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Correspondence: On the Nature of the Gain on Treasury Stock

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CORRESPONDENCE

On the Nature of the Gain on Treasury Stock

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: I do not find the article in the August number entitled "On the Nature of the Gain on Treasury Stock" as convincing as it appears that the author would think I should find it. The reason is this. I believe that the article is based on the rather dogmatic premise that a corporation is in essence the group of shareholders. On the contrary, the whole history of business corporations, in their legal and economic relations to their shareholders and to society, indicates that for some purposes they are best considered to be, essentially, the group of shareholders, and for other purposes, essentially, separate entities with characteristics as distinctive as those of natural persons. I believe that realization of this divided character of corporations accounts in large part for the "old theory" as to gain on treasury stock referred to in the article. A still older, and continuing, truth is that oversimplification of any complicated legal or economic problem rarely leads to an enduring solution.

Yours truly,

E. E. WAKEFIELD

Boston, Mass.

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: D. Paul Musselman's article "On the Nature of the Gain on Treasury Stock" [August, 1940, issue of THE JOURNAL OF ACCOUNTANCY] is a teaser.

As far as I could ascertain his inquiry is based on several premises; namely, that

(a) *Courts of law are fountains of economic science*

"The emphasis of this article, however, will be on the economic aspect" (page 105), but this economic aspect Mr. Musselman proves by court decisions (pages 111 and 112).

(b) *Managers' belief that they are making a gain proves that gain*

"Corporate managers, unhampered by accounting theory, are repeatedly buying in outstanding stock whenever favorable opportunities offer, and solely for the gain (as they believe) . . . the balance-sheets of 500 of the largest American corporations for 1933–1936 disclosed that two thirds of them had employed substantial idle funds in this manner" (page 104).

These quotations do not make clear whether the corporations bought their own stock for resale or cancellation. Their managements believed that they would gain. If they sold their shares for a higher price, then their belief was justified, a profit was made, and such a profit would be recognized by accountants. If some of these shares were sold at a lower price, then a loss, instead of a profit, was entailed.

If these shares were canceled, then the managers' belief that the corporation made a profit was erroneous, and accountants would tell them so.

(c) *Profits can be made by (a) dealing with oneself (b) on purchases*

Let us take an example of a corporation which issued a thousand shares at $100 each, bonds at face value of $30,000, made a profit of $20,000 and has $150,000 in cash. At this point it is clear that the corporation is accountable to the owners, the shareholders, for $120,000, $100,000 of which were contributed by the latter and $20,000 were earned. The corporation setting aside $30,000 due to the bondholders has $120,000 in cash. Now suppose that the managers, who represent the owners, the shareholders, have a chance to buy 100 shares at $80 and do buy and cancel these 100 shares. Has the corporation made any gain? No. The corporation's assets are now reduced to $142,000, of which $30,000 are still due to the bondholders, and to the shareholders is due an equally reduced amount of $112,000 which, according to the records made by the accountants, show that

$90,000 were contributed by the shareholders, $20,000 were earned, and $2,000 came from cancellation of 100 shares issued at $10,000, but repurchased for $8,000. The corporation did not gain these $2,000. There is no more gain in this transaction than in receiving a payment for an account receivable: there is just a change in asset accounts; in our case, in the purchase and cancellation of shares, there was a change in the capital accounts.

It is just like a donation by one of the shareholders. Individual shareholders, not the corporation, may or may not gain, because gains are made on sales, not on purchases. All shareholders are the owners of the corporation. In the cancellation of shares the ownerships are shifted, one shareholder loses, but other shareholders gain the same amount and the total ownership did not change.

At this point it cannot be said that the remaining shareholders gained $2.22 per share ($2,000 divided by 900 shares). If one is to insist that they gained, then a gain must be recognized on their shares, when the stock quotations rise on the stock exchange. There is a gain, but a nominal one, a book gain; accountants do not recognize it until after realized. If one of the stockholders sold his shares, his gain (or loss) will be the difference between the amount of the sale and the amount he paid for his shares, without any reference to their book value.

(d) *Book values equal actual or market values*

See his discussion regarding capital adjustments *v.* economic gains, on page 108.

(e) *Prosecutor, judge, and jury can properly be one person*

The author (left column on page 110) creates a bogeyman, "a triple paradox," and then slays him. It is no paradox at all, the property is reduced by $10x$ leaving a balance of $290x$, the amount for which the management of the corporation is accountable to *all* shareholders; the shift from A to the remaining shareholders creates no gain for the corporation.

It is possible that the justification for some of these premises lies in the paragraph at the bottom of the left column of page 111, but I must admit that I could not fathom it at all.

Yours truly,

BORIS BAIEVSKY