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Correspondence: Further Discussion of Discount on Capital Stock

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> "Our study is primarily one of methods—methods in the collection and utilization of numerical data to throw light upon economic and business problems. It attempts to reduce to a workable basis the principles of statistical analysis and to illustrate their force and the methods of applying them to concrete problems." (pp. 2-3)

It is true, of course, that the book is primarily intended for those who propose to become professional statisticians, but as we have already remarked, a public accountant ought to know at least the how of statistical analysis and demonstration even if he is not much interested in the why which Dr. Secrist explains very lucidly. Chapter III of the book is an illuminating exposition of why so many unthinking people subscribe unreservedly to the old slur, "Anything can be proved by statistics!" As the author shows, it is the careless, or worse, abuse, not the honest and scientific use of statistical methods, that has given rise to this sweeping generalization. W. H. L.

Correspondence

Further Discussion of Discount on Capital Stock.

Editor, The Journal of Accountancy:

SIR: It seems that the views I presented in the April number concerning discount on capital stock were too concise to be thoroughly understood by many.

Of course my discussion in no wise concerns the treatment of discount on treasury stock.

Some accountants tell me that it is correct to show the discount on the asset side of the balance-sheet, not as an asset but as a debit item. I disagree with them. It should never appear as a debit item for the very excellent reason that nothing should be on the debit side either as an asset, a deferred charge, a debit item or otherwise unless it represents previous, present or future value.

I hold to the statement that under no conditions should the discount appear as a debit item.

As I have said, discount on stock is nil. It merely represents the difference between the original net worth and the par of the capital stock and it is purely fictitious. It is properly a contra against capital stock account and must be so considered. Until profits are earned the liability upon the capital stock cannot possibly be greater than the original net worth; and when they are earned, while the total liability to stockholders is greater (the increase representing profits), the liability upon the capital stock alone as distinguished from the liability arising from profits can properly be increased only by the action of the directors in authorizing a transfer of undivided profits or surplus.

As I have said, this action is not necessary, but would be a good policy. The undivided profits and the surplus can quickly be paid out while the liability upon the capital stock is considered permanent until reduced by losses. Creditors and investors think more highly of a company having a liability upon stock equal to its par and a smaller surplus than one having a larger surplus and a liability upon stock less than its par.

The correct procedure to increase the liability upon capital stock is as a disposition (transfer) of undivided profits or surplus, not, as is being done now, by making a charge against profits and consequently decreasing the true earnings.

I am afraid that many accountants do not understand the distinction between charging the discount against profits and disposing of it as a disposition of profits. To charge it against undivided profits or surplus is just as wrong as it is to charge it against operating profits. Disposing of it does not affect the net worth any more than does the establishment of a sinking fund reserve.

In an analysis of the revenue and surplus statement the discount disposed of as a disposition (transfer) of undivided profits or surplus would not be picked out as a charge (expense or loss) passed through undivided profits or surplus instead of directly against operating profits.

Assume that a company issues $100,000 of stock at 90. Applying my treatment the balance-sheet would show

Capital stock	$100,000	
Discount on stock	10,000	
		$90,000

If at the end of the first year its net profits were $10,000, the balance-sheet would then show

Capital stock	$100,000	
Discount on stock	10,000	
		$90,000
Undivided profits or surplus		10,000

If it is decided to dispose of $2,000 of the discount by a transfer of undivided profits or surplus the balance-sheet would then show

Capital stock	$100,000	
Discount on stock	8,000	
		$92,000
Undivided profits or surplus		8,000

Applying the theory of considering the discount a deferred charge against profits the revenue and surplus statement would, in the above case, incorrectly show net profits of only $8,000. Applying my theory it would correctly show net profits of $10,000 and a transfer of undivided profits or surplus of $2,000.

Consider this important point: The directors of a corporation alone have control over the undivided profits and the surplus. They (or the stockholders) only have power to increase the original liability upon the capital stock and if they decide to do so it is done by a transfer from undivided profits or surplus. In the face of this, by charging the discount against profits, frequently upon the accountant's advice, the officers are taking unto themselves these important powers.

Yours truly,

JOSEPH ROBINSON.

Frederick G. Colley announces the opening of offices at 43 Exchange Place, New York, for the practice of accounting under the name of Frederick G. Colley & Company.

Frank Wittenberg announces the removal of his office to room 601 A. O. U. W. building, Little Rock, Arkansas.