ACCOUNTING PROBLEMS IN CORPORATE DISTRIBUTIONS

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During the past ten years substantial progress has been made in the development of the relations between accounting and corporation law.¹ Lawyers in increasing numbers have recognized the value of familiarity with accounting techniques, and this recognition has been reflected in law school programs.² A number of important states have made comprehensive revisions of their general corporation laws in terms which show the influence of accounting analysis. Writers on accounting have shown increased understanding of the legal aspects of their problems, and great strides have been made in clarifying the function of the accountant in the face of the extreme diversity of state corporation laws.

This diversity has been particularly troublesome in the most rapidly developing field of accounting, that of accounting for investors. In presenting the results of corporate operations in a form suitable for investors, present and prospective, accountants have striven for uniformity and have thus attempted to facilitate the comparative use of financial statements. They have been faced, however, with the necessity of showing also the varying legal results of certain types of transactions. This necessity has forced a fuller analysis of the accountants' task and has promoted recent efforts to formulate accounting principles.³ In these efforts, the profession has been actively encouraged, if not spurred, by the Securities and Exchange Commission. The statutes administered by the Commission have increased the responsibility of the accountant and have consequently made it possible for him more frequently to insist upon disclosure in accordance with "sound accounting practice", despite the wishes of corporate officers. The SEC, furthermore, is gradually developing by case to case methods

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1. See, e. g., Berle and Fisher, *Elements of the Law of Business Accounting* (1932) 32 COL. L. REV. 573; Berle, *Accounting and the Law* (1938) 13 ACCTG. REV. 9; GRAHAM AND KATZ, *Accounting in Law Practice* (2d ed. 1938).

2. See Graham, *Accounting in the Law-School Curriculum* (1939) 14 ACCTG. REV. 14.

3. See the report of the executive committee of the American Accounting Association, *A Tentative Statement of Accounting Principles Affecting Corporate Reports* (1936) 11 ACCTG. REV. 187 (also published by the association in pamphlet form as *A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements*). See also SANDERS, HATFIELD, AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938).

a common law of accounting and on many points has also issued formal regulations.

Problems of corporate distributions to shareholders furnish the most fertile field for the study of the relations between accounting and law. This paper represents an effort to explore some of these relations rather than to discuss for their own sake the accounting treatment of corporate distributions. No attempt is made to develop the subject comprehensively or systematically; the problems dealt with have been chosen because they afford the best illustrations of the evolution of corporate accounting principles and their influence on corporate financial practice.

DIVIDENDS FROM PAID-IN SURPLUS

Much confusion in corporation law and accounting has resulted from the authority frequently granted to corporations issuing no-par shares to allocate part of the consideration to paid-in surplus. In a number of important states, including Delaware, such surplus is available for dividends to the same extent as earned surplus.⁴ These statutes have handicapped accountants in their efforts to develop and enforce standards of disclosure as to shareholders' investment and undistributed earnings. Until recently, furthermore, accountants have not generally been astute in marking out their own field of influence in the face of these "liberal" corporation laws. Many accountants have tilted valiantly at the legal windmills, insisting that paid-in surplus is a contradiction in terms, and that the concept of no-par shares implies that all of the consideration automatically becomes "capital". Although these views have been frequently expressed in the proceedings of societies of accountants, the societies have apparently considered it outside of their proper functions to lobby against the progressive relaxation of corporation statutes. Instead, individual accountants have often protested against corporate dividends and other transactions as violating "sound accounting principles", and in their skirmishes with corporation lawyers in such cases, the accountants have almost invariably come out a poor second.

Much of the difficulty, of course, arises from the want of agreement as to the scope of the field of accounting, as to the matters with which "accounting principles" may appropriately deal. Typical are the questions of the sources of dividend distributions, particularly dividends out of paid-in surplus. An interesting discussion of the

4. For the purposes of this article, the surplus arising from the sale of par-value shares at a "premium" creates the same problem. There are, of course, many recent examples of shares with a nominal or low par value being sold for many times this amount.

function of accountants in relation to this question occurred at the Round Table on Accountants' Certificates at the fiftieth anniversary celebration of the American Institute of Accountants.⁵ The case was presented of a Michigan corporation which had paid cash dividends during the year and charged them to paid-in surplus pursuant to a resolution of the board of directors and an opinion of counsel. The discussion related to the form of comments or qualifications to be included in the accountant's certificate with respect to these dividends. One member argued that since the payment of dividends out of paid-in surplus violates accepted accounting principles, the item must be noted in the accountant's certificate as an exception to the general statement that "the accounting principles employed have been in keeping with sound accounting practice".

It was argued on the other hand that in no respects are the financial statements rendered misleading by the declaration of dividends from paid-in surplus and that, since the practice is authorized by statute, the accountant has no occasion to express an opinion. In answer to this argument, the chief accountant of the SEC suggested that the accountant might at least call attention to the source of the dividend and say that since the company distributed the dividend as a liquidating dividend he takes no exception to the procedure. One may admit that the payment of dividends out of paid-in surplus is not an "accounting practice" and that there is no occasion for adverse comment by the accountant. His function, however, may properly be considered as embracing not only the presentation of accurate statements but also the disclosure of certain information not appearing on the statements themselves. The source of dividends would seem a very important item to be disclosed. Indeed, the Michigan statute provides that when a dividend has been declared from surplus other than earned surplus "the shareholders receiving the same shall be advised of that fact . . . and the next annual statement of accounts to be given to the shareholders shall indicate the surplus from which such dividend was paid." *

Further considerations arise when the dividend is being charged to paid-in surplus despite the existence of an earned surplus. It is rather surprising that no state has enacted the rule that paid-in surplus is available for dividends only in the absence of an earned surplus.⁷

5. AMERICAN INST. OF ACCOUNTANTS, FIFTIETH ANNIVERSARY CELEBRATION (1937) 417-20, 448-49.

6. GEN. CORP. ACT § 22. Cf. ILL. BUS. CORP. ACT § 41 (b). See SEC rule N-19-1, Investment Company Act Release No. 71, Feb. 21, 1941, for an elaborate regulation of disclosure of sources of dividends by "management" investment companies.

7. But see Hills, *Model Corporation Act* (1935) 48 HARV. L. REV. 1334, 1364, § VII (b); SEC Investment Company Act Release No. 71, Feb. 21, 1941.

This is particularly true in the states where such dividends may be paid only on preferred shares and where the argument for permitting them is based upon the plight of the recently organized corporation which has no earned surplus or current earnings. At the round table discussion just referred to, this problem was discussed by one of the speakers who took the position that the payment of a legal dividend out of paid-in surplus need be specially noted by the accountant only when the corporation had an earned surplus available.⁸ In this situation, of course, it is especially important that the source of the dividend be disclosed. In a proceeding under the Holding Company Act the SEC has taken the position that where a "company purports to segregate earned and capital surplus, the financial statements are perverted when dividends are charged to capital surplus while there is an earned surplus credit balance. The showing of an earned surplus credit after the payment of dividends gives a false picture of corporate strength where the earned surplus credit remains only because the dividends have been charged to capital surplus. Dividends should, in our opinion, be charged to earned surplus where such a surplus exists."⁹ There has thus far been no indication, however, that for corporations not subject to the Holding Company Act the Commission will require this practice. Nor is there an indication that if the dividend is charged to capital surplus where an earned surplus exists the Commission will require that the earned surplus item on future balance sheets be explained by indicating what its amount would be if the dividend had been charged to earned surplus.

CHARGES AGAINST PAID-IN SURPLUS

More common than the declaration of dividends out of paid-in surplus is the practice of using paid-in surplus to absorb losses or write-downs of a more or less extraordinary character, charges which would otherwise have to be made against earned surplus or against future income. Here there has been much greater crystallization of opinion as to accounting practices which may be insisted upon even in the face of lax corporation statutes.

As early as 1932 a special committee of the American Institute of Accountants stated the following principle in a report to the Committee on Stock List of the New York Stock Exchange: "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst." This rule was adopted by the

8. AMERICAN INST. OF ACCOUNTANTS, FIFTIETH ANNIVERSARY CELEBRATION (1937) 449.

9. In the Matter of Associated Gas and Electric Corp., 6 SEC 605, 619 (1940).

Institute in 1934 and has been repeated and amplified in its later pronouncements.¹⁰ A similar formulation was included in the tentative statement of accounting principles published by the American Accounting Association in 1936;¹¹ and in the first of its accounting series of releases, the SEC published an opinion of its chief accountant which included the statement, "It is my conviction that capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been chargeable against income."¹²

The mobilization of accounting opinion behind this principle has been a gradual process, however, and in the early stages the SEC, over the emphatic protest of Commissioner Healy, went no further than to require specific disclosure of the doubtful practice and comment by the certifying accountant on its propriety.¹³ In April 1938, however, the Commission announced a new administrative policy relating to financial statements:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."¹⁴

Although the Commission is moving slowly and has taken a position on comparatively few controversial matters of accounting, this announcement represents a step of great importance.

10. See the Institute's Accounting Research Bulletin No. 3 (1939) and its bulletin, *Examination of Financial Statements* (1936) 30.

11. *A Tentative Statement of Accounting Principles Affecting Corporation Reports* (1936) 11 ACCTG. REV. 187, 191 (principle #17).

12. SEC Accounting Series Release No. 1, April 1, 1937. See also *In the Matter of Allegheny Corp.*, 6 SEC 960 (1940).

13. Healy, *The Next Step in Accounting* (1938) 13 ACCTG. REV. 1, 2-5; Kaplan and Reaugh, *Accounting, Reports to Stockholders, and the SEC* (1939) 48 YALE L. J. 935, 963-65, (1939) 14 ACCTG. REV. 203. See also (1938) 13 ACCTG. REV. 99, 212.

14. SEC Accounting Series Release No. 4, April 25, 1938.

DEFICITS AND "QUASI REORGANIZATIONS"

Some of the state corporation laws which narrowly restrict the declaration of dividends out of paid-in surplus permit, nevertheless, the use of such surplus to absorb an earned-surplus deficit and thus make available for dividends the earnings of future periods. Accountants have come to use the term "quasi-reorganizations" to describe these transactions as well as to describe the more frequent elimination of an earned-surplus deficit through a reduction of stated capital. As this unhappily legalistic term suggests, the enterprise is permitted to restate its accounts with the same result as though the business were transferred to a newly-organized corporation. In the case of such readjustments, however, the SEC and the accounting societies agree that "sound accounting practice ordinarily requires that a clear report be made to stockholders of the proposed restatement and that their formal consent thereto be obtained."¹⁵ Here we have another interesting question as to what is a matter of "accounting practice" and as to the relation between accounting and corporation law. As already suggested, it is not difficult to think of accounting practice as including matters of disclosure to shareholders, but to recognize the question of stockholder vote as one of accounting practice requires a much broader concept of accounting.

Where no shareholder vote has been secured, the SEC has prescribed that "to effect the minimum appropriate disclosure in the surplus accounts, information should be given in respect of subsequent earned surplus in approximately the following fashion:

<i>"Total deficit to December 31, 1939</i>	<i>\$700,000</i>
<i>"Less deficit at January 1, 1939, charged to capital surplus by resolution of the board of directors and without approval of stockholders, such action being permissible under the applicable state law</i>	<i>800,000</i>
<i>"Earned surplus since January 1, 1939</i>	<i>\$100,000"</i> ¹⁶

15. SEC Accounting Series Release No. 16, March 16, 1940 (italics added). Cf. In the Matter of Associated Gas and Electric Corp., 6 SEC 605, 620 (1940): "In short, the enterprise must be put on substantially the same accounting basis as a new enterprise. And because the primary excuse for the device is that it accomplishes expeditiously what might otherwise have to be accomplished by legal proceedings, clear disclosure of the transactions should be made, and appropriate consents should be secured."

See also American Institute of Accountants, Accounting Research Bulletin No. 3 (1939) *Quasi-Reorganization or Corporate Readjustment*. But see Hatfield, *Operating Deficit and Paid-in Surplus* (1934) 9 ACCTG. REV. 237.

16. SEC Accounting Series Release No. 16, March 16, 1940.

The Commission also requires that in the first financial statement filed with the Commission reflecting the action taken by the directors, there be included a full explanation of the transaction and its "possible effect upon the character of future dividends". The Commission suggests that such an explanation might well conclude with the statement that if subsequent earnings are less than the deficit written off, "distributions thereof may in effect represent distributions of capital or capital surplus."¹⁷ One may safely predict that corporations will usually prefer to seek shareholder ratification rather than comply with these disclosure requirements.

Even if shareholder consent is secured, it is agreed that "earned surplus thereafter should be so labeled as to indicate that it dates from a point of time subsequent to the inception of the corporation."¹⁸ In this connection, the SEC has added the requirement that "until such time as the results of operations of the company on the new basis are available for an appropriate period of years (at least three) any statement or showing of earned surplus should, in order to provide additional disclosure of the occurrence and the significance of the quasi-reorganization, indicate the total amount of the deficit and any charges that were made to capital surplus in the course of the quasi-reorganization which would otherwise have been required to be made against income or earned surplus."¹⁹

The requirement of "dating" surplus assumes that a corporation cannot emerge from a quasi-reorganization with an earned surplus, that amounts to be written off "should first be charged against earned surplus to the full extent thereof"²⁰ and only the remainder be charged against paid-in surplus. Special problems arise in applying this rule to corporations with subsidiaries. The American Institute bulletin states that such corporations should apply the rule "in such a way that no consolidated earned surplus will be carried through a readjustment in which some losses have been charged to capital surplus. If the earned surplus of any subsidiary cannot be applied against the loss before resort is had to capital surplus, the parent company's interest therein should be regarded as capitalized by the readjustment, just as surplus at the date of acquisition is capitalized, so far as the parent is concerned."²¹

One of the unsettled problems with respect to quasi-reorganizations is that as to the writing up of asset values. If shrinkages in value

17. *Ibid.*

18. *A Tentative Statement of Accounting Principles* (1936) 11 ACCTG. REV. 187, 191 (principle #19).

19. SEC Accounting Series Release No. 15, March 16, 1940.

20. American Inst. of Accountants, *Accounting Research Bulletin* No. 3 (1939).

21. *Ibid.*

have been written off against capital surplus, and if the value of assets which have appreciated is not restated, the sale of such assets may result in a striking inflation of the profits of the post-reorganization period. Neither the SEC nor the accounting societies have taken a flat position on this problem, although the Institute bulletin just cited states that in a quasi-reorganization, the "assets and liabilities shall be so stated that no artificial credits will arise from realizations of the assets or discharge of the liabilities."²²

Occasionally corporations have used the quasi-reorganization procedure to write down fixed asset values to an arbitrary or nominal figure and thus relieve future income of normal depreciation charges. Thus in 1933 fixed assets of U. S. Industrial Alcohol Company were written down from over 19 million dollars to one dollar.²³ In cases such as this, the SEC has required that the effect on the earned surplus and the profit-and-loss statement be disclosed in footnotes to the balance sheet and to the profit and loss statement.²⁴

CAPITAL AND SURPLUS ON THE BALANCE SHEET

Much of the confusion with respect to capital and surplus is attributable to the fact that there has been no single principle or purpose underlying the analysis of the interests of shareholders on the balance sheet. Different forms of balance-sheet presentation reveal three distinct criteria of analysis. One criterion of analysis, reflecting distinctions in items on the balance sheet, is in terms of source of corporate assets or asset values; contributions from shareholders thus being shown separately from accumulated earnings, and surplus arising from revaluation of assets being shown separately from both. The second principle influencing balance-sheet arrangement of net-worth items is that of legal availability for distribution to shareholders. The third may be designated as a criterion of "practical availability" for such distribution. This last principle has influenced balance-sheet arrangement to a comparatively small extent. Items of appropriated surplus or reserves reflect its influence, but it has not become customary to make such an "appropriation" of earnings where the earnings have been "reinvested" in fixed assets.

Until recently the principle of legal availability for dividends has had the most important influence in determining balance-sheet practice. But of late years, when accountants have ceased merely to fulminate against "liberal" dividend laws, accounting opinion has shifted to

22. On this and related problems, see also Wernitz, *Some Current Problems in Accounting* (1939) 14 *ACCTG. REV.* 117, 118-122.

23. (1940) 15 *ACCTG. REV.* 105.

24. Wernitz, *Financial Statements for Investors* (1940). 69 *J. ACCTCY.* 22, 27-28.

favor a balance-sheet arrangement primarily based upon origin of funds. The American Accounting Association's tentative statement of accounting principles states: "Two major divisions of the capital of a corporation should be recognized: paid-in capital and earned surplus. Subdivisions of each section should appear as may be appropriate."²⁵ Two of the advocates of this principle have stated further, "The balance sheet is lacking in clarity if parts of the capital paid in are shown separately without being totaled; hence stated capital and paid-in surplus should always be totaled separately from the surplus accumulated as the result of profitable administration of resources."²⁶ Many accountants have expressed agreement with this change in emphasis²⁷ and one of them has outlined in detail the way in which distinctions from the two other points of view may be presented as well. He suggests that the balance-sheet analysis of corporate net worth might be as follows:²⁸

I. Contributed capital.

- A. Legally restricted against distribution to shareholders.
- B. Not so restricted.

II. Accumulated earnings.

- A. Legally restricted against distribution to shareholders (earnings capitalized through a stock dividend or otherwise).²⁹
- B. Not legally restricted against distribution.
 - 1. Appropriated by action of directors.
 - 2. Not so appropriated.

A number of recent balance sheets show the influence of these considerations. Capital stock is now sometimes shown as the first "liability" item, including, or immediately followed by, "premium on capital stock", with earned surplus at the end of the statement.³⁰ More frequently, however, when capital stock and earned surplus are thus widely separated on the balance sheet, paid-in surplus is placed im-

25. Principle #14 (1936) 11 ACCTG. REV. 187, 190.

26. PATON AND LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS (1940) 97.

27. See, e. g., Broad, *Some Comments on Surplus Account* (1938) 66 J. ACCTCY. 215.

28. Dohr, *Capital and Surplus in the Corporate Balance Sheet* (1939) 14 ACCTG. REV. 38. In the summary above I have slightly modified Mr. Dohr's terminology.

29. This is one of the most novel features of Mr. Dohr's analysis. In practice, earnings so capitalized are transferred to "capital stock", as discussed in a later section of this article. See also Professor Paton's comments in the symposium on the question *Is It Desirable to Distinguish between Various Kinds of Surplus?* (1938) 65 J. ACCTCY. 281, 287.

30. Illinois Bell Telephone Co. prospectus dated Jan. 17, 1941; The Detroit Edison Co. prospectus dated Dec. 19, 1940.

mediately above earned surplus.³¹ This separation of the items making up the "contributed capital" is even more marked, of course, than that involved in the traditional juxtaposition of capital stock and surplus.

While emphasis on the distinction between contributed capital and accumulated earnings is clearly in line with the general policy of the SEC, the Commission's balance-sheet rules have not thus far required an arrangement in this form. Rule 5.02 of Regulation S-X requires a separate showing of "capital shares" and of surplus and states as to the latter: "Show in the balance sheet the division of this item into (1) paid-in surplus; (2) surplus arising from revaluation of assets; (3) other capital surplus; and (4) earned surplus."³² Recent prospectuses indicate, however, that this rule is construed so as to leave much discretion in the accountant as to the arrangement of balance-sheet items.

RESTORATION OF SURPLUS

The writer has elsewhere said that "if excessive amounts have been charged in past periods for depreciation, or if expenditures for permanent assets have been charged to expense accounts, thus understating profits and financial condition, these 'conservative' errors may later be corrected and the increase of past profits thus revealed used for dividends."³³ Thus, in *Statley v. Read Brothers, Ltd.*,³⁴ the court refused to enjoin a dividend out of surplus created by the restoration of a good-will account which had been written off against the profits of past periods. The court said, "No doubt the accounts showing the particular methods adopted were approved every year by the shareholders in general meeting, but I am not satisfied that the shareholders thereby intended, or bound themselves, for all time and in all circumstances to give up their claims to these profits and to treat them as capital only."³⁵

The chief accountant for the SEC has recently thrown doubt upon the soundness of this view. "It is conceded that an erroneous entry may later be corrected. But if a completed transaction is recorded in accordance with accepted accounting principles, is there justification for a reconsideration of the entry and subsequent change in treatment? . . . Perhaps the problem is merely a simple one of deciding whether there is a statute of limitations which runs against accounting deci-

31. Central Illinois Public Service Co. prospectus dated Dec. 8, 1938; Central States Electric Co. prospectus dated Dec. 27, 1939; Columbus and Southern Ohio Electric Co. prospectus dated Oct. 22, 1940.

32. ¶ 34.

33. GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE (2d ed. 1938) § 77.

34. [1924] 2 Ch. 1.

35. *Id.* at 5.

sions.”³⁶ One of the examples cited by Mr. Werntz is that of a corporation which had capitalized over \$4,000,000 of earned surplus by the declaration of a stock dividend. It later reduced its stated capital and attempted to restore the amount of the reduction to earned surplus. One can readily agree that earned surplus may not thus be restored. This case involved not merely a reversal of accounting entries. Regardless of the nature of the surplus which was originally capitalized, the surplus arising from the subsequent reduction of stated capital would seem clearly a capital surplus.

In another case cited by Mr. Werntz, the corporation had written off intangibles against earned surplus. At that time the corporation had no paid-in surplus but later acquired such surplus in connection with an additional issue of shares. The corporation sought to transfer from this paid-in surplus to earned surplus an amount equal to the former write-down of intangibles. Mr. Werntz expressed disapproval of this entry without considering the question of whether good will may properly be charged against paid-in surplus existing at the time of the write-off. He concluded, “If, under these circumstances, a transfer from paid-in surplus to earned surplus may not be availed of to increase earned surplus, may the corporation resort to a reversal of the entry which charged good will to earned surplus? I need not express an opinion on this question for so far as I can recall, the question has not yet been presented to us for consideration.”³⁷ The Commission has apparently not yet determined whether or not to repudiate the rule of the *Statley*³⁸ case.

STOCK DIVIDENDS

When a dividend is declared payable in the corporation's own shares, the principal accounting problem is as to the amount which should be transferred from surplus to stated capital with respect to the dividend shares. For par-value shares, the usual practice has been to transfer an amount equal to the aggregate par value. Where the shares have no par value, the problem is affected by the discretion which the directors have, under most statutes, to fix the consideration for which no-par shares are to be issued. In the absence of special provisions dealing with stock dividends, the directors are usually recognized as having full discretion as to the amount to be capitalized. There has been great variety in the practices followed and little progress has been made by accounting organizations in the development of standard requirements. To name only a few of the practices which

36. Werntz, *Some Current Problems in Accounting* (1939) 14 ACCTG. REV. 117 123.

37. *Id.* at 124.

38. [1924] 2 Ch. 1, cited note 34 *supra*.

have had more or less currency, the amount transferred has been, variously, a nominal or arbitrary amount per share, the average stated value of the previously outstanding shares, the full book value of such shares, and the market value.³⁹

In 1929, the New York Stock Exchange became concerned about this problem, largely because of the practice of some corporations to declare periodic stock dividends in lieu of cash dividends. With only nominal amounts of surplus transferred to capital, a corporation without substantial earnings would be able to follow an apparently generous dividend policy and continue to show an unimpaired earned surplus. The exchange took the position that in order for the distribution to be a "true earned stock dividend" there should be charged against earned surplus an amount per share equal to the sum of the stated capital and capital surplus represented by each share outstanding.⁴⁰ This suggestion covered par-value shares as well as no-par, and in the former case, the amount of earned surplus in excess of par would be transferred to capital surplus rather than to stated capital. The exchange did not make this practice mandatory, however, but merely required that full disclosure be made to shareholders with respect to the amount capitalized in connection with a stock dividend.

A number of recent statutes have contained provisions upon this point. The California Act requires in the case of no-par shares entitled to a preference on involuntary liquidation that the amount transferred to stated capital shall be equal to the liquidation preference. In the case of common shares, they shall be valued upon the basis of "the estimated fair value of such shares upon issue, as determined . . . by . . . the board of directors."⁴¹ The Michigan Act requires the transfer to capital of an amount at least equal to the average stated capital applicable to outstanding no-par shares.⁴² The Ohio Act permits the distribution of no-par shares with a transfer to stated capital of any amount fixed by the board of directors or "without any change of stated capital, as the board of directors may determine".⁴³ A stock "dividend" without any capitalization of surplus would seem identical with a "stock split".⁴⁴ While the Illinois Act requires some capitalization of surplus, no minimum is fixed; there is a requirement, however,

39. Further practices are listed in the Hoxsey article cited note 40, *infra*. See also SEC, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1940) pt. III, c. VI, I-106 to I-115.

40. See Hoxsey, *Accounting for Investors* (1930) 50 J. ACCTCY. 251, 264-69, 279-82.

41. GEN. CORP. LAW, CIV. CODE § 346a.

42. GEN. CORP. ACT § 22.

43. GEN. CORP. ACT § 8623-38.

44. Presumably the Ohio provision quoted above would not apply to a dividend payable in shares of a class different from that held by the recipients of the dividend.

that the amount transferred to stated capital be disclosed to the shareholders when the dividend is distributed.⁴⁵

Turning to the treatment of stock dividends upon the books of the recipient, we find a similar lack of uniformity of practice.⁴⁶ The orthodox accounting position has been to deny that the receipt of the dividend shares constitutes income to any extent.⁴⁷ Under this practice, the stock dividend is treated by the recipient just like a "split-up" of the shares held. This position seems clearly correct in the case of a large stock dividend which, if treated as a distribution of earnings at all, would be a distribution out of earnings accumulated prior to the acquisition of the shares upon which the dividend is declared. To enter the dividend shares at any figure would clearly be misleading in the absence of an adjustment in the value of the shares originally held. Especially in the case of small periodic stock dividends, however, their treatment as income by the recipient to the extent of the market value of the shares received has been occasionally defended. At least in the case of holding companies, this practice is open to serious abuse if the market value of the shares is substantially greater than the amount of surplus capitalized on the books of the declaring company. As Hoxsey pointed out, "there is the possibility of dangerous pyramiding of unearned paper profits, progressing geometrically, not arithmetically, if stock dividends are accounted for by the receiving company on a higher basis than that charged against earnings or earned surplus by the issuing company."⁴⁸ Because of this danger, the New York Stock Exchange requires of corporations with listed shares an agreement that they "will not take up . . . as income stock dividends received to an amount greater than that charged against earnings, earned surplus, or both . . . by the corporation paying such dividends." This rule has also been adopted by the SEC under the Public Utility Holding Company Act of 1935.⁴⁹

LIQUIDATION PREFERENCES AND STATED CAPITAL

One problem in accounting for preferred shares furnishes another illustration of the influence of accounting requirements in the reform of corporate practices. This is the problem of preferred shares with a

45. BUS. CORP. ACT § 41 (f). Special provision is made for "stock splits". § 41 (g).

46. See SEC, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1940) pt. III, c. VI, I-116 to I-123.

47. Authorities are cited in Kerrigan, *Corporate Distributions as Income to Stockholders* (1938) 13 ACCTG. REV. 366, 376.

48. Hoxsey, *Accounting for Investors* (1930) 50 J. ACCTCY. 251, 271.

49. Uniform System of Accounts for Public Utility Holding Companies (1936) 25 Note A. The general regulations of the SEC under the acts of 1933 and 1934 require that the company disclose and "explain" any difference between the basis on which the shares are "taken up" as income by the recipient and that on which they have been charged to income or earned surplus by the disbursing corporation. SEC Regulation S-X, rules 6.03 (c), 12.17 n. 3.

par or stated value less than the amount of the preference on involuntary liquidation. This type of preferred share has been referred to by Commissioner Healy as "that excrescence, that abomination which charter-mongering states—corporation 'Reno's' . . . , have put upon us . . . in their 'liberalization' of corporation laws."⁵⁰ Commissioner Healy gave as an example shares sold for \$50, having a par value of \$40, and entitled to an annual dividend of \$3 and to a \$50 preference on liquidation. In such a case, the shares are almost invariably carried on the balance sheet at the par value of \$40 with the \$10 additional consideration shown as capital surplus.

A more extreme case was presented by the financing of Dodge Brothers, Inc., in 1925. Here preference shares without par value were set up on the balance sheet at \$1 per share despite a liquidation preference of \$105 per share and a \$7 annual dividend rate. It was with respect to this balance sheet that Professor Ripley used the terms "prestidigitation", "acrobatics", and "accounting monstrosity".⁵¹

The SEC now requires that a spot-light be focused upon such acrobatics. The following information with respect to preferred shares must be set forth in balance sheets or in explanatory notes:

"Preferences on involuntary liquidation, if other than the par or stated value, shall be shown. When the excess involved is significant there shall be shown (i) the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value; (ii) a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital shares and the surplus, if such is the case; and (iii) a statement as to the existence, or absence, of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred shares exceeds its par or stated value."⁵²

In recent security issues, the statement made in most prospectuses, pursuant to the requirement of clause (iii), is that "there are no restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred shares exceeds its par or stated value." The chief accountant of the Commission has suggested that the requirement of a statement of such restrictions on surplus arose "out of the feeling that, if surplus had been contributed by the pre-

50. *The Next Step in Accounting* (1938) 13 ACCTG. REV. 1, 6.

51. MAIN STREET AND WALL STREET (1927) 194-96. These shares, together with the other securities of the corporation, were originally issued to investment bankers in return for the assets and business of the predecessor company. The bankers sold the preference shares at \$100 per share, with a "bonus" of one Class A Common share. The offering circular stated: "The capital stock of the company (no par value) will be issued almost entirely against the established earning power, which is not assigned a value in the balance sheet."

52. SEC Regulation S-X under Securities Act of 1933 and Securities Exchange Act of 1934, rule 3.18 (d) (3). This requirement was first announced in SEC Accounting Series Release No. 9, Dec. 23, 1938.

ferred shareholders,⁵³ a court of equity might enjoin dividends, at least to common shareholders, which reduced such surplus below an amount necessary to satisfy the liquidating value of the preferred shares . . ."⁵⁴ It is possible, however, that restrictions on surplus might exist in other situations;⁵⁵ it is possible that a dividend on common shares might be enjoined in any case where the difference between the aggregate liquidation preferences and the aggregate stated value of the preferred shares exceeds the total stated value of the common shares. In such a case a court might well enjoin a common dividend by analogy to the general rule against fraudulent conveyances, viewing the position of preferred shareholders as, for this purpose, similar to that of corporate creditors.

Commenting upon the Commission's requirements of disclosure in these cases, the editor of the *Accounting Review* has expressed a regret that current accounting standards do not require an even more striking presentation of the facts.⁵⁶ He suggested the following form:

Equity of preferred stock

1,000 shares at liquidating value of	
\$110 per share	\$110,000
Cumulative dividends in arrears, \$21	
per share	21,000
	<hr/>
Total equity	\$131,000

53. In some states part of the consideration received for preferred shares may be set up as paid-in surplus only if the amount allocated to stated capital is equal to the aggregate liquidation preference. ILL. BUS. CORP. ACT § 19; PA. BUS. CORP. LAW § 614. In California the entire consideration for no-par shares having a liquidation preference must be credited to stated capital. GEN. CORP. LAW, CIV. CODE § 300b.

For a case where the fact that part of the consideration for preferred shares had been credited to capital surplus was emphasized as special reason for showing the shares at their liquidating preference (\$100) rather than their stated value (\$40), see *In the Matter of Northeastern Water and Electric Corp., Holding Company* Act Release No. 2314, Oct. 2, 1940, at 8.

54. Wernitz, *Accounting Requirements of the Securities and Exchange Commission*, address before Texas Society of Certified Public Accountants, June 13, 1940, p. 8 of mimeographed text released by SEC (italics added). See also Mr. Wernitz's address, *Footnotes and Financial Statements*, before Minnesota Statistical Association, May 9, 1939, pp. 4-6 of mimeographed text.

55. The problem is briefly discussed in AMERICAN INSTITUTE OF ACCOUNTANTS, FIFTIETH ANNIVERSARY CELEBRATION (1937) 194-96, 197-98, particularly as it arises through a formal reduction in the stated value of the preferred shares.

In *Johnson v. Fuller* (E. D. Pa. 1940) Prentice-Hall Corp. Serv. ¶ 21,145, the court dismissed a bill brought by a preferred shareholder of The Curtis Publishing Company to enjoin a "voluntary" recapitalization. The court said, "It has been stressed by counsel for the complainant that there was a Twenty Million Dollar (\$20,000,000) surplus available from which the company might have paid the accrued dividends. But as was testified to, this Twenty Million Dollars (\$20,000,000) was really a bookkeeping surplus in that the total assets of the company were far less than the amount of the preferred stock taken at its liquidation value, and accordingly the existence of a surplus as set up, under these circumstances was only done by carrying the preferred stock at a much lower stated value than its liquidating value."

56. (1937) 12 ACCTG. REV. 424, 426.

Less net assets available	
Preferred stock, stated value	\$50,000
Common stock, stated value	5,000
Capital surplus	20,000
Earned surplus	10,000
	<hr/>
	85,000
	<hr/>
Deficit in equity of preferred shareholders	\$46,000

There is some reason to believe that the Commission's disclosure requirements are influencing corporations to fix the par or stated value of preferred shares at the amount of the liquidation preference.⁵⁷ Prospectuses for recent issues show a marked trend in this direction. In cases under the Holding Company Act, of course, the Commission's control is more direct. While many of the new preferred shares issued with the authorization of the Commission are given a stated value equal to the preference on involuntary liquidation, this is apparently not always required.⁵⁸

TREASURY SHARES

While purchases by a corporation of its own shares may not ordinarily be thought of as corporate "distributions" to shareholders, such transactions are closely related to corporate dividends and distributions of capital. These relations, furthermore, afford some of the most interesting illustrations of the interplay of accounting and law. An understanding of this interplay will be promoted by recognizing at the outset the complexity of the subject—the number of problems which are closely related and which must be viewed as a whole before the accounting treatment of any of them may be adequately considered. The following is an outline of the most important of these problems:

- I. What are the limitations on the power of a corporation to buy its own shares, particularly limitations in terms of corporate capital or surplus?
- II. What is the immediate effect of the purchase?
 - A. Does it have the effect of reducing the surplus available for dividends?

57. In a recent proceeding under the Holding Company Act, a corporation proposed to change its preferred shares from a stated value of \$50 to a par value of \$100. In approving the application the Commission commented that the change would result in "correctly stating the preferred stocks at their liquidating value . . ." The balance-sheet presentation of the shares at \$50 was referred to as "of doubtful propriety". In the Matter of Securities Corporation General, Holding Company Act Release No. 2301, Sept. 23, 1940.

58. In the Matter of East Tenn. Light & Power Co., 6 SEC 969, 974 (1940).

- B. If the purchase price was less than the par or stated value of the shares, does the discount represent in any sense a profit or an addition to surplus?
- III. What is the result of a resale of the shares?
 - A. Does the resale neutralize the effect of the purchase upon surplus (IIA, above) and restore its availability for dividends?
 - B. If the resale was at more than cost, is surplus available for dividends thereby increased?
 - C. If the resale was at less than cost, must the difference be treated as a reduction of the earned surplus?
- IV. What is the effect of a formal cancellation of the shares in compliance with the statutory procedure for this type of reduction of stated capital?
 - A. Does the cancellation neutralize the effect of the purchase on surplus (IIA, above) and restore its availability for dividends?
 - B. Where the par or stated value of the treasury shares exceeded their cost to the corporation, what is the significance of this discount when the shares are cancelled?
 - C. If the shares were purchased at more than their stated value, what is the effect of the cancellation?

It is with all of these legal problems in mind that the accounting for the purchase of treasury shares must be considered. There are four principal methods of showing treasury shares on the balance sheet. They may be shown (a) among the assets, or (b) as a deduction on the "liability" side (1) from the capital stock item, or (2) from surplus, or (3) from the total of capital stock and surplus. Furthermore, before selecting from these possibilities, the accountant must decide whether the shares are to be set up at cost or at their par or stated value, a decision which may influence his choice of balance-sheet presentation.

Let us begin by considering briefly the first two of the legal questions outlined above. In a majority of American jurisdictions, a corporation may not buy its own shares when the purchase would impair stated capital. This is frequently phrased as a rule that purchases of treasury shares may be made only "out of surplus". A few American states have adopted the English rule forbidding all purchases by a corporation of its own shares, with very few exceptions. In a few other states, notably Massachusetts and Wisconsin, it is held that a corporation may make purchases which impair its stated capital so long as the corporation is not rendered insolvent or its insolvency made imminent.

Throughout this section, we shall assume, unless otherwise noted, that the majority or "surplus" rule is in force.⁵⁹

As a corollary to this rule, it has come to be recognized that a purchase of treasury shares has the effect of rendering unavailable for dividends (or for further purchases of treasury shares) a portion of the surplus equal to the cost of the shares acquired. This is clearly a necessary corollary if the policy behind the surplus requirement is not to be defeated. Certainly, after purchasing treasury shares up to the full amount of its surplus, a corporation should not be free to continue its purchases. A dividend would similarly appear improper. It is surprising that so obvious a point escaped comment until rather recently and that its discussion appears to have been limited to accounting articles and texts.⁶⁰ In some states this rule concerning the "freezing" of surplus representing the cost of treasury shares is embodied in the statutes, either explicitly⁶¹ or through the excluding of treasury shares in computing assets and including them in stated capital.⁶² The same result should follow, however, in any jurisdiction in which the surplus rule has been accepted either by statute or common law decision. It may be, as Professors Dodd and Baker have suggested, that under the surplus test, once the actual facts were disclosed, no lawyer would seriously consider that the surplus would remain free for dividends or share purchases.⁶³ Most corporation lawyers, however, have apparently failed to call the point to the attention of the corporate officers and accountants. As will be noted, corporate balance sheets have generally failed to note this effect of a purchase of treasury shares.

With the surplus rule and its "freezing" corollary in mind, we may deal with the various methods of showing treasury shares on the balance-sheet. Listing treasury shares as an asset has long been criticized by accountants and is now, inferentially at least, forbidden by the SEC.⁶⁴ Certainly one may criticize the hiding of treasury shares under an asset heading "U. S. Government and Other Marketable Secu-

59. Space does not permit a consideration of the complications introduced by statutes distinguishing for this purpose between various types of surplus. See, e. g., ILL. BUS. CORP. ACT § 6.

60. The first suggestions of the point were in connection with suggestions that treasury shares be shown as deduction from surplus. Brundage, *Treatment of No-Par Stock in New York, New Jersey and Massachusetts* (1926) 41 J. ACCTCY. 241, 251-54; ROBBINS, *NO-PAR STOCK* (1927) c. XII; WILDMAN AND POWELL, *CAPITAL STOCK WITHOUT PAR VALUE* (1928) c. VII; MARPLE, *CAPITAL SURPLUS AND CORPORATE NET WORTH* (1936) 53-54; GRAHAM AND KATZ, *ACCOUNTING IN LAW PRACTICE* (2d ed. 1938) § 89.

61. MICH. GEN. CORP. ACT § 10h.

62. ILL. BUS. CORP. ACT §§ 2 (j), (k), (m), 6, 41 (a).

63. DODD AND BAKER, 1 *CASES ON BUSINESS ASSOCIATIONS* (1940) 751 n. 25.

64. SEC Regulation S-X, rule 3.16 (prescribing form and content of financial statements under the Securities Act of 1933 and the Securities Exchange Act of 1934).

rities"⁶⁵ or even "Investments in Non-competitive Companies".⁶⁶ It is not so clear, however, that the practice is seriously misleading if the item is separately listed and clearly described. Despite the criticism of accounting writers, the showing of treasury shares as an asset has been a not infrequent practice down to a very recent date.⁶⁷ If the shares are to be listed as an asset, it is important, of course, to show in some way the effect of the purchase upon surplus, and it may be desirable also to show the composition of the capital stock item. The following form will illustrate this treatment. This illustration is based upon the assumption (perhaps improbable) that a corporation with an earned surplus has purchased for \$4,000 shares of its own stock with a par value of \$5,000.

Form A

Treasury shares		Liabilities	\$10,000
(at cost)	\$4,000	Capital stock (par value)	
Other assets	96,000	Outstanding	\$70,000
		Treasury shares	5,000
			75,000
		Earned surplus (of which	
		\$4,000 is restricted by	
		purchase of treasury	
		shares)	15,000
	<u>\$100,000</u>		<u>\$100,000</u>

If treasury shares are not shown as an asset, they are shown, in practice, as a deduction from capital stock, from surplus, or from the total of these items. All of these methods are apparently permissible under the general regulations of the SEC. The method most frequently used is to show treasury shares as a deduction from capital stock. While the purchase of treasury shares does not, of course, reduce the legal capital, the showing of treasury shares as a deduction from capital stock is not seriously misleading in this respect. Under this method, of course, as where the shares are listed as an asset, it is important to

65. This method was used by Allied Chemical and Dye Corporation, according to a letter from Mr. Richard Whitney, President of the New York Stock Exchange, quoted in Nussbaum, *Acquisition by a Corporation of Its Own Shares* (1935) 35 COL. L. REV. 971, 985 n. 68.

66. See *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110, 112 (1939).

67. SANDERS, HATFIELD, AND MOORE, *A STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 90; SEC, *REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES* (1940) pt. III, c. VI, I-50 to I-58; Holt and Morris, *Some Aspects of Reacquired Stock, 1931-1933* (1934) 12 HARV. BUS. REV. 505, 507-8.

The Swift & Company consolidated balance sheet as of Oct. 28, 1939 showed on the asset side:

Treasury Stock, 79,465 shares (at market value, Oct. 31, 1936

\$23 3/8 per share, which is less than cost) \$1,857,494.38

show that earned surplus has been rendered unavailable for dividends in an amount representing the cost of the treasury shares.⁶⁸ This has not, however, been customary. Such notations have seldom been made except in the case of corporations organized under the laws of the states where the statute expressly sets forth the "freezing of surplus" rule.⁶⁹ It may not be unfair to say that, at least until recently, accountants have so spent their reforming zeal in insisting that treasury shares be not shown as an asset that they have had little left for the more important task of insisting upon the disclosure of the effects of the purchase upon the earned surplus. Taking the same case as that used in Form A, the following form illustrates the showing of treasury shares as a deduction from capital stock.

Form B

Assets	\$96,000	Liabilities	\$10,000
		Capital stock (par value)	
		Issued	\$75,000
		Treasury shares	5,000
			<hr/>
		Outstanding	70,000
		Discount on treasury shares	1,000
		Earned surplus (of which \$4,000 is restricted by purchase of treasury shares)	15,000
	<hr/>		<hr/>
	\$96,000		\$96,000
	<hr/>		<hr/>

68. This is, of course, not necessary in jurisdictions, such as Massachusetts, where the "surplus" rule is not in force. In such jurisdictions, treasury shares may properly be shown as a deduction from capital stock without further note.

69. Earned surplus shown as follows on the consolidated balance sheet of The Peoples Gas Light and Coke Co. (Ill.) Dec. 31, 1939:

Earned Surplus	\$9,690,986.75
Earned surplus of \$1,203,800 is restricted by statutory provisions for dividend purposes on account of reacquired stock and earned surplus of \$3,787,465 additional may be similarly restricted on account of stock acquired by a subsidiary.	

Despite the absence of an express provision to this effect in the Delaware statute, the following footnote was added explaining the earned surplus item on the consolidated balance sheet of Colgate-Palmolive-Peet Company used in the prospectus dated March 19, 1940: "The earned surplus of the Company is restricted under Delaware law to the extent of \$2,259,387.50, by reason of the acquisition of treasury stock, until formal corporate action shall have been taken to reduce the capital of the Company with respect to such treasury stock or until such stock shall have been sold, or otherwise disposed of."

When treasury shares are shown as a deduction from capital stock, they must be shown, of course, at their par or stated value, regardless of cost. If, therefore, the shares have been purchased for less than par, the difference must appear as an item on the "liability" side. It is sometimes called "surplus from purchase of treasury shares". Since this surplus is probably not a surplus available for dividend under the laws of any state,⁷⁰ it is obviously important that the item be clearly labeled. It is not to be confused, furthermore, with surplus arising from the resale or from the cancellation of treasury shares, types of surplus which are discussed below. The fact that the showing of treasury shares as a deduction from capital stock results in setting up this surplus or discount would seem a consideration militating against the practice. However, the accounting systems prescribed by a number of administrative agencies have adopted it and require crediting such discount to "Capital Surplus".⁷¹

If the purchase was for more than par, the practice of showing the shares as a deduction from capital stock (at par) requires a reduction of surplus by the amount of the premium. Where this method is to be used, the entry to record the purchase will usually set up the shares at par and charge the premium against earned surplus. In the event that the shares are later sold at cost, the question will arise as to the proper treatment of the premium on the resale. Many accountants would object to a crediting of the premium to earned surplus. On the other hand, it is not clear, either from the legal or from the accounting point of view, that the corporation which has purchased and resold at the same premium, should be considered as having a smaller earned surplus than before the purchase. The significance of this point will appear more clearly after a consideration of other methods of balance-sheet presentation.

The showing of treasury shares as a deduction from surplus is seldom resorted to in practice. Its principal advantage lies in the fact that it shows rather emphatically the effect of the purchase in "freezing" earned surplus to the extent of the cost of the treasury shares. As already noted, however, it is not the only way in which this restriction may adequately be disclosed. The following form illustrates this method of presentation.

70. *But see* *Starring v. Kemp*, 167 Va. 429, 433, 188 S. E. 174 (1936).

71. *See* DODD AND BAKER, 1 CASES ON BUSINESS ASSOCIATIONS (1940) 752-53, n. 28, 29.

Form C

Assets	\$96,000	Liabilities	\$10,000
		Capital stock (par value)	
		Outstanding \$70,000	
		Treasury shares 5,000	
			75,000
		Earned surplus \$15,000	
		Less cost of treasury shares 4,000	
			11,000
	<u>\$96,000</u>		<u>\$96,000</u>

As already suggested, some accountants have supported this practice,⁷² and the Michigan statute requires that the effect of the purchase be revealed "either by showing the cost of such respective purchases as a deduction from surplus or by classifying its surplus accounts in such manner as to show the amount of surplus applied to such purchases and which therefore shall not be available for dividends of any kind or for additional purchase of its own stock or for any other purpose."⁷³

Increasing support is developing for the practice of showing treasury shares as a deduction from the sum of capital stock and surplus. In the language of the tentative statement of principles approved by the executive committee of the American Accounting Association: "The cost of reacquired shares of capital stock should, if the shares are reissuable, be regarded as an unallocated reduction of capital and surplus rather than as an asset; . . ." ⁷⁴ In this method of presentation, as

72. See note 60 *supra*. One of these writers carries the theory underlying this practice one step further. He suggests that the purchase be entered by a debit to earned surplus and a credit to cash with the treasury shares shown in the ledger only by memorandum entry. ROBBINS, NO-PAR STOCK (1927) c. XII.

73. MICH. GEN. CORP. ACT §10h. Compare the second alternative with the parenthetical notation suggested in Forms A and B above. It is to be compared also with the practice advocated by MARPLE, CAPITAL SURPLUS AND CORPORATE NET WORTH (1936) 67-68. In addition to an entry setting up treasury shares at cost, he suggests a transfer from earned surplus to "surplus reserved as stated capital". The amount he would so transfer, however, is the cost or stated value of the shares, whichever is lower. If a premium was paid, an additional charge against surplus is made as part of the first entry. While the author explains that his second entry will be reversed (and the "reservation" of surplus thus cancelled) if the shares are resold at cost, he does not state whether the premium would in that event be credited to earned surplus. An affirmative answer to this question is given in a recent text. KEHL, CORPORATE DIVIDENDS (1941) §45.4. Mr. Marple's treatment of treasury shares, which is followed by Mr. Kehl, is unnecessarily complicated. With simpler methods available for showing the financial and legal situation, the general adoption of their form of statement is neither likely nor desirable.

74. *A Tentative Statement of Accounting Principles Affecting Corporate Reports* (1936) 11 ACCTG. REV. 187, 190 (principle #16).

in Forms A and B, it is probably necessary to indicate the restriction upon earned surplus. The following form is illustrative:

Form D

Assets	\$96,000	Liabilities	\$10,000
		Capital stock (par value)	
		(\$5,000 held in treasury)	\$75,000
		Earned surplus (of which \$4,000 is restricted through purchase of treasury shares)	15,000
			<u>\$90,000</u>
		Less cost of treasury shares	4,000
			<u>4,000</u>
		Net Worth	86,000
	<u>\$96,000</u>		<u>\$96,000</u>

This method, like those illustrated in Forms A and C, has the advantage of permitting treasury shares to be carried at cost, whether more or less than par.

If the shares have been formally retired and the stated capital thus reduced by the procedure outlined in the statute, the result in most states may be illustrated by the following form of balance sheet (assuming that, prior to the cancellation, the shares were shown as a deduction from the sum of capital stock and surplus, as on Form D, above).

Form D-1

Assets	\$96,000	Liabilities	\$10,000
		Capital stock	
		Issued and outstanding	70,000
		Surplus arising from cancellation of treasury shares	1,000
		Earned surplus	15,000
	<u>\$96,000</u>		<u>\$96,000</u>

The earned surplus of \$15,000 is now shown without any restriction. This seems clearly the result under the Illinois statute;⁷⁵ the "freezing" of surplus lasts only so long as the treasury shares are held. To be sure, the result may disappoint the expectations of prior creditors as to their margin of safety, but similar injury to creditors is made possible by the absence of limitations on other types of reduction of stated capital also. There would seem no special reason for giving the creditors added protection in the case of a reduction arising through the cancellation of treasury shares. In the case of a California corporation, however, a cancellation of treasury shares does not have this result. The statute provides that earned surplus shall be "reduced" by an amount equal to the cost of the shares purchased,⁷⁶ and there is no provision that cancellation restores the earned surplus.⁷⁷ When treasury shares purchased at a discount are cancelled, a surplus arises from the reduction of stated capital. Such a surplus, of course, is very similar to paid-in surplus, and, under the statutes of a number of states, is subject to similar restrictions.⁷⁸

Assume, however, that the shares are not cancelled but resold, and that the proceeds exceed their cost to the corporation. A bitter fight has raged among accounting authorities as to the proper treatment of the excess proceeds.⁷⁹ The forces opposing the treatment of this item as an addition to earned surplus appear to have won the day.⁸⁰ The American Accounting Association's tentative statement of principles provides that gains from the sale of reacquired shares constitute "paid-in capital";⁸¹ in 1938 the committee on accounting procedure of the American Institute of Accountants ruled that the excess proceeds should be treated as capital surplus.⁸² In May of the same year, the SEC published an opinion of its chief accountant to the effect that the item "should be treated as capital stock or capital surplus as the circumstances require."⁸³

One writer has urged that it is anomalous to consider as capital surplus a part but not all of the consideration received upon the reissu-

75. ILL. BUS. CORP. ACT §§ 2 (k), 6, 41 (a).

76. CIV. CODE § 342.

77. The entire amount of the reduction of stated capital (less any deficit) apparently becomes a "reduction surplus" subject to special restrictions. *Id.* at § 348 (b).

78. See, e. g., ILL. BUS. CORP. ACT § 60.

79. See Montgomery, *Dealings in Treasury Stock* (1938) 65 J. ACC'TY. 466; May, *Recent Opinions on Dealings in Treasury Stock* (1938) 66 *id.* at 17.

80. This, despite the recent withdrawal of the Treasury Department from its traditional position that taxable income cannot arise from a purchase and resale of a corporation's own shares. U. S. Treas. Reg. 103, § 19.22 (a)-16; *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939).

81. Principle #15, see note 3 *supra*.

82. (1938) 65 J. ACC'TY. 417.

83. SEC Accounting Series Release No. 6, May 10, 1938.

ance of the treasury shares.⁸⁴ He considers more "logical" either the position that all of the consideration becomes capital or capital surplus, or the position that none of it does and that the "profit" is an addition to earned surplus. The first of these results is prescribed by the California statute which provides that "the consideration received [on the reissuance of treasury shares] shall be added to paid-in surplus except as far as needed to write off a deficit of net assets below the amount of stated capital."⁸⁵ In Illinois, however, paid-in surplus is defined as "all that part of the consideration received by the corporation for, or on account of, all shares issued which does not constitute stated capital."⁸⁶ This language can hardly be construed to include the "profit" received upon the reissuance of treasury shares. The Attorney General of Illinois has therefore ruled that profit on the resale of treasury shares constitutes "earned surplus".⁸⁷

After this survey of the several aspects of the problem and of the various procedures in use, the following is suggested as the most desirable accounting practice. It is assumed that the "surplus" rule is in force and that there are no statutes bearing specially upon the accounting questions.

Treasury shares should be set up at cost, regardless of par or stated value. No surplus thus arises on the purchase. On the balance sheet the cost of shares held should be shown as a deduction from the sum of capital stock and surplus and the surplus should be "tagged" as restricted in the same amount. Upon cancellation of the shares and reduction of stated capital, this "tag" should be removed, and earned surplus should be reduced by the amount of the premium, if any, or capital surplus increased by the amount of any discount. Upon resale (assuming, of course, no cancellation), the "tag" should similarly be removed and earned surplus reduced by the amount of the loss, if any, or capital surplus increased by the amount of any gain.

84. Husband, *Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles* (1937) 12 ACCTG. REV. 386, 398-99.

85. CIV. CODE § 342b. § 342 provides for a "reduction" of earned surplus in an amount equal to the cost of the shares.

86. BUS. CORP. ACT § 2 (1).

87. Op. No. 526, Nov. 10, 1933, reprinted in ILL. BUS. CORP. ACT ANN. (1936 ed.) 42.