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A Symposium

[In order to stimulate discussion, THE JOURNAL OF ACCOUNTANCY has requested from a number of persons comments in answer to the question, Is it desirable to distinguish between various kinds of surplus? We publish here the answers received from Samuel J. Broad, Thomas H. Sanders, William A. Paton, Maurice E. Peloubet, and Howard C. Greer.—*Editor.*]

Comments of SAMUEL J. BROAD

I have read with interest Mr. Cranstoun's thoughtful observations on surplus published in "The Commentator" department of THE JOURNAL OF ACCOUNTANCY for January and believe the suggestions he makes are worthy of further consideration and discussion.

For many years past the question as to the desirability of distinguishing between various kinds of surplus has been actively discussed among accountants, and as several committees have found, even if the distinction is made there does not seem to be any general agreement as to where the dividing lines should lie. The principal difficulty has not been so much how the credits might be segregated as how to determine what classes of charges might properly be made against the different classes of surplus.

I think most of our difficulties may be traced to the fact that we have become so involved in discussing a variety of technical, legal and other niceties that we have lost sight of fundamentals. The underbrush has become so thick that we cannot see the trees.

The basis of accountancy is the fundamental economic concept of the distinction between capital and income. Looking at a corporation from the viewpoint of its relation to its owners or stockholders, capital may be briefly described as the money or assets they have invested in the corporation, and income as the increment resulting from the use of the capital, including services which the capital has made available. Unfortunately, in attempting to reconcile with this fundamental idea the numerous and varying statutory and legal doctrines (some of them fictitious, such as those which permit a corporation to consider only part of a stockholder's contributions as capital and the balance as surplus), we have wandered into a maze of intricacies which obscure the underlying facts. Our difficulties regarding the classification of surplus, in my mind, arise from this fact.

I would like to make a plea for a return to first principles. I would like to see the amounts contributed by stockholders considered as capital regardless of the form of the contribution. Legal necessities might require that capital be segregated between (1) that portion which is the legal capital, and (2) the balance which legally has the status of surplus, but is capital from an economic viewpoint. Premiums received on the sale of stock would naturally fall into the latter category. Similarly with regard to commissions (or in some jurisdictions, discounts) on the sale of preferred or common stock, the net amount paid to the corporation represents the capital contributed, the fund which has been entrusted to the corporation for the purpose of producing income.

If the stockholders agree to a reduction of capital and a corresponding credit to surplus, and authorize recognized shrinkages in asset values to be charged thereagainst, they in effect authorize the shrinkages to be considered as a loss of their capital; but any such surplus which remains still represents capital originally contributed by the stockholders and should be so regarded.

One might make out a strong case for treating transactions of a corporation in its own capital stock in a similar manner. If capital stock is repurchased, the capital invested in the business is temporarily reduced by the cost of the stock and it would be necessary to show any resulting legal restriction on "surplus." If the stock is later resold at a higher price, the temporary reduction of capital is made good and the excess remaining represents a further contribution by new stockholders. If, on the other hand, the stock is resold at a lower price, the reduction of capital is not wholly made good and, to the extent of the deficiency, this reduction becomes permanent. As a reduction of capital is involved the reduction would logically be charged against capital. If, however, the latter did not include an equivalent amount of legal "surplus," a charge against undistributed profits would, I believe, be necessary in order to reflect legal restrictions as to the payment of dividends.

The accumulated profits of the corporation not paid out as dividends have usually been described as "earned surplus." I believe we would clarify their economic (as distinct from their legal) status if we were to discard the term "earned surplus" and describe the item as "undivided profits" or "undistributed profits." The term "surplus" today seems to have retained little accounting or economic significance.

Space does not warrant an attempt to deal with all the classes of transactions which give rise to surplus or surplus charges, but it is believed that most of them would fit themselves into the pattern suggested above. An exception is the item of unrealized appreciation which is sometimes reflected in the accounts. The term "appreciation" denotes an increment and thus falls within the classification of profits, rather than of capital. However, one of the accounting principles enunciated by the American Institute of Accountants states that:

"Unrealized profit should not be credited to income account either directly or indirectly, by charging against such unrealized profits amounts which would ordinarily be chargeable against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. . . ."

This precludes the inclusion of unrealized appreciation as income. I believe, moreover, that accounting thought is definitely tending towards the view that unrealized appreciation should not be included as surplus either, but that, pending realization by sale, depreciation charges or otherwise, it might preferably be considered as a valuation reserve. While true appreciation may at times have an important bearing on the legal permissibility of dividends, it has less reality from an accounting viewpoint in a balance-sheet which purports to "deal with the status of the investment in the business" and not to reflect present-day valuations of all the assets.

Much has been made of the importance of showing the amount of surplus available for distribution as dividends. In many cases, however, I doubt whether any accountant should, or would, take the responsibility for its determination, involving as it frequently does difficult legal interpretation and decisions which are not within his province as an accountant. Of course, if there are known to be legal restrictions on the use of "surplus" for dividends, these should be shown. But in my view it is more important that the accounts should show (1) how much of the income of a corporation since its inception (or, if there has been an informal reorganization, since the date thereof) is still undistributed; and (2) if distributions to stockholders have been made from a source which in reality represents a return of their own investment.

Comments of THOMAS H. SANDERS

The increasing tendency to make hard and fast definitions of surplus, particularly as to the division of surplus into capital surplus and earned surplus, calls for a consideration of what is and what is not essential about surplus.

Let it be granted at once that it is the duty of accountants to report accounts as clearly and as helpfully as they can. About things on which they can be specific and categorical, they should be specific and categorical. No accountant, we take it, would think of reporting cash on a "more or less" basis; but surplus is a different order of thing. After the accountant has done his best with the books, the *amount* of surplus is, it is true, a fairly definite thing, being the amount of surplus resulting from all the steps taken in income determination and asset valuation. This statement in itself, however, lends a considerable elasticity to the amount. But a request to subdivide surplus into earned and capital surplus is to ask not only for the total *amount*, but also for a statement as to the *nature* of the surplus, a request which is not so easily satisfied. The manner in which capital and income intermingle with each other, the income stream emerging from the capital funds only in large part to rejoin them, creates a situation where nobody can make positive assertions with complete assurance.

But certain broad things can be said. One is that it is very desirable to maintain a clear distinction between the problems involved in the reporting of the annual changes in surplus and those concerned with the showing of the cumulative surplus balance. It is safe to say that the former is a much more important matter than making subdivisions of the surplus balance. Changes in surplus can, at the time they occur, be specifically described, and good accounting should require that they be so described. Even this, however, does not mean that every item can be readily classified as capital or earned surplus. Surplus arising from the restatement of capital stock is probably the most unquestioned kind of capital surplus. Surplus from reappraisal of capital assets is in most cases capital surplus, but could under certain conditions be merely a correction of depreciation charges, which means earned surplus. Surplus transferred from the income statement, if properly determined, is the clear case of earned surplus. At the time these items arise the important thing is to indicate clearly the *source* of the surplus, and this is not always the same thing as labeling them as capital or earned.

The showing of the cumulative surplus balance or balances in the balance-sheet under classified headings, though important, is less important than the showing of the changes as above described. It is difficult over the years to preserve the different kinds of surplus in a state of accuracy, because the subsequent adjustments are themselves open to question as between the different kinds of surplus. Nobody can thoroughly understand a surplus amount in a balance-sheet without looking up its entire history; and although showing it subdivided into capital surplus and earned surplus will put him on notice that there are two elements present, he is not much wiser unless he looks up the complete history in the old annual reports.

It would seem, therefore, that reasonable requirements for surplus would say:

1. All substantial changes in surplus shall be clearly described at the time they occur, and classified into capital or earned surplus as far as possible. This will furnish the chief guide to those who wish to study the meaning of surplus in a particular company.

2. The cumulative surplus amount shall be classified into capital or earned surplus as far as possible. But an absolute requirement for a division between capital surplus and earned surplus will lead only to the inclusion in the balance-sheet of more items which look like certainties, when in fact the amounts are tentative and qualified in a high degree.

Comments of WILLIAM A. PATON

"Is it desirable to distinguish between various kinds of surplus?" This question assumes that there are a number of types of surplus, and consideration of this assumption is necessary as a preliminary step in formulating an answer.

Ignoring legal complications for the moment, it seems clear that the ideal definition of capital stock, in dollars and cents, is the following:

> Capital stock represents the amount of money actually invested by the stockholders.

Similarly, corporate surplus should be defined:

> Surplus is measured by the amount of recognized profits retained by the enterprise and validated by existing assets.

These definitions undoubtedly express the underlying conceptions suggested to business managements and investors by the terms "capital" and "surplus"; they emphasize the only line of cleavage running through the corporate net worth (when it is represented by a single class of stock) which has a definite and commonplace meaning to the various interested parties. And the fact that these conceptions persist in the face of the legal and technical juggling to which the stockholders' equity has been so widely subjected testifies to their general reasonableness and significance.

The principal difficulty in the way of the rational interpretation and reporting of capital and surplus has been the willingness of the law to permit a portion of the funds invested—obviously capital from a practical administrative viewpoint—to be construed and labeled "surplus," and to permit a portion of the undistributed profits—obviously surplus from the point of view of managers and investors—to be converted into legal "capital." In other words, the primary encouragement for a breaking down of a simple and useful classification of net worth is found in our lax and confusing legal situation.

Since the law is quite ready to call capital "surplus" and surplus "capital," the accountant who has a lingering desire to present a clear picture of net worth has found himself in a somewhat embarrassing position. On the one hand, he is faced with the necessity of avoiding any appearance of ignoring the legal conditions attaching to the corporation; on the other hand, he wishes to recognize the objective economic and administrative situation, and meet the needs of those who are thinking primarily in these terms. As a way out, he has adopted—not altogether fortunately—the practice of classifying surplus into two divisions, (1) capital or paid-in surplus and (2) earned surplus.

Mr. Cranstoun's suggestions in the January, 1938, issue of THE JOURNAL seem to me to be eminently sound, although he perhaps does not go quite far enough. As I understand it, he proposes to restrict the surplus reported as such to the cumulative amount of undistributed profits. This practice, if it could be generally adopted, would clear the atmosphere in a very satisfactory manner. It must be complemented, of course, by the reporting of the total issue price of the capital stock as capital. As implied by Mr. Cranstoun, this may be done in the following manner:

Capital Stock:		
Designated as legal capital..............	xxx	
Received in excess of legal capital........	xxx	xxx

Such a treatment is entirely acceptable from a legal point of view, and it has the marked advantage of avoiding the application of the term surplus to any part of the proceeds of the capital stock.

A further step is indicated. If it is unreasonable to report original investment as surplus, it is likewise hardly proper to report undistributed profits as capital, even where so designated by legal process. It may be argued, therefore, that the amount of surplus capitalized by the stock "dividend," or through any other means, should still be shown as a section of surplus. That is, the method of showing surplus which is consistent with Mr. Cranstoun's recommendation with respect to capital stock is as follows:

Surplus (undistributed profits):		
Designated as legal capital..............	xxx	
Legally available for dividends..........	xxx	xxx

I cannot agree that the amount of surplus in the sense of undistributed profits is not a significant fact. If corporate net worth is reported as just suggested, the extent to which the business to date has been financed with stockholders' capital investments on the one hand and undistributed profits on the other is clearly shown, and I believe these data are significant as well as understandable. At any rate, it seems fair to conclude that, unless net worth is divided into capital and surplus along these lines, the classification is bound to be misleading to most readers and hence worse than useless. Of what possible value is a showing of a division of capital and surplus which is the result of an arbitrary (even if legal) assignment of investment and profits to the two categories?

But even if the term surplus in the financial statement is restricted to the amount of undistributed profits, some further classification may be in order. No doubt the practice of subdividing surplus account under fancy titles has been carried much too far in some cases, and quite generally the importance of the process of earmarking surplus has been exaggerated. Nevertheless, where surplus is unavailable for dividend appropriations as a result of a particular contract, or some other special legal requirement, it is necessary for the accountant to indicate the amount impounded. Similarly, the division of surplus legally available between the amount which may be assumed to be invested in fixed assets or in the retirement of indebtedness, and the amount which is financially available for expansion of working capital or for dividends, may be decidedly helpful to the reader of the balance-sheet.

It does not seem necessary or even desirable to attempt to classify surplus in the balance-sheet in terms of the kinds or sources of recognized profits. It is the function of the income sheet to show all profits realized, period by period, with adequate classification as to origins.

With respect to an adjustment of net worth which reflects revaluation of assets either up or down, I agree that to report the increase above cost as surplus (or the decrease from cost as a deduction from surplus) is poor accounting. Perhaps the most satisfactory practice is that which shows the amount of appreciation (or declination) as a modification of the amount of the stockholders' equity as otherwise determined.

The following setup will serve to summarize the foregoing comments on the ideal presentation of capital and surplus:

Equity of stockholders		
Capital (description as to character, shares, etc.):		
Designated as legal capital..............	xxx	
Received in excess of legal capital.........	xxx	xxx

Surplus (undistributed profits):		
Designated as legal capital..............	xxx	
Restricted by purchase of outstanding stock	xxx	
Invested in plant facilities and debt retirement..............................	xxx	
Available for working capital and dividend appropriations......................	xxx	xxx
Total stock equity on a cost basis..........		xxx
Adjustment resulting from plant appraisal		xxx
Total stock equity on an appraisal basis....		xxx

Comments of MAURICE E. PELOUBET

The question on surplus should have been put, "Is it possible to distinguish between various kinds of surplus?" rather than "Is it desirable to distinguish between various kinds of surplus?"

It is not difficult to tell the nature and amount of the meat, vegetables, and seasoning which go into the soup pot, nor is it difficult to measure the amount of soup which is taken out, but it is very hard to say that in a given ladle of soup there has been taken out so much of the carrots, so much of the liver, so much of the salt and so much of each of the other constituents of the ladleful of soup. We know what went into the pot, we know how much we took out and that, I think, is nearly all we do know. So it is with surplus. We can tell how much earnings went into the pot and we can also tell how much profit on capital transactions, how much profit on the sale of fixed assets, how much contributions to capital, and how much of any other item has been put in. We can also tell how much of these has evaporated in the form of various sorts of losses (particularly if some water has been put in and we know how much has been ladled out of the pot as dividends or distributions), but when we try to say that this year's ladleful of dividends contains only earnings and that last year's ladle contained partly earnings and partly gain on sale of capital assets, we are making an assumption which we cannot prove and which would make no difference to any one if we could prove it.

We pay dividends or make distributions from cash, not from a surplus account, just as the cook ladles out soup from the pot. If the cook recorded the ingredients in a book as they were used, he would not serve the diners from the book in which he records the amount of meat, vegetables and other ingredients used to prepare the dinner. This record showing what the cook used to prepare the soup and how many he served from it is exactly the same as a surplus account and has the same relation to actuality. We do not eat the figures in the cook's account book and we do not pay the dividends out of surplus. We eat the soup and we pay out the cash. It is true that the management of the restaurant has a vital interest in knowing what the cook used and how many portions were served. This record is the same sort of thing as a surplus account, showing in gross amounts the various items of which it is composed.

If the cook should put a piece of soap in the soup, the result would be a mixture but it would not be soup. If we put items in the surplus account which do not represent a genuine increase in the stockholders' equity, no matter how they come about, we have the same sort of mixture of assets and liabilities and the results will probably be as unpalatable to the stockholders as the soup flavored with the soap would be to the diner. As long, however, as all the elements in the surplus genuinely belong there, no matter how they arise, and so long as we know how and when they arise, it would seem that the accountant's duty is done.

There is no means by which the source of the remaining balance in the surplus account can be determined except under assumptions which are not susceptible of proof. If some one else cares to make other assumptions, the statement will be different and either will be equally important. We are interested in a correct statement of net worth, of stockholders' equity, and this must be based on a correct statement of assets and liabilities. If we stick to that, we cannot be wrong in the surplus.

Comments of HOWARD C. GREER

The form of this question rather implies that if the answer is negative, the accounts now commonly known as earned surplus, paid-in surplus, and capital surplus, will be merged in a single account, and the distinction between them abolished. The initial paragraphs of Mr. Cranstoun's recent observations on the subject carry somewhat the same implication.

The remainder of Mr. Cranstoun's comments, however, make it plain that he is recommending not the indiscriminate merger of these various types of surplus, but rather their separation to provide a clear distinction between contributed capital and undistributed earnings. This certainly would be wholesome. The objective, if I understand it correctly, would be the abolition of the "No Man's Land" now represented in many financial statements by so-called "surplus" accounts with equivocal titles which leave the reader uncertain as to whether the equity stated is the result of a capital contribution or of accumulated earnings.

The suggestion that this clear distinction be made appears in the "Tentative statement of accounting principles" issued by the executive committee of the American Accounting Association in 1936. That statement contains the substance of Mr. Cranstoun's proposals for a two-way division of net worth, and goes somewhat further by specifying as definitely as possible the charges and credits which properly may be considered applicable to each section.

Of particular importance is the recommendation that all charges for property written off or written down shall be made to the profit-and-loss account of the year in which the loss of useful or recoverable value is recognized. This insures that such charges ultimately shall be reflected not only in the earned surplus account, but also in stated net profits of some year or years.

The point which Mr. Cranstoun, in common with many other accountants, finds of the greatest difficulty is the disposition of credits arising from the revaluation upward of property taken into the accounts at figures which the management subsequently comes to believe are too low. This is a natural difficulty, since revaluations of this kind do violence to every proper conception of the function of accounts in recording the history of a business enterprise. There simply is no place for the credit created by such upward revaluations, unless it be in an offsetting "valuation" account, which will be deducted from the related asset on the balance-sheet so as to reduce the net book value once more to the properly depreciated original cost. Mr. Cranstoun makes it clear that if accountants will cease to recognize any other treatment of such "revaluations" the most troublesome problem of distinction between contributed capital and undistributed profits will disappear.

It is rather surprising to find a statement that "the average investor cares to know only one thing about surplus . . . (its) availability for the payment of dividends." While the facts as to the "growth and composition" of earned surplus are vital, the mere fact of its existence in itself should be proof that the corporation has had earnings in excess of dividend payments to the extent indicated. If the period covered by the accumulation also is stated (e.g., "Undistributed profits from January 1, 1924 to date"), the simple fact becomes quite informative as an indicator of the type of further investigation of the earnings history which needs to be made. When companies are required to re-date their earned-surplus account after recapitalization proceedings involving extensive capital write-offs, even the average investor will have a new and valuable clue, on the face of the balance-sheet, as to what may have taken place in a company's past history.