Journal of Accountancy

Volume 67 | Issue 5 Article 2

5-1939

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Recommended Citation

Short, Frank G. (1939) "Accounting for the Issuance of Shares for Assets Under the Decisions of the Securities and Exchange Commission," *Journal of Accountancy*: Vol. 67: Iss. 5, Article 2.
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Accounting for the Issuance of Shares for Assets Under the Decisions of the Securities and Exchange Commission

By Frank G. Short

Somewhat over a year ago I accepted an appointment as instructor in accountancy at Hastings College of the Law (an affiliated college of the University of California). The scarcity of text material suitable for use in a law school has caused me, as it may have others in similar positions, to commence a collection of cases involving accounting principles with the hope that eventually a sufficient number might be available to warrant the preparation of a case book.

It is apparent that the paths of accountancy and law meet more frequently in the field of administrative law than in any other branch of law. It is also well known, at least to accountants, that within the field of administrative law the decisions of the Securities and Exchange Commission are of outstanding current importance. Consequently, I decided to commence my collection of cases dealing with accountancy by a review of the decisions of that Commission. It has been suggested that this case material might be of interest to the profession particularly if it were accompanied by some comments of my own.

In line with the foregoing thought, there are submitted below extracts from the decisions of the Commission in a number of cases which deal with the accounting principles applicable when a corporation acquires assets in consideration of the issue of its capital stock. Although the cases reviewed were decided under the securities act of 1933, it seems clear that the Commission will consider them as authority in deciding similar questions arising under the securities-exchange act of 1934. In the case of such transactions the directors by formal resolution or by legal inference state that the assets acquired have a value equal to the par or stated value of the capital stock issued therefor. It is a matter of common knowledge that in many instances no such value in fact exists.

Quotations from Decisions of Commission with Brief Statements of Facts Involved

In the Matter of Unity Gold Corporation —1 S.E.C. 25

In this case the registrant acquired certain mining rights for a consideration which, in part, consisted of 599,995 shares of the registrant's $1 par value capital stock. The purchase arrangements included an undertaking on the part of the vendor that he would immediately donate to the treasury of the registrant 475,000 of these shares and "it was also requested" that 109,435 shares were to be issued in the names of various promoters. Of the total, only the remaining 15,560 shares were to be retained by the vendor. Following the closing of this transaction, the registrant sold shares to the public at prices less than $1 per share. The cost of mining rights as shown on the registrant's balance-sheet included $599,995 representing the par value of the nominal purchase price. Capital-surplus account was credited with $475,000 representing the par value of the stock donated to the company, and against this capital surplus account there was subsequently charged discount on such stock as was sold to the public at prices less than par.

"*First.* The finding with regard to items 39 and 45 largely determines the question with regard to the inclusion of the 109,435 shares in the cost of the mining rights. Promoters' fees, which a substantial portion of these shares represent, cannot be deemed to be so intimately connected with the purchase of the property as to justify their inclusion in the cost of the latter without, at least, segregating them. Rather, they represent expenditures in the nature of organization expenses for which a separate entry is expressly required by form A-1. Or they might be entered, with an appropriate specification, under the item 'other intangibles' there provided. Accounting theory and practice reveal some disagreement as to whether such expenses are properly to be regarded as representing capital assets or should be treated as a deferred or prepaid expense, but there is no disagreement that expenses in the nature of promoters' fees should be listed separately from expenditures representing the consideration paid for physical property. See Hatfield, *Accounting* (1927) 66 et seq.; Paton, *Accounting* (1930) 709; Paton and Stevenson, *Accounting* (1928) 433–6; Kester, *Advanced Accounting* (1933) 395. See also Interstate Commerce Commission, *Classification of Investment in Road and Equipment of Steam Roads*, 36, and *Uniform System of Accounts for Telephone Companies*, 39.

"*Second.* The cost figures of the registrant include as an element of cost in the acquisition of the Katinka lease and option the 475,000 shares that were 'donated' back to the registrant by the Industrial Company. . . .

"The purpose of a transaction of this type—pretending to a transfer and retransfer of capital stock as between purchaser and vendor—is primarily to attempt to make the stock fully paid and nonassessable so that thereafter it can be sold as such at any price without making purchasers of the stock liable to the corporation's creditors. See *Buck* v. *Jones*, 18 Colo. App. 250, 70 Pac. 951 (1902; *Spier* v. *Bordeleau*, 20 Colo. App. 413, 79 Pac. 332 (1905); *Clinton Mining & Mineral Co.* v. *Jamison*, 256 Fed. 577 (C.C.A. 3d Circuit 1919). It is for this reason that some accounting authorities, though admitting that entries of the type described are untruthful in principle, have been led to condone the practice. The truthful entry—the making of a credit for the donation to the overvalued property account instead of to capital surplus—would admittedly be more nearly expressive of the property's value, 'but such an entry is perhaps too frank an admission that the property was not worth the par of the stock, that the reacquired stock is not true treasury stock, and that subsequent purchasers are liable for the discount.' See 1 Finney, *Principles of Accounting* (1932), ch. 8, p. 16. See also Sunley and Pinkerton, *Corporation Accounting* (1931) 134, 137. The accountant, according to these authorities, is thus entitled to arrange his entries so as to support a legal fiction devoid of any reality and having the tendency to create values where none exist. But other authorities hold a different conception of the accountant's obligation. Thus Hatfield says: 'But whether the presumption is in favor of valuing the property at the amount of stock originally given the vendors, or at the net amount retained by them, if it is established that the former figure would be an actual overvaluation, there is no excuse for such an incorrect representation in the accounts. The accountant should transcend the limitations under which courts labor.' Hatfield, *Accounting* (1927) 219. See also Paton, *Accounting* (1930) 712–717.

"The misleading consequences of such an entry are reëmphasized by the contra entries necessarily made to capital surplus as evidenced by the balance-sheets of this registrant. These indicate a capital surplus arising out of this donation of 475,000 shares. . . .

"This capital surplus, giving to the uninitiated a conception of prosperity, is as nonexistent as the $475,000 added to the property account by the transfer and retransfer above described.

"In behalf of the respondent's contention that the sum stated to be the cost of the property could include shares 'donated' by the vendor back to the registrant, counsel rely on Colorado

cases which stand for the proposition that shares issued in exchange for property will be regarded under Colorado law as fully paid despite the fact of a concurrent donation back to the issuing company of a substantial portion of these shares. *Buck* v. *Jones, supra: Spier* v. *Bordeleau, supra.* These cases involved suits by creditors against stockholders based upon the theory that the stock acquired in such a fashion was not fully paid. The court held that such a transaction, concerning property as to whose value there was no independent evidence, represented a valuation put upon the property by the directors at the total amount of the stock, which valuation would be presumed to have been honestly made, and hence would not be upset unless some evidence were available to overcome the presumption. The simultaneous donation—a fact scarcely noticed in these opinions—does not seem to have been regarded as evidence sufficient to overcome the presumption of honest valuation. Many courts, though adhering to the doctrine that the valuation thus placed by the directors on the property acquired would presumptively be deemed to have been honestly made, have regarded substantial donations of stock so acquired by the vendor of property, when such donations were made concurrently with the purchase, as evidence that would raise a presumption of fraud or gross overvaluation sufficient to permit rejection of the directors' valuation. *Enright* v. *Hekscher*, 240 Fed. 863 (C.C.A. 2d Circuit, 1917); *Hasson* v. *Koeberle*, 180 Cal. 359, 181 Pac. 387 (1919); *Libby* v. *Tobey*, 82 Me. 397, 19 Atl. 905 (1890); *Honeyman* v. *Haughey*, 66 Atl. 582 (N. J. Ch. 1906); *Douglass* v. *Ireland*, 73 N. Y. 100 (1878); *Blake* v. *Griswold*, 103 N. Y. 429, 9 N. E. 434 (1886); *Atwell* v. *Schmidt*, 111 Ore. 96, 225 Pac. 325 (1924). With the question of whether or not stock reacquired under these circumstances is true treasury stock and hence is to be regarded as fully paid and nonassessable, this Commission in this case has no concern; but, under the standards of truthfulness demanded by the securities act, such an entry cannot be regarded as otherwise than untrue and misleading.

"*Third.* It remains to be considered whether the 15,560 shares, constituting the purchase price after elimination of the promoters' shares and donated shares, can properly be taken at their par value of $1 each in determining the cost of the property to the registrant. This appears to be another situation where principles of accounting have made some concession to widespread practices which are concededly deceptive except in so far as their common acceptance deters investors and creditors from the reliance which is theoretically justified. Stock issued in payment for property is frequently carried at par for purposes of determining the value of such property. Where, however, there is evidence that the stock is actually worth substantially less than par, accounting authorities for the most part agree that an appropriate discount should be made. Sec. 1 Finney op. cit., Ch. 8, p. 11; 2 id. Ch. 38, pp. 3–4; Hatfield, op. cit., 72; Paton, op. cit., 715. In the present case, the registration statement states in item 38 that stock of the registrant was sold to the public at prices ranging from 15 to 75 cents a share, but no sales at $1 per share have been shown to have been made. Under these circumstances, since the cost figures are to be taken as reflecting the consideration paid for the property, entering the stock at par would be untrue and misleading.

"Registrant seeks to defend the entry of $599,995 on the ground that it represented the 'prospective value' of the lease and option. The difficulty with this position is twofold. First, registrant purported to state the cost of the property to it and not its prospective value. This cost is measured by what registrant parted with, which consisted of only 15,560 shares and $5,000 cash for the property, and not 599,995 shares and $5,000. These 15,560 shares cannot be contended to have a cash value of $599,995. Second, if we assume that there is no evidence as to the actual value of the shares actually given for the property and also assume that they had no ascertainable market value as of the time

of the purchase, it is arguable that the value of the consideration given for the property should be measured by the value of the property acquired and this latter figure then be stated as the cost of the property. But in such an event the value of the property must be an approximation of its value at the time of the transaction. The concept 'prospective value,' as the testimony indicated, bears no substantial relation to the value placed upon the property in the transactions surrounding its purchase. It had cost the vendor only $2,000, paid not in cash but stock. Though about $5,000 had been expended on the property, no gold had been produced. The sum of $15,000 had still to be paid by July 15, 1934, in order to exercise the option."

In the Matter of Continental Distillers and Importers Corporation—1 S.E.C. 54

In this case a promoter had acquired property and sold it at a profit to the registrant (a corporation controlled by the promoter) for a consideration payable in par value shares.

" . . . it appears that a large part of the $75,000 should be considered payment to promoters and not cost of property. The very least that was necessary to avoid misleading effect in this respect was to state, in connection with the property item on the balance-sheet, that cost was determined in a sale in which the vendor, Reynolds, was in control of the vendee, the corporation. This fact is stated neither on the face of the balance-sheet nor in the accountants' certificate."

In the Matter of Brandy Wine Brewing Company—1 S.E.C. 123

In this case capital stock having a par value of $100,000 had been issued to a promoter (who controlled the corporation) ostensibly in consideration of real property which had cost the promoter $29,000. As a result of objections by the Commission, the registrant had made an attempt to remedy the criticisms and had filed an amended balance-sheet showing the real property at a cost of $29,000 and promotion expense at $71,000. The Commission issued a stop order largely upon the basis of the latter item in the balance-sheet. In this connection, the evidence supported the fact that $71,000 was an amount in excess of the fair value of the promotional services rendered by the promoter. It is not so clear, however, that $71,000 was not the cost of these services.

"Statutory provisions in the state of incorporation making values fixed by directors conclusive for certain purposes, in the absence of fraud, cannot foreclose this Commission's inquiry as to the truthfulness of a statement that a corporation has received services of a certain value, reasonably determined, nor prevent such a statement from being tested for truth under the standards set by the securities act. Under those standards, if the valuation of services is so grossly and unreasonably excessive as to be outside the range of reasonable difference of opinion, this item of $71,000 in the balance-sheet amounts to a misstatement of a material fact. To put it in other words, if a large portion of this stock was in reality donated to a promoter, the statement that it was issued for services is false. . . .

"The Commission finds from all the evidence that the valuation of $71,000 set on Klachko's promotional services rendered the registrant before August 21, 1934, is so grossly and indefensibly excessive as to be outside the range of reasonable difference of opinion; that a large portion of the stock issued to him was in fact a gift; and that the entry of $71,000 for promotional services as an asset on the registrant's balance-sheet . . . is an untrue statement of a material fact."

In the Matter of Franco Mining Corporation—1 S.E.C. 285

In this case a donation of stock was made to the registrant by the vendors about two months after the original issue of the stock.

" . . . This transaction would seem to be a donation to the corporation and not a cancellation and readjustment of the initial purchase price. The balance-sheet as submitted fails to reflect any donation of these shares of stock. Such a donation would normally have been reflected on the basis of the value of such shares by a credit to 'donated surplus' or 'reserve for donated stock.'"

In the Matter of Yumuri Jute Mills Company—2 S.E.C. 81

In this case the entire issue of 1,000,000 shares of no-par-value common stock having a stated value of $1 per share was issued to promoters ostensibly to compensate them for their services in securing certain franchises, privileges and exemptions from the Cuban Government and for other promotional services. Presumably concurrently, the promoters had given the company an option to acquire 250,000 of these shares at a price of 20 cents per share. The balance-sheet offset the stated value of the issued capital stock by an item "Franchises, grants and leases . . . $1,000,000" under the caption "Intangibles."

" . . . The Commission held in that case (Unity Gold Corporation, *supra*) that under the standards of truthfulness demanded by the securities act, it cannot be regarded as otherwise than untrue and misleading to state on the balance-sheet that the cost of the asset is the original stated value of the capital stock given to promoters for the asset when there is a concurrent 'donation back' of part of the capital stock to registrant as part and parcel of the purchase transaction. In the instant case registrant has a concurrent option to repurchase the capital stock given in consideration of the capital asset at a figure materially lower than the value attributed to the capital stock on the balance-sheet. We find that the existence of the option to repurchase 250,000 shares of stock at 20 cents per share impugns registrant's statement on its balance-sheet that the 'franchises, leases, and grants' were acquired at a cost to registrant of 1,000,000 shares of stock at a stated value of $1.

"Registrant attempts to condone its statements in this regard by contending that this option to purchase 250,000 common shares is to be exercised only in the event that the common stock is needed as an inducement to underwriters to purchase the six per cent cumulative preferred issue, and therefore that the difference between the balance-sheet valuation of $250,000 and the option price of $50,000 (at which price the underwriters would be required to purchase the common stock from registrant) is the inducement to the underwriters to purchase the preferred stock. But registrant's contention in this regard does not dispute the fact that its own valuation placed upon the stock given for the franchises, leases and grants is substantially less than its par value. Consequently to take its par value as the measure of the cost of these franchises, leases, and grants to the registrant is misleading.

"We find that these items on the balance-sheet are misleading in other respects. . . .

" . . . From what registrant states in the footnotes to the balance-sheet and in answer to item 39 the $1,000,000 (attributed on the balance-sheet entirely to franchises, grants, and leases) was arrived at by adding together the estimated worth of all services and expenses which led to the organization of the company. We find that it is materially misleading to attribute the entire $1,000,000 to such specific intangibles as 'franchises, grants, and leases,' when as in this case, much of the stock was admittedly issued for promotional services of all kinds. The failure to break down this item on the balance-sheet into its component parts results in concealing from the view of investors matters of relevancy to the worth and nature of the underlying asset."

In the Matter of Rickard Ramore Gold Mines, Ltd.—2 S.E.C. 377

In this case an attempt was made by the registrant to reflect in the balance-

sheet the cost of mining properties acquired for shares on the basis of the principles embodied in the Unity Gold decision. In certain respects the attempt was inadequate and the following quotations omit the opinion of the Commission on the inadequacies, since these merely repeat the principles indicated in the Unity Gold decision. However, even if the attempt had been successful the Commission still would not have been satisfied as the following quotations indicate.

"The 'cost' of the company's properties is set up upon the balance-sheet . . . at $1,500,000, being the par value of the 1,500,000 shares issued for the properties and is then reduced to a net 'cost' of $150,000 by the taking of a ninety per cent discount upon the par value of the shares, thus, in effect, establishing a valuation of ten cents for each share issued. This evaluation was derived from the fact that James Travis and Company purchased from the company at ten cents the first 125,000 shares of the stock which it sold to the public, and from the further fact that an option to purchase the company's shares held by Rickard Gold Mines, Ltd. at ten cents a share was granted to James Travis and Company. . . .

"Neither the balance-sheet nor its accompanying explanatory comment makes any reference to the stipulated fact that the provisional directors who fixed the value of the company's properties for balance-sheet purposes were selected and controlled by James Travis and Company, Ltd. This fact was material and its omission is fatal to the propriety of the balance-sheet and its explanatory comments."

In the Matter of Queensboro Gold Mines, Ltd.—2 S.E.C. 860

"The balance-sheet submitted, moreover, is itself deficient. While custom permits an enterprise to set up its property in its balance-sheet at cost, we have repeatedly held that the arbitrary valuation of assets at the par value of stock issued in their purchase is not such a cost and is misleading when, as appears here, the actual value of the stock at the time of the acquisition was substantially less than par. *In the matter of Unity Gold Corp.*, 1 S.E.C. 25, 33 (1934); *In the matter of Canusa Gold Mines, Limited*, 2 S.E.C. 548 (1937). Nor is the mischief fully cured by an explanatory note revealing that the figure is 'purely arbitrary' and that the vendor, who purchased the property 'at a nominal cost' to himself, 'controlled the board who valued' the property. *In the matter of Mining and Development Corporation*, 1 S.E.C. 786, 799 (1936). Such disclosure, while helpful, is not sufficient. If, as asserted in the explanatory note the 'actual value is not known,' the investor is at least entitled to know the cost, in this case the actual value of the stock issued, as measured by all available standards, and this both the balance-sheet and the explanatory note fail to show."

COMMENTS ON PRINCIPLES APPARENTLY UNDERLYING ABOVE DECISIONS

The Commission's decisions in the above cases are based on certain underlying principles which, it may be assumed, the Commission is prepared to enforce in future cases involving parallel circumstances. In the following paragraphs I attempt to outline these principles and comment on the propriety of their adoption as accepted principles of accounting. It should be understood that the latter comments represent my personal views, formed in each case without an extensive consideration of the subject, and stated primarily in the hope that they may provoke discussion upon this important subject.

1. The first principle apparently adopted by the Commission is that where a corporation issues its capital stock ostensibly in consideration of assets conveyed to the corporation and a portion of such capital stock is not retained by the vendor but, in fact, finds its way into the hands of a promoter, then that portion of the stock which is received by the promoter shall not be

considered as representing a cost of the assets ostensibly acquired, but rather such shares shall be considered as having been issued for promotional services. It appears to me that this principle is based upon the fact (generally true) that at the time of the issue of the capital stock the corporation was the mere *alter ego* of the promoter. From this viewpoint, I believe the principle is sound and that it should be generally accepted by accountants. Its application obviously results in a nearer approach to sound values for assets and, what is more important in view of the current trend of accounting thought, in a nearer approach to truthful determinations of future income. The latter result, of course, arises from the fact that the annual depreciation, depletion, or amortization of the assets nominally acquired will be more fairly determined if the basic value of the assets themselves is more fairly determined. The principle that the legal fiction of corporate entity may be disregarded where it can be shown that the corporation has no independence but is the mere puppet of its controlling owner is well established in law. I believe its general adoption by accountants would be a step in the right direction. Naturally, this would throw additional burdens upon accountants, but the additional responsibilities can, I think, be borne. However, the accountant should not be held responsible for failure to discover facts not disclosed after reasonable investigation, nor should the principle necessarily be adopted except where it is clearly evident that the corporation is the *alter ego* of the promoter.

2. The next principle apparently adopted by the Commission is that if assets are acquired by a corporation in consideration of the issue of its capital stock and if about the same time and pursuant to a previous understanding the vendor donates a portion of such capital stock to the corporation, then the assets shall be considered to have been acquired for the net amount of capital stock retained by the vendor. In this case, if the donated stock is subsequently sold at a discount, the accounting treatment shall be such as would be given to the sale of newly issued capital stock at a discount. If, however, there is a lapse of time between the issue of the capital stock and the donation to the corporation (assuming, of course, that there has been no prearrangement) then the donation results in paid-in surplus, which ultimately will be measured by the amount for which the donated stock is sold by the corporation. This principle has already been formally approved,* in substance if not in my language, by the American Institute of Accountants and may, therefore, be considered an accepted principle of accounting. There can be no reasonable doubt as to its soundness, since its use has the effect of recording the substance rather than the form of the transactions.

3. Another principle apparently adopted by the Commission is that if assets are acquired by a corporation in consideration of the issue of its capital stock and if other events occurring about the same time (e.g., the cash sale of similar stock or the granting of an option on similar stock) indicate that such capital stock has a market value less than its par or stated value, then the cost of the assets acquired shall be based upon the market value of the stock, the difference between the market value and the par or stated value representing a discount to be treated in the same manner as the discount on capital stock sold for cash. It appears to me that this principle should be generally adopted by accountants, at least as to future transactions (it might be impossible to adjust the entries recording such transactions when they occurred many years ago), providing the evidence of market value

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* Report of the special committee on development of accounting principles, approved by the council of the Institute on October 15, 1934.

is substantial in character. It is apparent that this principle has the effect of reflecting substance (real or market value) rather than fiction (par or stated value). Its use will result in a nearer approach to sound asset values and sound depreciation, depletion, or amortization charges to future income. Obviously, if the reasoning involved in this principle is carried to its logical conclusion, the principle would apply in those cases where the capital stock is selling at a premium. In such event, of course, the excess of the market value over the par or stated value would constitute paid-in surplus. The Commission has not had occasion to pass on such a case, but there is no reason to expect that it would not be consistent.

4. The next principle apparently adopted by the Commission deals with the case where assets are acquired by a corporation from a promoter who is in control of the corporation at the time of the acquisition in consideration of the issue of the corporation's capital stock. In such cases, if the proper value of the assets, determined in accordance with the principles already outlined, exceeds the cost of such assets to the promoter, then the amount of such excess must be considered as a payment for services. In most cases these services would be promotional and the payment would be so treated. However, I rather infer from the wording of the Commission's decision that the latter is not a hard-and-fast rule and that warranted exceptions would be approved. Such exceptions are, obviously, necessary. For instance, if we consider a case of an inventor who has spent many years developing a patented process, and who following its development becomes the promoter of a company to exploit it, it would obviously be absurd to consider the entire excess of the consideration received for the patent by him from the corporation over the trifling cash cost as being a payment for promotional services. Obviously, the amount and value of his services as an inventor would far exceed those of his services as a promoter and the cost of the former are unquestionably proper charges to the cost of the patents. This principle is again based upon the conception (generally true) that the corporation at the date of acquisition of the assets is the mere *alter ego* of the promoter. Hence, my advocacy of the adoption of that theory above would apply with equal force here, at least as to transactions occurring in the future. It would ordinarily be quite impossible to apply it now to transactions which had occurred any considerable period in the past. Even in the future, the principle will be quite difficult of application, for many, I might almost say most, promoters have no accurate records which show their costs. However, if a reasonable amount of estimating were recognized, this fact would not necessarily be a drawback and there are many other instances in accounting where results are based upon estimates with perfect propriety, providing the estimates are fairly made. Obviously, if the reasoning upon which this principle is based is carried to its logical conclusion, it would apply equally to those occasional cases where the assets acquired had a cost to the promoter greater than the apparent cost to the corporation. In such cases, it would appear that the assets should be set up at their cost to the promoter and the excess of this amount over the par or stated value of stock issued therefor should constitute paid-in surplus. Also, the principle should be equally applicable to those cases where the consideration paid to the promoter took the form of cash or evidences of indebtedness rather than capital stock. In other words, if the principle is sound, the method of payment should not affect the accounting treatment of the transactions. The Commission has not had occasion to pass on such cases, but there is no reason again to expect that it would not be consistent. Needless to say, if

the principle outlined in this paragraph were to be generally adopted by accountants, then they should not be held responsible for failure to discover facts not disclosed after reasonable investigation, nor should the principle necessarily be adopted except where it is clearly evident that the corporation is, in fact, the *alter ego* of the promoter.

5. Another principle apparently adopted by the Commission is that if a corporation makes any payment for promotional services and if the amount of such payment in relation to the value of such services is "so grossly and indefensibly excessive as to be outside the range of reasonable difference of opinion," then the amount of such excessive payment shall be regarded as a gift. I can see no merit whatever to this proposition. It is based on the *value* concept rather than on the *cost* concept, which latter is the general basis used in accounting. If the profession were to adopt the Commission's theory, it would result in many companies having deficits before they commenced operations (the amount of the deficit being equal to the so-called gift) and it would also result in our facing the practically impossible task of measuring the value of promotional services. I believe the Commission may itself find that its view expressed in the Brandy Wine Brewing Company case is unfortunate. Incidentally, the Commission could have made a much more logical finding, having substantially the same effect, in the Brandy Wine case. Its basis had already been suggested in the Unity Gold case, in which the opinion reads in part, ". . . if we assume that there is no evidence as to the actual value of the shares actually given for the property and also assume that they had no ascertainable market value as of the time of purchase, it is arguable that the value of the consideration given for the property should be measured by the value of the property acquired and this latter figure then be stated as the cost of the property. But in such event, the value of the property must be an approximation of its value at the time of the transaction." This, I think, is a logical principle. However, its application in the Brandy Wine case would result in the excess of the par value of the stock issued over the value of the real property (not in dispute) plus the value of the promotional services being considered as discount on stock and not as a gift. In this connection, the concept that the value of stock issued for the acquisition of assets may properly be measured by the value of the assets received in consideration therefor has a very practical disadvantage. I refer to the fact that the application of this theory necessarily involves appraisals. In a number of cases, too numerous and lengthy to quote from in this article, the Commission has found fault with asset values based upon appraisals because of defects in the appraisals themselves. I think accountants will generally sympathize with the Commission's attitude in these cases, for they are well aware of the abuses that have been made of appraisals in the past. Also, even if it were the custom to make appraisals on the basis of fair market value at the date of the transaction, it would be most difficult to support such values.

Partly based on the quoted portions of the above decisions and partly based on the unquoted portions, one gets the impression that the Commission takes the stand that failure to follow the principles outlined in the preceding paragraphs is not cured by full disclosure in the form of footnotes or otherwise. Also (see the Rickard Ramore Gold Mines, Ltd. case) the Commission apparently takes the stand that even though the principles outlined in the preceding paragraphs are followed, it may still demand additional disclosure. One suspects, however, that these stands do not involve any question of accounting principles. Rather, they provide suitable technicalities upon which stop orders may be based in those cases where the

Commission feels that a stop order should issue but cannot find any other "misstatement of a material fact or failure to state a material fact."

An Illustration of the Result of Applying the Foregoing Principles

The effect of the foregoing can best be considered by applying the reasoning involved to a typical problem. Let us suppose that a promoter hears of a situation in a small city in which there are three ice plants who have all been engaged for some time in a price war with resultant losses to all. The owners are too stubborn to get together with their competitors, but they are each so disgusted with the situation that they are quite anxious to sell out. The promoter after several months of negotiating (during which he incurs expenditures of $5,000 for engineering advice, traveling, entertainment, etc.) succeeds in obtaining options to buy the three plants at the very low total cash price of $650,000. Armed with his options, he then negotiates with an investment banker, who orally agrees to underwrite $500,000 of noncallable preferred stock in the company which the promoter proposes to incorporate to operate the combined businesses. The deal with the underwriter provides for the purchase of the preferred stock at 90 and is conditioned upon at least $200,000 of the proceeds being retained for working capital and the underwriter's receiving as a bonus $100,000 par value of the proposed common stock. The promoter then enters into new negotiations with the owners of the ice plants and persuades them to enter into agreements with him substituting $250,000 in cash and $500,000 par value of common stock for the $650,000 cash purchase price provided for in the original options (which are then destroyed). He then causes a company to be incorporated which enters into formal agreements with the owners of the ice plants to purchase their plants for $1,000,000, payable $250,000 in cash and $750,000 par value of common stock. The underwriting agreement is also formally consummated, the preferred stock issued, and $250,000 of the proceeds paid to the owners of the ice plants. The $750,000 par value of common stock is issued and ultimately disposed of—$500,000 to the owners of the ice plants, $100,000 to the underwriters, and $150,000 to the promoter.

The above represents a fairly typical set of conditions and includes one new element (the bonus to the underwriters) often met with in practice, although not specifically dealt with in any of the Commission's decisions. However, the line of reasoning followed by the Commission makes its treatment quite clear. Below will be found balance-sheets arranged in parallel columns as follows:

- A The balance-sheet which would result from an application of all of the above principles except No. 5, which I have considered entirely illogical.
- B The balance-sheet which would result if the accountant who prepared it did not in the course of his inquiries discover the former existence of the options, which had been destroyed, and who, therefore, had no knowledge of any circumstances which would indicate that the common stock was not worth its par value.
- C The balance-sheet which would result from the application of principles which have been orthodox in the past and which probably still represent general practice. These principles are based upon the legal principle of corporate entity and the assumption that, if this principle is to be disregarded, it must be based upon a decision of the courts and not upon any action of the accountant. Hence, no transactions are reflected in this balance-sheet except those to which the corporation is a party.

	A	B	C
Cash	$ 200,000	$ 200,000	$ 200,000
Ice plants	655,000 (a)	755,000	1,000,000
Discount on preferred stock	130,000 (b)	150,000	50,000
Discount on common stock	150,000 (c)		
Promotional services	115,000 (d)	145,000	
	$1,250,000	$1,250,000	$1,250,000
Preferred stock	$ 500,000	$ 500,000	$ 500,000
Common stock	750,000	750,000	750,000
	$1,250,000	$1,250,000	$1,250,000

(a) Original option price $650,000 plus $5,000 cost of obtaining options.
(b) Nominal discount $50,000 plus $100,000 common stock at 80.
(c) Twenty per cent of $750,000, based upon substitution of $500,000 common stock for $400,000 of original cash option price.
(d) $150,000 common stock at 80 minus $5,000 cost of obtaining options.

Let us now suppose that after a few years the company establishes average earnings after taxes, but before depreciation, of $175,000 per annum. The promoter and the investment bankers at that time decide that they will distribute their common stock to the public at a price approximately equal to ten times earnings. The following is the result (assuming a depreciation rate of five per cent and preferred stock dividend requirements of six per cent):

	A	B	C
Net profit before depreciation but after taxes	$175,000	$175,000	$175,000
Less: Depreciation	32,750	37,750	50,000
Net profit	$142,250	$137,250	$125,000
Preferred dividend requirements	30,000	30,000	30,000
Earnings available for common stock	$112,250	$107,250	$ 95,000
Earnings per share of common stock	$ 14.97	$ 14.30	$ 12.67
Price per share to the public	$150.00	$143.00	$127.00

A comparison of columns A and C indicates that accountants have generally been following principles which are less conservative from a balance-sheet viewpoint, but more conservative from an income viewpoint than those embodied in the Commission's decisions. The effect of the orthodox accounting treatment (assuming column A to be a correct balance-sheet) is that by charging an additional $17,250 per annum to income the directors are precluded from paying out this much of the profits as dividends. The result is that at the end of twenty years $345,000 of the intangibles have been converted into tangibles. In the meantime, the stock will tend to have a lower market price because of the apparently lower earnings. I think it will be admitted that

these results represent conservative financial policy. It may be open to question, however, as to whether it is any part of the duty of an accountant to obtain conservative financial policies by the use of accounting principles which have the effect of forcing conservatism. Needless to say, the accountant should advise conservatism, but if column A represents a nearer approach to the truth than does column C, then it is submitted that the function of accounts is to approach the ideal of truth as nearly as may be and not to force conservatism in financial policy.

It remains to be considered whether the principles embodied in the Commission's decisions represent a closer approach to a truthful recording of the transactions than do the principles heretofore used in accounting. I have indicated that I believe they do, with one exception (No. 5). If accountants generally should come to the same conclusion then, needless to say, we should use every effort to persuade our clients to write off by voluntary charges to surplus the additional amounts of intangible assets which will result. Unfortunately, under the going-concern principle, which is basic in accounting, we cannot support any theory that they are compulsory charges to income or that they need be written off at all.

Needless to say, the preparation of balance-sheets in accordance with the Commission's decisions constitutes an admission by the company that the assets acquired in consideration of capital stock do not, in fact, have a value equal to the par or stated value of such capital stock. I am not competent to judge the legal effect, if any, which such an admission may have. Consequently, I believe clients should be advised to consult their attorneys before a balance-sheet is prepared for our audit embodying these principles. As auditors, we obviously have no right to dictate the manner in which the balance-sheet shall be drafted. Rather, our rights and duties are confined to those of reporting upon whether this balance-sheet is based upon accepted principles of accounting.