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PROBLEM NO. 14 (DEMONSTRATION)

The Hampton Circle Swing Company was organized in New York on April 1, 1912, with an authorized capital stock of $500,000, divided into 5,000 shares of the par value of $100 each. The certificate of incorporation was filed April 5th.

At a meeting of the directors held on April 6th, there was acquired from W. J. Hampton at a valuation of $500,000, all his right, title and interest in various patents held by him on the Hampton Circle Swings.

In order to raise funds with which to exploit the invention Mr. Hampton donated to the company 2,499 shares of stock. Of this 2,250 shares were sold from time to time at an average price of 90, and 225 shares were used in giving a bonus of 10% in stock.

The parts necessary to erect and equip three swings were purchased from the Danielson Iron Company. The cost was $73,247.92, of which $50,000 was paid in cash. The labor incident to erection was paid for in cash and amounted to $45,386.58. One swing was installed at Coney Island at a cost of $39,544.83; one at Atlantic City at a cost of $41,275.17; and one at Fort George at a cost of $37,814.50. The privileges cost, collectively, $12,000. The net income from the operation of the swings for the season was: Coney Island, $12,273.85 (sold before Labor Day for $50,000); Atlantic City, $2,863.15 (installation not completed until after July 4th); Fort George, $6,743.35. The salaries and expenses of the company from April 1 to September 30, 1912, were $18,787.59. The balance on account was paid to the Danielson Iron Company and $2,000 was paid for a privilege at Ocean City for the season of 1913.

Prepare:

(*a*) Journal entries opening the books of The Hampton Circle Swing Company and covering subsequent transactions.

(*b*) Balance sheet, September 30, 1912.

SOLUTION TO PROBLEM No. 14

It is probable that circle swings are sufficiently familiar to the average reader to require no description. They have sprung into existence and attained popularity within the past fifteen years. They are now an important feature of most modern amusement parks.

This problem is taken from a company which was organized by the man who it is understood was the inventor of the circle swing and is largely based on facts. It illustrates the ingenuity of an inventor who was an organizer and man of business ability as well as a mechanical genius.

With a sufficiency of patents and no funds, this man, who for our purposes may be called "Hampton," set about to organize a corporation and acquire the entire capital stock thereof in exchange for his patents. The details of organization, such as the paying in of the small amount of cash required and the matter of organization expense may be passed over since such points have been fully discussed in previous problems and the purpose of the present problem is to bring out other points.

With the donation by Hampton of 2,499 shares of stock we are brought face to face with the first debatable point. Presumably no one will dispute the fact that the stock, from the standpoint of the company, becomes treasury stock, since it complies with the usual interpretation of the term which holds that treasury stock is such stock as has been once issued for value and subsequently acquired. Parenthetically it may be noted that Hampton while having provided stock which may be sold at whatever price it will bring, or if desirable, given away, has not parted with the controlling interest in the corporation. It is also apparent that his object in donating the stock was to provide what may be rather loosely termed "working capital."

On the question of what account title or interpretation shall be given to the credit which arises when treasury stock is debited, authors, authorities and novices differ. It has been variously referred to as "stock donation account," "treasury stock donated," "treasury stock suspense," "working capital," "capital surplus suspense," "surplus from donated stock," etc. A consideration of what it is rather than what it is called will doubtless be of some interest.

The capital stock in the amount of $500,000 was originally issued for patents. Were the patents worth $500,000? Future operations of plants and income derived therefrom only will answer such a question. If in the judgment of the directors, this being a New York corporation, such was the value, their judgment in the absence of fraud would be conclusive. If it is conceded that $500,000 was the value of the patents, any subsequent donation of stock would affect the surplus to the extent of the value of the stock. The question of this value then becomes the second question to be settled.

Any attempt to fix or estimate the value of the donated treasury stock would encounter ridicule. Obviously it is worth what it will bring upon sale. It is therefore apparent that some temporary disposition must be made of the credit if an account is to be set up for the treasury stock. Of the titles mentioned all are available except "surplus from donated stock." It should in the opinion of the author be pointed out that this is not yet surplus. It is merely a bookkeeping account set up as an expedient for holding the amount in suspense until the exact amount of the surplus arising from the donation is determined. For this purpose, "stock donation account" perhaps serves as well as any other.

In the problem under discussion, when the donated stock is received, treasury stock may be debited in the amount of $249,900 and "stock donation account" credited. When the 2,250 shares are sold at 90, and 225 shares given away as a bonus, treasury stock should be credited in the amount of $247,500, and cash, $202,500, discount on stock, $22,500, and stock bonus, $22,500, respectively, debited. The accounts for discount and stock bonus might then, if it were desired to close the books, or set up a comprehensive balance sheet, be closed out to the stock donation account, the balance of which ($202,500), after bringing down an amount corresponding to the inventory of treasury stock ($2,400), could be closed out to capital surplus or to profit and loss surplus. The former would not be available for dividends while the latter would be. So far as the author has been able to ascertain after energetic research, there is no legal restriction upon treating such an item as profit and loss surplus. So to treat it, however, and pay it out as cash dividends would defeat the purpose of the donation. To its distribution as stock dividends there could apparently be no objection.

Up to this point the question at issue has been presented from one point of view—that point of view being taken by those who would contend that the patents could be consistently valued at $500,000. With a view to full discussion, it should be pointed out that those who oppose this view hold that the donation of the stock is in itself evidence that the assets acquired should not be valued at the par value of the capital stock issued for them. The treatment of the accounts in this case would be the same as previously presented except that the amount previously credited ultimately to capital surplus or profit and loss surplus would be credited to patents, thereby reducing the book value of the asset. This treatment it seems cannot be consistently applied if the directors hold to the contrary through their right to fix the value, but such procedure would undoubtedly be conservative.

Still another theory concerning the matter holds that the donation of stock is equivalent to discounting the capital stock and such theorists would debit discount on stock and credit patents in the amount of the donation. One of the earlier legal decisions in the matter holds such a transaction to be evidence of discount, or issue below par; but the courts have latterly held the contrary. If such an entry as was above noted should be made it is evident that treasury stock would not appear on the books, but that sales of the stock would be debited to cash and credited to discount on stock. It is presumed that the balance of the discount account would be written off against profits over a period of years.

The journal entries required by the problem are as follows:

Patents	$500,000.00	
To capital stock outstanding		$500,000.00
Treasury stock	249,900.00	
To stock donation account		249,900.00
Cash	202,500.00	
Discount on stock	22,500.00	
Stock bonus	22,500.00	
To treasury stock		247,500.00
Stock donation account	247,500.00	
To discount on stock		22,500.00
Stock bonus		22,500.00
Capital surplus		202,500.00

Cost of swings		118,634.50	
To accounts payable			73,247.92
Cash			45,386.58
Accounts payable		50,000.00	
To cash			50,000.00
Privileges (1912)		12,000.00	
To cash			12,000.00
Cash		21,880.35	
To income from swings			21,880.35
Coney Island	$12,273.85		
Atlantic City	2,863.15		
Fort George	6,743.35		
	$21,880.35		
Cash		50,000.00	
To cost of swings			39,544.83
Profit and loss			10,455.17
Salaries and expenses		18,787.59	
To cash			18,787.59
Accounts payable		23,247.92	
To cash			23,247.92
Privileges (1913)		2,000.00	
To cash			2,000.00
Profit and loss		30,787.59	
To privileges (1912)			12,000.00
Salaries and expenses			18,787.59
Income from swings		21,880.35	
To profit and loss			21,880.35
Profit and loss		1,547.93	
To profit and loss surplus			1,547.93

THE HAMPTON CIRCLE SWING CO.

BALANCE SHEET—SEPTEMBER 30, 1912

Assets		*Liabilities and Capital*	
Equipment (cost)	$ 79,089.67	Capital stock outstanding	$500,000.00
Patents	500,000.00	Stock donation account	2,400.00
Treasury stock	2,400.00	Capital surplus	202,500.00
Cash	122,958.26	Profit and loss surplus	1,547.93
Privileges (1913)	2,000.00		
Total assets	$706,447.93	Total liabilities and capital	$706,447.93

PROBLEM NO. 14-A (PRACTICE)

The Roller-Coaster Company was incorporated January 1, 1912, under the laws of the state of New York, with an authorized capital stock of $750,000, divided into 5,000 shares of preferred and 2,500 shares of common stock of the par value of $100 each.

The stock was all issued to Frederick Johnson for patents. Johnson donated the common stock for working capital. Ninety per cent of it was sold at an average price of 85.

Three outfits were erected as follows: Coney Island, cost $60,827.92; Midland Beach, cost $61,382.43; Glen Island, cost $59,783.47. The cost is composed of material obtained from sundry creditors in the amount of $120,421.78 (of which $97,-421.78 was paid in cash), and labor of installation, $61,572.04.

Privileges cost $8,750. The net income from operation for the season was: Coney Island, $8,762.50; Midland Beach, $5,327.90; Glen Island, $2,275.85. A privilege at Old Orchard for the season of 1913 was purchased for $500. The salaries and expenses of the company from January 1st to September 30th were $22,836.79.

Prepare:

(*a*) Journal entries opening the books and covering subsequent transactions.

(*b*) Balance sheet, September 30, 1912.