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Correspondence : “ Some Phases of Capital Stock ”

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Correspondence

"Some Phases of Capital Stock"

Editor, The Journal of Accountancy:

SIR: In the May issue of THE JOURNAL OF ACCOUNTANCY an article by William A. Paton appears, entitled *Some Phases of Capital Stock.* Its purpose, as stated in the first paragraph, is "to raise a question as to the propriety of certain doctrines and practices which at present find common endorsement among accountants." In this same paragraph we are also advised that the accounting profession either does not understand certain matters or in its treatment of them wilfully ignores certain important aspects of them; while further on the assertion is made that "present accounting practice and opinion are not always sound." It is our intention to examine some of Mr. Paton's arguments as we are of opinion that, in his presentation of them, he has ignored some of the most important principles involved and failed in his practical application of them, either wilfully or otherwise.

In this article, Mr. Paton says that writing off discount on stock against accumulated profits obscures two of the most important facts which a balance-sheet should show: (1) original proprietary investment and (2) accumulated earnings; and he concludes his argument on this point by remarking that stock discounts either should not be introduced into the accounts in the first place, or, if brought in, should be retained—otherwise the resulting balance-sheets will not show accurately the essential facts in which the investor or other person is interested. From these, and other remarks, we are convinced that Mr. Paton's conception of a balance-sheet is fundamentally wrong, and that he expects it to perform functions it was never intended to and cannot possibly perform.

A balance-sheet is a statement of the accounts of a concern as they exist at a particular moment of time and as regards capital and surplus accounts is not and cannot possibly be, as Mr. Paton's arguments assume, a history of them. If a balance-sheet states the accounts correctly as at the date which it bears, then that balance-sheet is properly drawn, irrespective of how these accounts originally came into being or of any changes that have subsequently taken place in them. All the information, therefore, which an investor or other interested person has any right to expect from a balance-sheet, as regards the undivided profits of a company, is the present amount, and in the hypothetical case given by Mr. Paton, the last statement is a strictly legitimate balance-sheet, subject only to the proviso that the transfer of the discount has been properly authorized, and to no other consideration. No stockholder has any right to read that the original amount invested was $100,000 or that the total accumulated profits during the company's life are $20,000, but only that these figures represent the present capital and surplus in the business. There are many ways in which the same result could be obtained.

Suppose for instance, the company decides to reduce its capital and eliminate this discount by complying with the necessary formalities and then immediately declares a 30% stock dividend. The position is exactly the same as before. Will Mr. Paton now contend that the surplus should still be shown as $50,000? Or is anyone deceived?

If a stockholder wishes to learn what change has taken place in the surplus since the presentation of the last balance-sheet he should refer to other statements usually furnished him and in a form that he can readily understand. It is not only unnecessary for him to examine the books of the company but seldom will he be allowed to do so. It is difficult to imagine any shareholder who would object to such a prudent step as that cited, unless he were annoyed at this $30,000 being made unavailable for dividends. The other interested parties, who would comprise chiefly the creditors, would certainly have no objections as this amount has now become part of the permanent capital and their faith in the company will be so much increased. This is the real point in the matter and it seems to have been entirely overlooked by Mr. Paton.

We agree with Mr. Paton that the purpose of a balance-sheet is to convey essential information—information as to the company's affairs at the date of the balance-sheet—but deny that the elimination of stock discounts is a practice inconsistent with this purpose. The elimination of stock discounts is a procedure to be condemned or upheld on its own merits, taking into consideration the particular facts relating to each individual case, and not because it requires that the figures in a balance-sheet be different from those in its predecessor. The purpose of a balance-sheet is served when it states the figures that were correct at the date when it was drawn.

Further, no conclusion as between years can be arrived at from a comparison of the undivided profits at different dates. Undivided profits are subject to many other disturbing factors beside stock discount. Dividends may be declared and paid, reserves of various kinds may be set up and provision may be made for sinking funds. It would be a very ignorant stockholder indeed who would form erroneous conclusions in the manner Mr. Paton fears. If it is desired to do anything to help such an unfortunate person we submit that it would be much more sensible, more practical, productive of greater good and less evil to draw a proper comparison for him than to deprive a capable and prudent executive of its legitimate powers or compel it to continue a state of affairs that has outlived its usefulness, for the purpose of perpetuating a fiction in the balance-sheet. All that is necessary is to furnish such stockholder with a clean cut statement of profit and loss appropriation and almost without exception this is done.

We are also at a loss to understand Mr. Paton's remarks that writing off stock discounts is not the only practice which disturbs surplus, and that this account is often subdivided into a dozen or more accounts scattered promiscuously among the items in the liability side of the balance-sheet. Surely Mr. Paton does not mean to say that the entire profits of a company are to be continually salted down in surplus account year after year and never used for any purpose for fear of disturbing the "essential elements" of a balance-sheet. This is nonsense. No company conducts business with this end in view, and prospective shareholders for such a one would, we think, be hard to find. Most companies are in business for profits and these profits are expected to be used for the benefit of the stockholders. When profits are ascertained they are placed in surplus until it is decided how they are to be disposed of, and when this is decided they are logically taken out of surplus. Surplus account, then, is the balance of accumulated profits remaining unused at any time. If the management deem it wise to utilize any portion of these unused profits in any legitimate way or to set them aside for any particular purpose or purposes so that they will not be available for less needful ones, that is what they are there for, and the necessary consequence that these reservations will appear separately and specially labeled in the balance-sheet is no reason why such actions should be avoided.

Yours faithfully,

A. R. M. Boyle, C. A.

Winnipeg, Manitoba, May 15, 1919.

Walter Preston Kohr, Frank Clinton Brubaker and Raye Maynard Fisher announce the formation of a partnership under the firm name of Kohr, Brubaker & Fisher, with offices in Marshall building, Cleveland.

Frank L. Norris, F. Ernest Grubb and Edward A. Coughlan announce the formation of a partnership under the firm name of Norris, Grubb & Coughlan with offices in Finance building, Philadelphia.

Jay J. Livingston, Leon A. Paperno and Theodore Wachtell announce the formation of a partnership under the firm name of Livingston, Paperno & Wachtell, with offices at 55 Liberty street, New York.

R. W. Harvey and Egbert S. Harvey announce the formation of a partnership under the firm name of Harvey & Harvey, with offices in Davidson building, Charleston, West Virginia.

Leslie, Banks & Co. announce the opening of an office in Chicago in the Continental & Commercial Bank building and the appointment of C. A. H. Narlian as resident partner.

Charles H. Hubbell and Douglas S. Meaden announce the formation of a partnership with offices at 306 Hickox building, Cleveland.

E. F. Leathem & Co. announce that W. F. Vieh is now in charge of their office in Little Rock, Arkansas.

Samuel Newberger announces the opening of an office at 44 Court street, Brooklyn, New York.