuance of the stock was not $750,000. The amount of the earnings in excess of cash distributions was not $199,904. No intimation of the amount legally distributable ($435,814) is to be derived from the summary. In short it is a stupid and meaningless botch.

On the other hand, a member of the legalistic school might present the following on his balance-sheet, in accordance with the formula in exhibit C:

Capital stock	$ 864,090
Assessment on common stock	45,000
Appreciation	36,738
Surplus	435,814
Total	$1,381,642

This does show the amount that may legally be distributed, but the "capital stock" figures are so fantastic that the attempt to attribute sense to them fairly makes one dizzy. The legalistic

school hews to the line as to statutory surplus, but it certainly lets the chips fall where they may in other respects.

Or, once more, suppose that we live in a more enlightened age and that the amount legally distributable has been computed from material factors in the manner which I have set forth. The elements of the computation do not include "capital stock," "assessments," "earnings" or other historic factors, and about all that could be shown on the balance-sheet is the following:

Statutory corpus	$1,335,000
Statutory surplus	46,642
Total	$1,381,642

It is evident, then, that every attempt to present subdivisions of the quantum in the balance-sheet must be based on the dictum of some school of accounting thought. The results presented by both the die-hard and the legalistic schools are unscientific, distorted and essentially meaningless. Both evidently endeavor to show in a crude way origins and dispositions of values, and both fail. They fail because each in its blundering way is trying to present something of the "whence"-"whether"-"who" aspects, and neither expresses the whole of any one of them. It is quite impossible to express in the balance-sheet one or more of these extraneous aspects except in extremely simple cases where several of the aspects coincide, as for example:

Capital stock		$100,000
Surplus:		
Net income	$88,674	
Dividends	65,000	23,674
Total		$123,674

Even in this simple case it would be impossible to present both the "whence" and "whether" aspects if the surplus were computed (as it should be) from material and not historic factors.

The acceptance of the principle upon which the suggested exhibits rest—that one and only one aspect of the quantum may logically be presented in a single statement—would effect an immediate clarification of our primary accounting concepts. We should better be able to see just what our objectives really are and what is the best way to attain them. Certainly it would sweep away much of the prevailing confusion in accounting thought. No advancement, no scientific development of accounting principles, is possible in a fog of confused concepts.

Quite naturally, progress can not be made faster than new thoughts are received by those who are accustomed to read accounting statements, and this means that a large non-technical group must slowly be educated. The shock of seeing a balance-sheet without "capital stock" or "surplus" on it would be severe in many quarters, no matter how logical such a treatment might seem to the accountant presenting it. The statutory surplus amount is always of interest to the investor or creditor and the balance-sheet caption might well read as follows:

Quantum (statutory surplus, $435,814).......... $1,381,642

If a summary of data regarding origins and dispositions or ownership relations is desired on the balance-sheet as a matter of convenience, an asterisk placed before the quantum caption may refer the reader to a summary at the foot of the page and thence to a following exhibit for further details.

The question arises as to the manner in which accounting records should be maintained in order to reflect the basic aspects of the business. Obviously, the records should reflect at all costs the primary factual elements presented in exhibits A and B. At the end of the year the operating accounts may be closed directly into the quantum account, and the books after closing will show only balance-sheet items. A set of subsidiary accounts whose control is the quantum account will disclose the facts reflected in exhibit B. In simple cases an analysis ledger sheet for the quantum account will supply the necessary data. The computation of the statutory corpus and surplus may be carried on in another set of subsidiary accounts controlled by the quantum account or, in simple cases, the computation need be made only in statement form when desired, as it will be based on the elements either reflected elsewhere in the accounts or readily available. A similar set of subsidiary records will supply the data relating to the corporate structure set forth in exhibit D.

The treatment of capital stock with par value is precisely the same as the treatment of capital stock without par value. This is as it should be, for a certificate of stock simply gives evidence of the title to an aliquant share in the enterprise. The amount actually received from the equity owner will show in the statements, regardless of what is printed on the certificate.

In closing, it should be said that the statements here described are revelatory only and are not designed to be interpretive.

They supply the basis for interpretive statements by a full disclosure and logical arrangement of factual elements. A clear understanding of primary concepts must precede intelligent attempts to interpret financial data, and, if we have this, accountancy will be in a position to advance under its own steam.

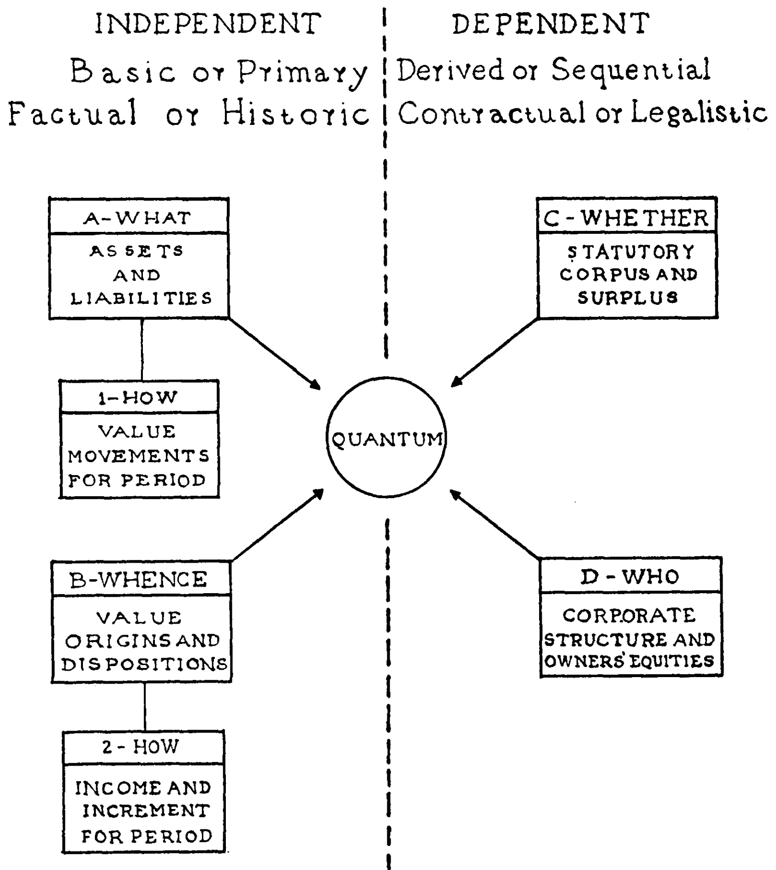

Exhibit B

GADGET MANUFACTURING COMPANY

Summary of value origins and dispositions from the commencement of business to December 31, 1935

			Increments					Decrements	
			Proceeds of stock issues						
Year	Quantum	Net annual increment	Original	Reissues	Assessment	Net income	Appreciation of property	Cash dividends	Payments to acquire stock
1925	$ 776,445	$ 776,445	$ 750,000			$ 63,945		$ 37,500	
1926	1,151,496	375,051	350,000			113,051		88,000	
1927	1,172,343	20,847				181,597		82,000	$ 78,750
1928	1,265,982	93,639				143,369	$56,520	80,000	26,250
1929	1,312,606	46,624				148,450	2,826*	99,000	
1930	1,306,199	6,407*				51,419	2,826*	55,000	
1931	1,303,563	2,636*			$45,000	44,810*	2,826*		
1932	1,279,506	24,057*				21,231*	2,826*		
1933	1,299,068	19,562				32,828	2,826*		10,440
1934	1,299,431	363		$ 1,840		38,349	2,826*	37,000	
1935	1,381,642	82,211		12,250		120,037	2,826*	45,000	2,250
Total		$1,381,642	$1,100,000	$14,090	$45,000	$827,004	$36,738	$523,500	$117,690

* In red.