A Statement of Accounting Principles

PREPARED BY

THOMAS HENRY SANDERS
Harvard University Graduate School
of Business Administration

HENRY RAND HATFIELD
University of California

UNDERHILL MOORE
Yale University
School of Law

1938

PUBLISHED BY
AMERICAN INSTITUTE OF ACCOUNTANTS
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FOREWORD

The executive committee of the American Institute of Accountants believes the report contained in this booklet to be a highly valuable contribution to the discussion of accounting principles and has, therefore, authorized its publication for distribution to all members of the Institute and others interested in accounting.

The standing of the three authors who collaborated in the work will assure a wide and respectful hearing.

The profession is indebted to the Haskins & Sells Foundation for the permission granted the Institute to publish and distribute the report.

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LETTER OF INVITATION TO THE COMMITTEE

Dr. T. H. Sanders,
Graduate School of Business Administration,
Harvard University,
Boston, Massachusetts.

Dear Dr. Sanders:

The Haskins & Sells Foundation desires to make a contribution to the subject of accounting principles, by inviting a committee of men from the universities of the country to make an independent and impartial study of such subject and prepare a report which will be given to the public.

By such means it is hoped that there may be established a body of principles which will become useful in unifying thought and which by its acceptance will serve to standardize accounting practices. Such a body of principles would be valuable to corporation accounting officials who are responsible for the preparation of financial statements, to the accountancy profession whose members have occasion to render opinions concerning such statements, to the legal profession whose practitioners are required to prepare corporate charters, indentures, and agreements involving financial matters, to legislators who are charged with devising laws governing the organization and conduct of corporations, and to regulatory bodies and divisions of the government which administer laws involving accounting matters.

The need for the kind of study suggested has become increasingly apparent, particularly during the past three years. Sharp variations among the statutes of the different jurisdictions have existed for some time. These statutes collectively are not only inconsistent and contradictory, but in some instances they permit practices which are difficult to reconcile with dutiful business management. Federal agencies have issued regulations involving accounting principles which have resulted in contradiction between agencies, and Federal regulations involving such matters conflict frequently with those of state regulatory bodies. The stock exchanges in their efforts to promote greater publicity of corporate financial information, the Federal government in its administration of the securities act of 1933, as amended, designed to afford adequate disclosure with respect to new issues of securities, and through the securities exchange act to insure the same information to the holders of and prospective investors in listed securities, have raised sharply the question as to what are accepted principles of accounting. Notwithstanding the difficulties involved, accountants who certify to financial statements filed with the Securities and Exchange Commission have been required by the regulations of that commission to express an opinion concerning such financial statements and the practices of the registrant in the light of accepted principles of accounting.

Accounting practices at present are based, in a large measure, upon the ethics and opinions of reputable accountants, and to some extent upon the accounting provisions of the various laws, but wide variations of opinion often exist among equally reputable practitioners. There is no unified body of opinion, nor is there any official tribunal for the final determination of technical differences of opinion.

Due and full recognition must be accorded to the efforts of those bodies which already have done much to organize thought on these problems, as well as to the conscientious individuals who have labored to set up higher standards of accounting in fields where such standards hitherto had been unknown. The Securities and Exchange Commission, the New York Stock Exchange, the Internal Revenue Bureau, the American Institute of Accountants, and the American Society of Certified Public Accountants, the two latter through their technical committees, have all done much to condense experience into sound and unified thought. But in spite of these efforts the conditions above described still obtain. Furthermore, experience is constantly accumulating from the actual operation of these various sets of accounting principles.

Therefore, it would seem most appropriate and opportune that a committee composed of eminent accountants and lawyers should be appointed to formulate a code of accounting principles which would be useful in the clarification and improvement of corporate accounting and of financial reports issued to the public. The work of such a committee, if executed with care and vision, should be not only a valuable contribution in the solution of many perplexing problems in the present-day field of accounting and education, and in the rationalization of statutes governing corporations, but should be an important public service.

The profession of accountancy owes to business, the investor, the credit grantor, the educational institution, and to itself the duty to accept the task of formulating such a code of principles, as the legal profession has concerned itself, from time to time, with the clarification and simplification of the civil and criminal laws of the country.

The Foundation understands that you are ready to serve as chairman of such a committee, with Professor Henry R. Hatfield of the University of California, and Professor Underhill Moore * of Yale University as fellow members. The Foundation thus appoints a com-

* Appointed March 20, 1936.

mittee of university men whose independence and impartiality will be unquestioned, in the belief that this will be the most effectual means of supplementing existing agencies working to the same ends, and that the committee will be able to enlist the assistance and support of those who have the practical experience necessary to sound conclusions.

The Foundation expresses the hope that the committee will canvass the material available for a study of the character contemplated, that it will seek the views and opinions, with respect to accounting principles, of accounting officials of corporations, business executives, credit men, investment bankers, bank credit men, statisticians, prominent and experienced public accountants, teachers, practising attorneys, government officials, and national and state accounting societies, and, in general, of any one who may wish to be heard, to the end that there may be evolved a reasonable number of accounting principles, based on practical business concepts of capital and income, which will merit the approval of those competent to judge of their soundness, and thus attain to general acceptance.

Your acknowledgment and formal acceptance will be appreciated.

Yours very truly,

HASKINS & SELLS FOUNDATION, INC.

July 15, 1935.

LETTER OF TRANSMITTAL

HASKINS & SELLS FOUNDATION, INC.
New York, New York.

GENTLEMEN:

The terms "accounting principles" or "principles of accounting" have long been current. Their use in business has greatly increased of late. Since 1933 a large and increasing majority of auditors' certificates published in company reports to stockholders have used the terms. They are also found in statutes and other governmental regulations. The demand for a statement of accounting principles has become insistent.

In response to this demand your Foundation requested the undersigned to associate themselves together as a committee to undertake a statement of accounting principles.

The committee began its work in the summer of 1935. Before beginning the drafting of its statement of accounting principles, the committee made inquiry in four directions. First, by means of personal interviews, supplemented by correspondence, the committee sought the opinions of competent persons as to the matters which should be dealt with in its statement, as to matters of current practice, and as to the more difficult and controversial relevant questions. Discussions were had in various parts of the country with members of the several groups interested in accounting, the committee interviewing as many of the persons whose opinions were sought as time permitted. Notwithstanding the inability of the committee to hear many whom it desired to hear, the investigation was carried far enough to make its results fairly representative of accounting opinion throughout the United States. Second, the accounting literature of the present and past was reviewed. Third, the necessary consideration was given to the statutes and decisions referring to accounting. Fourth, by an examination of current corporation reports and the attached certificates of auditors, as well as by means of the interviews referred to, the committee attempted to keep before it the current practices of accountants.

In the preparation of its statement the committee has attempted to set forth the principles and rules of accounting which dictate what should appear in a balance-sheet and an income statement and in the accounts from which they are compiled. In its statement of principles the committee has, where it was judged desirable, included reasonably complete reference, with citations, to legal provisions of concern to the accountant.

The committee desires to acknowledge with thanks the assistance which it has received from many who have given generously of their time and thought.

A report entitled "A Statement of Accounting Principles" is herewith respectfully submitted.

HENRY RAND HATFIELD,
UNDERHILL MOORE,
THOMAS HENRY SANDERS, *Chairman.*

November 22, 1937.

A STATEMENT
OF ACCOUNTING PRINCIPLES

INTRODUCTION

Principles of Accounting

The distinction between capital and income, which every one recognizes and the economist attempts to state with refined accuracy, is fundamental in accounting. Making effective and effectively maintaining as near as may be the distinction between the capital and income of a particular enterprise are the ultimate objectives which determine the activities of accountants and the functions of accounting.

With accounts planned with an eye to these objectives and accurately kept, and with statements made from them without misrepresentation or concealment, accounting facilitates the conduct of business, the achievement of its purposes, and the orderly division of its income among the contributors.

The accountant provides the principal business executives with statements of financial condition and results prepared objectively as to the facts reported, but subjectively as to an understanding of the needs of those who will use them. In this manner accounting performs its function of assisting even the most constructive and imaginative efforts of the executives, which efforts must be based upon a clear understanding of the financial condition, cost of operation, and resulting income of the business.

Accounting also contributes to the determination of the various equities or interests in business. In so far as these are defined in contractual relations, the determination is not normally a difficult one; trouble arises only in the more unusual cases where carelessness, accident, or

Note:—All notes to which reference is made in the text will be found on page 117, *et seq.*

misunderstanding has crept in. The position of bondholders is usually defined in the bonds and in the documents which accompany those instruments; most of the disputes occur when the resources of the company become inadequate to the meeting of the provisions there made. The position of stockholders as owners of the residual equities in the business is still more indefinite and subject to fluctuation.

Furthermore, accounting facilitates compliance with the various statutory requirements. For example, the requirements of the Bureau of Internal Revenue and of the Securities and Exchange Commission must be satisfied. While each of these Federal departments prescribes regulations to accomplish its own purposes, yet compliance with the regulations would be impossible without properly prepared accounts and statements.

In the performance of its functions accounting follows certain conventional procedures which must be understood if accounting statements are not to be misinterpreted. First, the balance-sheet and income statement are a resultant or composite of two very different classes of information. Their first source is the historical record of all the transactions preceding them; but because such a summary would fail to recognize many important facts arising out of the conditions at the date of the balance-sheet, another series of processes must be gone through if a true picture of those conditions is to be obtained. These processes involve the exercise of judgment at all those points where accounting conventions have come to require that the historical amounts be adjusted to something nearer to practical present-day conditions. What this means in detail will be developed in the treatment of the several items of the balance-sheet and income statement; broadly it involves the determination of the rates at which the historical cost of fixed or capital assets shall be written off as charges against income, and the statement of the current assets upon a basis which experience has shown to be safest and most helpful. These things can be decided only by the application of intelligent and impartial judgment to all the facts of the case. An understanding of the extent to which judgment has thus entered into the preparation of accounting statements is essential to the comprehension of them.

Another important convention in accordance with which statements are prepared is that the business is a going concern which will continue to operate on a more or less normal course. Everybody recognizes that a forced liquidation would bring about large reductions in the asset values; that intangibles would usually disappear completely; that tangible capital assets would be sold at near scrap values; and that even current asset values would be seriously impaired. But such valuations are not significant facts about the business in normal condition, expecting to turn its assets in the ordinary course of trade. The course of trade is therefore one of the factors to be taken into consideration when applying judgment to the amounts to be stated in the accounts, but this does not as a rule contemplate the forced liquidation of the business. What is sometimes referred to among banker's as the "pouncing" value has no place in the balance-sheet of a company which probably will not be pounced upon for the satisfaction of its liabilities.

In addition to the financial and economic factors, one other general element enters into the preparation of financial statements, namely, the legal element. It is the function of the liabilities side to show the amounts of the different classes of equities or interests in the assets listed on the other side of the balance-sheet. To this extent, therefore, the principles of accounting are dictated by legal considerations; in fact, it has been said that the ultimate function of accounting is to make proper allocation between the respective equities. It is probable that the managerial function is the most comprehensive of all those which accounting must serve, but in any case the legal aspects of the balance-sheet must be borne in mind by all who would understand it.

Finally the purport of notations and exceptions appended to financial statements by the accountant or included in his certificate should be understood. Neither the company accountant, nor the public accountant who sits in review and judgment, is called upon to judge and review the facts under survey, but only the manner in which the company officers are reporting those facts to the end that the reader may have a clear basis for judging them. Qualifications, explanations, dissents, and condemnations apply to the reporting job which the company has done, not to the question of what the accountant thinks about the business.

Summarizing, it may be said that the functions of accounting are:

1. Making a historical record, properly classified, of all the transactions of a business enterprise;
2. Making from time to time the calculations and estimates necessary to a determination of the financial condition of the business and its income;
3. From these historical records, calculations, and estimates, preparing from time to time statements showing all the more important aspects of the capital and income of the business and of the legal equities in them, satisfying thereby the need for information of all the parties in interest, especially of:
   (a) the management of the business,
   (b) outside groups, such as investors and creditors,
   (c) government, in such matters as taxation and regulation.

The problem of the methods by which these functions may be adequately performed is the problem which this statement of accounting principles attempts to answer.

The answer must be based upon experience, acquired in attempting to perform these functions and illumined by criticism. A statement of generally followed accounting practices expresses that experience in detail. Reflection upon the whole body of that experience is the basis of criticism. The principles of accounting are, therefore, the more general propositions describing the procedure which should be followed in the making of records and the preparation of financial statements, if the functions enumerated are to be properly performed.

General Acceptance of the Principles of Accounting

There is, it is believed, a corpus of principles of accounting which are generally accepted. It is true that they are not "written law"; they have not been codified; they must be sought in accounts and financial statements, in treatises, and in other evidences of professional opinion. It is true that they have not been adopted by vote of the profession. But that they have been accepted is evidenced by the common ways of thought and speech which make communication in accounting matters possible, by the generally uniform practice of all accountants when dealing with some situations, by the general agreement that, among all the possible ways of dealing with other situations, only a few can be used with propriety, by the restrictions of controversy in respect of propriety to a relatively small number of situations out of the innumerable number about which disagreement is possible. So fully is the existence of a body of accepted accounting principles recognized that accountants commonly state in their reports and certificates that the statements presented have been prepared "in accordance with accepted principles of accounting."

The existence of a body of generally accepted accounting principles does not mean that there is only one proper accounting treatment for every situation with which the accountant must deal. For many such situations, there are available a number of treatments which are in accord with the generally accepted principles. But the affirmation of the general acceptance of accounting principles does mean that many and, indeed, most of the possible treatments are inappropriate. The failure to see that it is not the essential nature of a principle to forbid all courses of action save one, that a rule of conduct which permits some courses of action and forbids others is a principle, explains, it is believed, the denial by some of the existence of accounting principles and their general acceptance.

The Statement of the Principles of Accounting

The activity during the last few years in the formulation of accounting principles evidences a demand for such a formulation. The American Institute of Accountants, particularly through its committees on accounting principles and on coöperation with stock exchanges, has spoken for the public accounting profession. The American Accounting Association has also published a brief statement of principles. The Securities and Exchange Commission has issued its accounting regulations for the administration of the legislation for which it is responsible. The Bureau of Internal Revenue has enlarged the volume of its accounting rules for the determination of taxable income, and has become more insistent upon conformity with them. Federal and state utility commissions are constantly issuing new systems of accounts, or revisions of old systems.

There is, however, no body within whose conceded province lies the formulation of accounting principles.

Even the various agencies of the Federal and state governments have not in their regulations attempted to do more than state the accounting rules compliance with which they judge necessary to the enforcement of the statutes which they administer. Though the provisions of these regulations, or some of them, may incorporate a principle of accounting, no one of these sets of regulations attempts a complete statement of principles. Thus the provisions of the regulations are not offered as general principles of accounting, but rather as directions as to what must be done to comply with the statute administered. For example, it would probably be conceded that a large part of all the rulings issued by the Bureau of Internal Revenue are of the nature of accounting principles having general acceptance and application; other of their regulations, however, have been adopted primarily as measures of administrative convenience and expediency for the determination of taxable income and the collection of the tax, but would not be suitable or adequate for purposes of business policy. In the case of the Securities and Exchange Commission, the purpose of the regulations is the display of the true financial condition and earnings of the respective companies, which is the most general of the purposes to which accountants may address themselves. It is, therefore, probable that a larger proportion of the regulations of the Securities and Exchange Commission may be regarded as based on accounting principles of general acceptance and availability than is the case with regulations of the Bureau of Internal Revenue. But even the regulations of the Securities and Exchange Commission are limited by the provisions of the legislation to which they give effect, and by the conceptions of those who have sought to interpret that legislation. The accounting systems of public utility commissions show increasingly the tendency to be influenced by particular theories of regulation.

Consequently, it is neither untimely nor improper to attempt a statement of accounting principles.

PART I

GENERAL CONSIDERATIONS

PART I

GENERAL CONSIDERATIONS

I. Capital and Income

Since the distinction between capital and income is fundamental in accounting and in business, it is desirable to set forth working definitions of these terms.

A. Capital

1. Capital in its most general sense means a store of wealth from the use of which the owner hopes to obtain additional wealth. The capital of a business consists of all its property or assets, both fixed and current.

2. Capital in a narrow and technical sense refers to the owner's equity in the property or capital as defined in (1) above. In this narrow sense, capital excludes borrowed capital, which is represented by the liabilities. In turn, capital in the narrow sense divides into (a) contributed capital and (b) accretions from earnings or operation, these two parts being reflected in the phrase "capital and surplus."

B. Income

1. Income is the increment in wealth arising from the use of capital wealth, and from services rendered.

2. Income in the narrow sense is the owner's share of this increment. This is the income which it is sought to define as "net income" in the income statement.

C. Distinction between Capital and Income

Thus it is convenient to think of capital as a store of wealth existing at any one time, and to think of income as the flow of increments in that wealth yielded by the activities of the business.

Additions to the wealth of the business resulting from further investments by the owner, or further contributions by lenders, are increases of capital and not income. Similarly restatements of the money value of the same capital goods, and actual increases in them, are increases in capital in the narrow sense, and are not income.

Income normally arises from the sale of goods or services for amounts greater than their cost.

II. Conservatism in Accounting

There is a prevalent impression that, while overstatement of assets or earnings is a major fault, understatement is less objectionable, and may be a positive virtue. It will be agreed at once that deliberate misstatement in either direction is not to be condoned; but when, as frequently occurs, the demand is made for "accurate statement," the subject may not be thus simply dismissed. "Accurate statement" in a literal sense is not possible; reasonable judgment must enter into many of the items shown in the statements. In most of the cases where understatement is alleged, the makers of the statements assert that they reflect the more essential truth, and that the difference is solely in the point of view. It is therefore proper to inquire into the circumstances which have led to any bias which may exist in favor of understatement, to observe the principal forms which understatement is apt to take, and to appraise the consequences of each.

A. Forces Tending to Conservative Statement

1. The common belief that less mischief is done by understatement than by overstatement is, in the hands of honest men, probably true; but with dishonest men understatement may serve their turn as well as overstatement.

2. With many and substantial exceptions, the more common tendency is to err on the side of optimism in exercising the necessary judgments of accounting; to offset this required an emphasis on the other side. This policy should be followed whenever it is likely that the tendency is towards overstatement. But when the tendency is in the opposite direction, the accountant should act accordingly, and emphasize the more optimistic aspects.

3. Many leading bankers, lawyers, and business men feel that a too great devotion to mathematical accuracy in accounting statements may tend to mislead, or to result in overlooking the broader aspects of the matter. Men of experience know that political, social, and economic forces may cause losses which cannot be specifically foreseen, and they look to accountants of larger mold to indicate the unfavorable possibilities.[1]

This view requires that any statement shall show adequate reserves to provide against all reasonable contingencies, even though these are not susceptible of precise definition or measurement. Whether these reserves will be of the nature of appropriated surplus, or allowances recording subtractions from specific assets, or general contingency reserves, will depend upon the circumstances of the individual case. In many instances, the management and its accounting advisers will have to decide as best they may, knowing that the provision they are setting up partakes of the nature of more than one of these categories. Undistributed surplus will, of course, accomplish in some part the same purposes, the unsatisfactory feature of this being that such surplus contains no qualification to serve notice of the presence of contingencies which should be mentioned.

The net result of these considerations is that conservative statement reflects conservative management in the past, and is likely to induce the same policies in the future.

The following instances illustrate the application of the principle of conservatism.

B. *Application in Specific Examples*

1. Intangible Assets

The writing off of such intangible assets as goodwill evokes scarcely any protest, even when it is recognized that substantial goodwill exists. The general distrust of goodwill and the knowledge that it has been widely used to capitalize exaggerated expectations of future earnings leave an almost universal feeling that the balance-sheet looks stronger without it. When actual consideration has been paid for goodwill, it should appear on the company's balance-sheet long enough to create a record of that fact in the history of the company as presented in the series of its annual reports. After that, nobody seems to regret its disappearance when accomplished by methods which fully disclose the circumstances.

2. Tangible Property

Conservatism in the statement of tangible property, and consequently of earnings, is for the most part a resultant of the policies with respect to depreciation and maintenance, and means simply that larger amounts of these have been charged to revenue than some others may consider necessary. While it will be at once agreed that these charges should be determined as accurately as possible, yet again there is room for considerable difference of opinion. The experience of the last eight years has demonstrated in many cases that policies which formerly were regarded as unduly conservative turned out to be only the barest prudence.

3. Current Assets

The debatable area with respect to the statement of current assets is usually less than in the case of fixed, since the former are not as a rule stated above currently realizable values. There are nevertheless the same kinds of doubt to be resolved, and when the more conservative elements prevail, mere differences of opinion as to the amounts of reserves to be provided against inventories and accounts receivable need not give rise to charges of deliberately excessive provision.

4. Inventory Policies

Such inventory policies as the base-stock method frankly abandon the usual basis of keeping inventories within the cost or market area. A long-time view is taken; a low point is chosen as the inventory base price; the ups and downs of current prices above that point are ignored with respect to the base inventory; most of the time the inventories stand in the balance-sheet at something much below either cost or market, and there results some equalizing of profits over periods of prosperity and depression.

5. Contingency Reserves

It is a well settled rule that reserves shall be set up for specific contingencies which threaten with more or less imminence and certainty; in such case it is preferable to report the amount of the reserve and nature of the contingency, unless such announcement would unduly increase the contingency for which provision is being made.

General reserves for more remote and undefined contingencies are also sometimes necessary; indication should be given, by their place in the balance-sheet or otherwise, whether or not they are for the time being regarded by the company as subdivisions of surplus.

6. Concealment of Profits

All the instances so far mentioned are within the limits "that differences of opinion might condone." [1] There remain those proceedings which amount to a deliberate understatement or concealment of profits. An instance is the practice, more common in England than in the United States, which shows in the books an amount of profits arrived at by generally accepted methods but in the published report shows a smaller amount. The more common devices are to reduce the inventory in the balance-sheet below the amount shown in the ledger, or to set up in the books a segregation of part of the surplus and, in the balance-sheet, to combine this with accounts payable. It is clear that such practices constitute a misstatement of fact in any literal sense of the word. This procedure is usually undertaken for the purpose of averaging profits over the years, so as to make a better showing in the lean years than the facts warrant. This, it is asserted, enhances the company's credit and prestige.

Doubtless it is procedures like these that are condemned in the passage:

> It is equally important that the general and surplus reserves should not be used for the purpose of equalizing earnings of a corporation over a period of years. The practice of equalizing earnings is directly contrary to recognized accounting principles.[1]

This would be less true if the accounting procedure adopted were announced in the reports.

The intentional concealment of profits is properly designated as the establishment of a secret reserve. The other instances of conservatism mentioned above are usually no more than the considered judgment of the company and its accountants, and in these cases the term "secret reserve" is not correct.

7. Arbitrary Valuations

The practice of attributing arbitrary amounts to certain balance-sheet items is usually based upon the flexibility of capital-stock amounts and the legal sanctions under which property paid for by the issue of stock may be valued at the discretion of the directors. As a result, balance-sheets have shown items of property and goodwill, capital stock, and restatements of capital and surplus, often in amounts having relatively little basis in actual values. While exact agreement with real values cannot be attained, yet accounts will be the more respected in proportion as they avoid arbitrary or fictitious values, and reflect real values as nearly as possible.

C. Conclusion as to Conservatism

Proper reserves for all purposes should be insisted upon; they are to be regarded as sound accounting and a source of financial strength to the company. To this extent conservatism is to be commended. But to arrive at profits on the books by recognized methods and then to conceal part of them in the published report, is a practice which cannot be approved.

III. Form and Terminology of Financial Statements

While the form of a statement is in part a technical question, it is also a contribution to the picture which the statement is attempting to portray. The order of the items carries some impression of their importance and mutual relationships. In companies like railroads, public utilities, and heavy industries, the amount and character of their plant investments are of great significance, and this importance is accentuated when the ratio of plant to gross income is very large. But even in such case the current position may be a crucial matter, and the general tendency toward placing current items first on both sides of the balance-sheet has much in its favor. It is undesirable, however, to make hard and fast rules, and the fact that companies in such industries have for years placed their plant and property assets first creates a presumption in favor of continuing that practice.

When the business is a vast and complicated entity, its financial statements are at best but very condensed summaries of the voluminous matter with which they deal. It is, therefore, desirable that the accountant avail himself of every device which will convey to the reader, in terms as clear and direct as possible, the results of his decisions on questions of principle. Although questions of form and terminology are in some senses not questions of accounting principle, yet they enter materially into the presentation of accounting results.

When it was the custom to prepare the balance-sheet and income statement as mere copies of ledger accounts, the item descriptions were of the barest sort, and nothing was attempted in the way of exposition. But with the statements being more and more read apart from the books by people with no other information, lucidity and comprehensiveness are obviously desirable and will be assisted by:

(a) grouping the items into a few main classes;
(b) arranging the items in the groups, and the groups in the statements, in a logical and consistent order;
(c) arranging the groups and items by proper headings and indentations to show their relationship to each other;
(d) using subsidiary columns for details, and main columns for totals.

A. Uniform Form of Statement

There is considerable demand for a uniform form of balance-sheet and income statement, based on the idea that uniformity would eliminate bad accounting practices and lessen misunderstanding. But, because of the essential differences between industries, complete uniformity is undesirable.

Advantage may be derived from the use of uniform forms for (1) companies in the same industry and (2) all companies when the statements are designed for limited specific purposes.

In the first case, forms of statements have been included in the uniform accounting systems worked out by numerous trade and manufacturing associations for the companies engaged in their respective industries. Uniform statements here aid comparisons between companies most likely to be compared, which as a rule are small and medium-size companies. The great industrial companies of the country are so vast and complex that it is better to have their own statements in a form which seems to them preferable. Also in this class are the form of balance-sheet included in the annual report which every railroad files with the Interstate Commerce Commission and the forms required by state public-utility commissions under the uniform accounting systems prescribed for the several types of public-utility companies. In general, all reports to governmental authorities from specific types of business, such as banks and insurance companies, are prepared on the uniform form prescribed for each type.

In the second case are included:

(a) The form of balance-sheet in the Federal income-tax return for corporations, the purpose of which is to assist the Bureau of Internal Revenue in auditing the return of income for tax determination. Every corporation must file this balance-sheet, and it is natural to use a uniform form designed to serve the special purpose.

(b) The form of balance-sheet included in the report which many companies file with Dun and Bradstreet, Inc., in order to obtain with them a credit rating.

(c) The form of balance-sheet used by banks for the purpose of determining the amount of credit to be granted to borrowing corporations.

But it is noteworthy that the Securities and Exchange Commission, in its requirements for financial statements to be filed with it in connection with new issues or listing upon national exchanges, has not prescribed a form, but has set forth in some detail the information which it desires to have shown.

B. Terminology

Much which has been said about the form of statements may also be said about terminology. A clear, concise, descriptive, and generally accepted terminology in financial statements would undoubtedly be advantageous. But such a terminology is largely an evolution from practical experience and cannot well be imposed by external authority, even if such authority existed. Some progress is made from time to time. Thus the term "fund," at one time used indiscriminately to indicate a reserve and a body of assets, is now, under the influence of the American Institute of Accountants, very generally restricted to the latter.

C. Amount of Information

The amount of detailed information to be given in a financial statement should be related to its purpose. As regards statements prepared for the management, the officers have the facilities for making their wants directly known, and the means of realizing them. The needs of management for information are, moreover, comprehensive enough to include practically all other needs. For reports furnished to divisions of the Government the appropriate authorities will state their own requirements. But it is necessarily left largely to the management to judge what information it is appropriate to give to the public. A number of powerful influences, statutory, legal, commercial, and financial have helped to define the desirable practice. In the last analysis the question must be answered on the basis of what the intelligent investing and financial public need for their information; the better examples of company reporting today substantially satisfy that need, and anything much more voluminous is not necessary. Granting that the balance-sheet and income statement, with the usual supplementary schedules and notes, should show every material financial fact, the question is, "What is material?" The definition of "material" by the Securities and Exchange Commission is: "The term 'material,' when used herein to qualify a requirement for the furnishing of information as to any subject, limits the information required to such matters as to which an average prudent investor ought reasonably to be informed." *(Instruction Book for Form 10, 1937*, p. 5.) The solution must necessarily be relative; no fixed measurements can be laid down, but the following rules should be observed:

1. Any general impression clearly conveyed by the statements should be a true impression. The statement, though technically correct, should avoid creating a false impression in the mind of the reader.

2. No information should be omitted which, if disclosed, would materially alter the impressions given by the statements.

These rules apply with especial force to (a) the determination of the periodic income; (b) the showing of the current position.

It should be remembered, in the application of these rules, that although accounting statements contain information about the past and the present, investors and credit agencies are constantly trying to read the future in them. While the accountant cannot make himself responsible for these prognostications, yet he must know that his statements will be put to such uses, and should not include anything which will definitely mislead a person of ordinarily intelligent familiarity with such matters, nor omit anything necessary to make the statements complete.

PART II

THE INCOME STATEMENT

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I. General Purposes

The division of the life of a business enterprise into fiscal periods has created the problem of determining the income of the enterprise for each particular fiscal period. This determination is a most important task of accounting. The preparation of an income statement is an attempt to perform this task. The income statement discloses, first, the procedure followed in making the determination and, second, the net income itself. In doing so, the income statement exhibits the extent to which the proprietorship has increased or decreased during the fiscal period, with the exception of:

- (a) additional contributions by stockholders or others,
- (b) returns of capital contributions, and
- (c) other exceptional increases and decreases discussed under "Capital Gains and Losses."

The income statement may or may not show the appropriation of the income for the period for dividends, or for other purposes.

II. General Principles of Income Determination

A. All income and all expense should be correctly allocated to the periods to which they apply. In this way the net income of the period under consideration will be properly ascertained. In any business a considerable proportion of the income and of the expense will be so clearly associated with the period under consideration as to raise no question about its allocation. But in nearly every business an appreciable proportion of both income and expense is either plainly identified with a prior or later period, or its allocation is in doubt. The principles of accounting furnish a guide for the treatment of these areas of doubt, but there must always be a considerable exercise of judgment in arriving at the best procedure. The proportion of the total income and expense thus depending upon experienced judgment varies greatly from relatively small amounts in businesses of quick turnover and small fixed investment to very large amounts in businesses of slow turnover, long-time contracts, and large fixed investment. In businesses of the former class the financial statements may always be prepared with greater assurance of correctness than is attainable in the latter class of business.

B. Since the income statement is prepared for the information of owners, managers, creditors, and taxing authorities, and for regulatory and other purposes, those accounting practices are best which serve these purposes in the most reliable and helpful manner.

It sometimes becomes necessary to prepare separate statements to serve the several purposes. The different statements should be reconcilable with one another, and the purpose of each should be always to afford a substantially sound view of the facts to those to whom it is addressed. Furthermore, since reliable information is the main objective of an income statement, for whatever purpose prepared, no considerations of policy should prevent a true showing of the facts.

C. While technical form and terminology may be helpful in achieving precision, they should be freely departed from whenever they obstruct a plain showing of the facts. Informative comment on the income statement is desirable whenever it will conduce to added understanding of the facts. But when the facts as such have been clearly stated to the intelligent reader, interpretation should be left to him.

D. In general the problems of income accounting end with the ascertainment of the net income of the business entity for the period. But this amount is inevitably made up of several economic elements, such as interest on the proprietors' investment, compensation for risk-taking, and reward for superior enterprising. But it is not practicable to record such subdivisions of net income in the regular financial accounts. If the proprietors desire to consider the several economic elements of income in relation to their management problems, they may do so by means of statements other than the regular financial accounts.

III. Divisions of the Income Statement

The income statement should be divided into at least two sections, an operating section and a non-operating section.

A. The Operating Section

A somewhat liberal definition of what constitute "operations" is permissible in the preparation of this section. It must include the operation of the main functions of the enterprise. It need not include incidental operations. It must exclude the interest cost on borrowed funds.

Items of income and expense should not be treated in the income statement in such manner as to make it impossible or difficult to ascertain the net operating income.

B. The Non-Operating Section

This section, if only two sections are used, should include such items as profit on sale of capital assets, interest, unrealized gain from appreciation (if shown at all as income),[1] and gains and losses due to causes not connected with the immediate management of operations.

IV. The Operating Section

A. Gross Revenues from Sales and/or Gross Operating Revenues

The gross revenue of the business will ordinarily be the total of the billings for the period for goods sold or services rendered. If the company sells goods and renders services, both in considerable amount, the two sources of income should be shown separately. Any other subdivision or classification of gross revenues which is significant to those concerned should be shown.

Care should be taken that no items are included both in sales and in inventories still on hand and that the same procedure as to this separation is observed at the beginning and at the end of the period.

The amounts used in recording sales in the ledger will be the invoice amounts, with cash discounts, returns, and allowances shown in separate accounts. The income statement should show the treatment of all these elements. Terms like "sales," "net sales," "gross sales" are used so variously that the situation is not clear unless discounts, returns, and allowances are either (1) shown as separate items, or (2) mentioned as qualifying the sales item.

In a consolidated income statement, sales will represent only sales to customers outside the consolidated group. Intercompany sales within the group should be eliminated. When a consolidated company also reports as a separate unit, it should show two amounts: (1) sales to other members of the consolidated system; (2) sales outside the system.

Since sales are thus made the basis of income determination, it is important to define sales in terms which conform with this purpose. With few exceptions only sales which convey title to another in exchange for cash, a legal claim, or other valuable consideration are properly included. The amount should, therefore, not include:

1. Consignments to an agent or branch still held for sale.

2. Approval sales, until final acceptance of the goods.

3. Instalment sales, where the payment period is long enough and conditions uncertain enough to require treating some portions of the sales as deferred income. In such cases income is to be reported on a collection basis, rather than on a sale basis. If, as collection experience accumulates, it appears that a high degree of safety attends this class of business, it is proper to record all sales as gross income for the period, subject to provision for uncollectibility.

4. Subscriptions and contracts for delivery or completion in a future accounting period. Subscriptions to periodical publications, insurance premiums paid in advance, and contracts for future delivery are examples. Obviously accounting must consider the precise terms of the contracts and all other circumstances; it will in general take up income only as the contracts are completed by delivery of the goods or services. The accounting should be consistent from period to period and should avoid having any period anticipate the income of succeeding periods. Long-time contracts of large amount, which authorize installment billing as parts of the work are completed, thereby justify including the amounts billed in gross income, even though delivery in the ordinary sense has not been made.

B. Sales Discounts, Returns, and Allowances

Items of this character are either deductions from billed prices or actual cancellations of billings because of goods returned. In either case the items are to be treated as deductions from gross sales, in order to arrive at the actual net amount received or receivable from customers as total revenues.

Some forms of allowance are offered to customers as part of the selling activities, directly designed to increase sales. The accounting classification should distinguish between sales allowances to be treated as deductions from gross revenues and those to be treated as selling expenses, in the light of all the circumstances.

C. Cost of Goods Sold and/or Operating Expenses

These amounts should be consistent with the determination of gross sales or gross operating revenues. In principle the costs charged should be the specific costs of the specific goods and services sold, and this principle should be followed as far as may be practicable. There should be no material discrepancy between the physical quantities on which the sales revenues are based and those included in the computations of cost of goods sold.

The statements should in some way indicate whether the cost of goods sold has been arrived at by an inventory method or by direct costing. In the former case it is desirable to show the inventories, either in the income statement itself or in a supplementary schedule.

Cost of goods sold and operating expenses should be subdivided to correspond with subdivisions of gross sales and gross operating revenues.

A consolidated income statement will omit intercompany transfers from cost of goods sold, to correspond with their treatment in the sales revenue figures. Similarly, each consolidated company will show separately (a) cost of goods sold to other members of the consolidation, (b) cost of goods sold outside the system. This will make possible the elimination of intercompany profits from the consolidated statements.

Similarly, profits on transfers between departments, if used for any purpose, should be eliminated from the accounts before determining cost of goods sold. If the management desires to show profits on interdepartmental transfers, this will preferably be done outside the regular financial accounts. It is recognized, however, that in certain cases of joint products and joint costs, the costing of secondary products or by-products at current market prices may have such practical advantages as to justify it, provided it is reasonably and consistently applied.

The division of expenses into those to be included in cost of goods sold and those to be treated as subsequent income deductions may be left to the judgment of the management. In making this division it should be borne in mind that usually, though not necessarily, it determines also the cost items to be included in the inventory valuations.

D. Depreciation

Only those principles of depreciation which affect the income statement are dealt with here; those affecting the balance-sheet are discussed in the appropriate place.

1. Purpose and Amount of Depreciation

There is much difference of opinion as to the purpose of the accounting provision for depreciation and, hence, much difference in practice as to the amount to be provided. On these questions the following observations are offered:

(a) The main purpose of the accounting provision for depreciation is to allocate to the period a proper amount of operating expense. A further purpose is to maintain the capital investment intact.

(b) The question is frequently debated as to whether the provision for depreciation should cover the actual cost or the cost of replacement. In so far as the average of the costs of a composite plant and the average replacement costs as distributed over the years will show little divergence, the problem becomes of little moment. But the uncertainty of any estimate of replacement cost makes it a less desirable base for computing depreciation than the known original cost, and the latter generally is used.

(c) The other factor in the computation is the estimated service life of the property. This should take account of both physical wear and tear and functional obsolescence. What is wanted, therefore, is the estimated service life, from whatever cause retirement may arise.

(d) It is agreed among accountants that the allocation of the total depreciation to the several fiscal periods should not be capricious, though there is no consensus as to the preferable method. In the United States the straight-line method commonly is used; in England the reducing-balance method. Until some agreement is reached, the use of either, or of any of several variant methods, may be considered good accounting practice. There should, however, be some indication of the method used, and the method should be consistently followed.

(e) The question of the adequacy of so-called retirement and similar methods of providing for depreciation can be answered only from an examination of the total amounts actually provided for depreciation and maintenance over a considerable period. It is the sum of the two which is to be regarded as adequate or inadequate.

(f) In the opinion of many competent observers, retirement methods do in fact result in inadequate charges for depreciation, especially when considered with respect to the maintenance of the original investment. It cannot be too strongly urged that the maintenance of the original investment, by adequate charges against earnings, is the principal means by which the physical plant itself is kept in up-to-date operating condition.

2. Accounting Treatment

One of the few topics relating to accounting on which there is general agreement is that depreciation involves a charge against the earnings of the period. A competent authority reached the conclusion that practically all manufacturing corporations treat depreciation of plant as part of their cost of production.

There is, however, considerable difference in practice as to the place in the income statement at which the depreciation charge appears. Because of the desirability of clearly showing the amount of depreciation it is often not included with wages, fuel, etc., in a single total, but is shown as a separate item. No item should be designated as operating income, and still less as net operating income, before the deduction of depreciation expense.

It is satisfactory to arrange the income statement either:

(a) with depreciation expense definitely included in operating expense (as by the Interstate Commerce Commission), or

(b) with depreciation not so treated, but in such a form that one can ascertain:

 (1) the remainder after subtracting other operating expenses from sales, or earnings, and

 (2) the amount of depreciation as a separate item.

By this method the ascertainment of net operating profit is easily made. Either of the following arrangements, taken from published statements, is satisfactory:

Net Sales	$100
Cost of Sales and Other Operating Expenses (including depreciation $3)	77
Gross Operating Profit	$ 23

Or:

Net Sales Billed	$100

Cost, Expenses and All Charges (except depreciation and interest)	87
	$ 13
Depreciation of Plant and Equipment......	4
Net Income from Sales..............	$ 9

E. Maintenance and Repairs

There should be charged against the earnings of the period all the costs of normal and ordinary repairs and maintenance necessary to keep the plant in good working order. In so far as operation above or below normal may require more or less than ordinary expenditures for maintenance, it is reasonable to charge larger or smaller amounts against current revenue. While the primary purpose of the accounts is to record the amount actually incurred during the period for these purposes, consideration must also be given to the adequacy of this amount to maintain the property in good working order. If all the costs of ordinary repairs and maintenance have not been charged, the accounts should in some way indicate that fact.

Reserves to equalize maintenance over the months of the fiscal year, or even over successive fiscal years, may properly be employed, so long as the practice is clearly disclosed.

It is essential to distinguish (1) maintenance expenses, (2) additions and betterments, and (3) retirements. The first are to be charged against revenue, the second to the property accounts, and the third to the reserve for depreciation, in so far as a reserve has been provided for these units, and otherwise to a retirements-expense account. Where retirements charged to the latter account are normal and recurring, they should be treated as an additional maintenance item to be deducted from revenue.

Probably the most accurate way of making these distinctions effective is by the use of a "units of property" system, as required by some public service commissions. But care should be taken to see that a technical accuracy does not lead to an unconservative statement of the property accounts. Thus, while the careful operation of such a system of recording additions and retirements of plant units insures that the plant account properly reflects the physical units of which it is composed, equal care must be taken that installation and other attendant costs are included not more than once in the property accounts.

Net costs of demolition and removal are ordinarily to be charged against revenue. The general rule is that the property accounts should contain charges only for the cost of the property in being at the time, all other charges to be made against revenue.

While maintenance charges are thus related on one hand to the charges for property additions and subtractions, they are related on the other hand to depreciation charges. It is the sum of these three factors which reflects the total plant situation. Recognizing that the question is largely a technical and engineering one, the accounts should include everything which will throw light on its financial aspects.

Broadly speaking, a plant should be maintained out of revenue in a state of efficiency corresponding to the normal progress of the manufacturing arts in that industry. Whether the charge be carried through the maintenance or the depreciation accounts is secondary.

In so far as maintenance charges are made against revenue, there is little point in charging part of the general overhead to maintenance. But when the maintenance department is also engaged upon new construction to be charged to the property accounts, care must be taken not to charge to the maintenance department any share of general overhead that would ordinarily be charged to cost of property sold.

Maintenance expense may, for managerial purposes, be allocated among the manufacturing, selling, and administrative divisions, according as they have been served during the period. The part thus allocated to manufacturing will become merged in the cost of goods sold and in the inventory figures; yet it may be desirable, under certain conditions, to show the total amount of repairs for the period in the published income statement. This is a matter which must be dealt with as reasonably as possible; often it is necessary to resort to a separate schedule,[1] supplementary to the income statement proper.

F. Gross Profit or Gross Margin

The difference between gross revenues and costs is the gross profit or gross margin.

The significance of this figure is sometimes debated. Clearly it depends first upon the precise make-up of the cost of goods sold. In a manufacturing company this is usually the cost of making the goods; in a trading company it is usually the purchase invoice cost of the merchandise plus freight. There has been some discussion as to whether a gross margin may not be significant for a bank, computing it as the difference between interest received and interest paid. In the case of department stores the Securities and Exchange Commission has authorized the inclusion of certain buying and even advertising expenses in the cost of goods sold.

Two types of questions are here involved, (1) those arising from the structure of the business as seen by its managers and (2) those concerned with the items which it is desirable to show separately in published statements. It is desirable that the companies in each industry should, as far as possible, agree upon uniform practices. It is also desirable that discussion as to the public disclosure of the various items should not obscure the value to managers of an adequate and logical classification.

G. Selling and General Administrative Expenses

In a purely trading business these items will be the principal operating expenses, and should therefore be carefully classified. In a manufacturing business they may be no less important in amount, and should receive proper attention.

As a general rule, no part of selling and general administrative expense becomes a part of the inventory value of merchandise on hand. There is an exception to this rule in the case of goods manufactured to order; in that case work in process and finished goods on hand have in effect been already sold, and there can be little objection to the inclusion of a proper proportion of selling costs in their inventory value.

The practice of some companies of apportioning general administrative expense between manufacturing and selling, on the ground that those two functions are the main activities of the business, may be approved, provided the allocation is reasonably made.

H. Taxes

The different bases of assessment of property, income, and other taxes justify the usual practice of treating them separately in the accounts. In the income statement it is proper to include taxes other than income taxes in operating expenses and to treat income taxes as a later deduction from income. The growing desire to show the total burden of taxation is a reasonable one and may be satisfied by grouping all taxes together in the income statement, or by narrative comment or comparison.

V. The Non-Operating Section

The magnitude and character of the company's operations are to be considered in determining which items of income and expense should be included in, and which should be excluded from, the operating section. For example, in a steel plant all the necessary transportation may well be treated as "operation"; but holding stocks in other companies in unrelated industries is outside any normal meaning of "operations," and the income from them is therefore to be shown in the non-operating section.

The items of income and expense excluded from the operating section and placed in the non-operating section should be classified according to their source, and the titles should make the classification explicit.

In view of the fact that income and expense items are ordinarily of a regularly recurring nature, any items of a nonrecurring character should be so described. This rule applies equally to income and expense, but is disregarded more often with respect to income items.

A. Interest

It is desirable to show the division of the earnings of the business as an economic enterprise between those who furnish capital on loan at fixed interest rates and the stockholders who take the residuary gain or loss. Interest will thus be a separate charge against earnings.

B. Capital Gains and Losses

So-called "capital gains" and "capital losses" are conspicuous examples of occurrences affecting the asset values of a business enterprise for which accounting practice discloses no generally followed or standard method of accounting. The principles which should determine how such losses or gains should be accounted for are discussed in that section of this report which deals with conservatism in accounting. Whether such gains or losses should be wholly included in the current income statement, wholly excluded from all income statements, or apportioned among the current and succeeding income statements is a matter to be determined by sound business judgment, made upon all the facts of the particular case, guided by the principle of conservatism. When sound business judgment dictates the entire or partial exclusion of such a gain or loss from the income statement, it is proper to carry it, or the portion of it excluded, on the balance-sheet as a deferred charge clearly described, or as an additional item in the net-worth section, leaving the existing surplus accounts unaffected, unless and until sound business judgment dictates the absorption of such gain or loss in one or more of the surplus accounts.[1]

There is some opinion in favor of passing all capital losses and gains through the income statement, on the ground that resort to surplus account may be misused to relieve the income statement of proper charges, and to the end that the income statements may cumulatively show all changes in net worth. Some capital gains and losses are, however, sufficiently abnormal to have no direct relation to current income, and sufficiently large to distort current income, even when clearly shown as separate items. In such cases charges or credits to surplus are justifiable. In cases of doubt the tendency should be to include such items in the income statement.

A consistent policy will include like treatment of related gains and losses. Divergent treatment of gains and losses from the same source are particularly to be condemned.

C. *Unrealized Profits*

In general, it is not proper to include in the income statement any profit arising from appreciation of unsold assets. The objection is not overcome, even when it is indicated in the report that such amounts are not available for dividends.

In the case of some commodities, such as grain or cotton, regularly quoted and readily realizable on an organized exchange, it may be the most convenient thing to value inventories on the basis of the current quotations. Market value is one of the alternatives allowed in valuing inventories of securities held by a dealer. [Reg. 94, Art. 22(c)-5.] No great harm can result from taking up the resulting profits or losses in such cases, provided (a) a consistent policy is followed, (b) the practice is clearly disclosed, including the possible effects on dividends.

As to unrealized gains on capital assets, there can be no justification for including these in current income. In general, such gains should not be recorded; but if special reasons seem to require it, the credits should be to capital surplus.

D. Unrealized Decline in Value

Accepted accounting practice requires that unrealized declines in the value of current assets should be reflected in the income statement.

Unrealized declines in capital assets, other than those to be provided for by depreciation, are not ordinarily to be recorded. When unusual declines of large amounts have taken place and are likely to be permanent, the assets may be written down against capital, or capital surplus, or earned surplus. Write-downs resulting from inadequate depreciation in past years are proper charges against earned surplus; write-downs recording catastrophic physical or economic destruction of capital may be proper charges against capital or capital surplus. No such step should be taken without full consideration of its effect in reducing subsequent charges against income.

E. Correction of Past Errors

When, in computing profits for a past accounting period, an error has been made the correction of which does not involve an amount so large as materially to distort the income statement for the current period, the error may properly be corrected through the income statement rather than through surplus. Since by assumption such corrections in the income statement are small in amount, they may properly be combined with the items to which the corrections apply. If, however, the amount involved is sufficiently large to distort materially the income statement for the current period, the correction should not go through income, but through surplus.

F. Net Income to Surplus

The net income of the period is carried to surplus. But dividends may first be charged, in which case the balance is carried to surplus. In either case the amount so carried to surplus, and the reconciliation between the income statement and surplus in the balance-sheet, should be clearly shown.

It is not proper to describe net income as "available for dividends"; the question of availability for dividends involves other considerations in addition to the determination of net income.

G. Deficits of the Development Stage

It is sometimes considered that early deficits (operating losses sustained in the developmental years of a business) are subject to different accounting rules from those which apply to the going concern. Well known examples of such different treatment may be cited, but it is doubtful whether they fulfill the present requirements of accounting. Discussion of the problem may conveniently be divided into (1) determination of the deficit, (2) its disposition.

1. In the early years, but after completion of the physical plant, some expenses, such as maintenance, naturally will be less than in later years, and it is sufficient to show what they are. Furthermore, it may be justifiable to charge to Development (an asset account) some expenses

which later may regularly be charged against income. Or it may be better to make all the charges to income and carry forward the resulting net deficit as an intangible asset. In any case the accounts should indicate what has been done.

2. Normal and expected losses incurred in developing a business to full capacity may reasonably be charged to asset accounts, though it would be more conservative to carry them as deficits until they may be charged off against ensuing earnings. This decision may be left to competent judgment, which will consider: (a) that whatever course is followed should be clearly shown; (b) that such deficits should not be converted into assets purporting to be tangible, but only into intangible assets; (c) that such procedure is justifiable only when the expectation of future earnings affords hope of earning a return on such assets, or of amortizing them; and (d) that the fact that the business may, upon reaching maturity, be transferred by reincorporation to new proprietors (while introducing the new element of the actual investment of these new proprietors) should not be permitted to conceal the true character of the predecessor company's investments and assets. At this stage the problem becomes one of asset determination rather than of income determination.

H. Provision for Inventory and Other Reserves

The charges to be made against income for writing down inventories or other assets, or for setting up reserves other than the customary ones for depreciation and doubtful accounts, give rise to some of the most difficult questions for the accountant.

When inventory is valued at market because it is lower than cost, a vigilant management will wish to know the amounts of such write-downs, and the accounts should provide the information. When these amounts are large, there is some justification for the demand that they be disclosed.

If the management wishes to go further and adopt a still more conservative policy with respect to inventory valuation, calculated to reduce the fluctuations in profits, that should be regarded as well within its province. The base or normal-stock method is a notable example. It is not, as some suppose, an artificial treatment of the figures; on the contrary, it takes cognizance of two important facts: first, that a minimum inventory is a constant necessity to the operating company, and second, that in times of prosperity the incipient conditions of depression are already present. The basic question is, what is the accounting period? A narrow adherence to the conditions and figures for the one year will exclude any notice of what may come after, while a recognition of the fact that the year is simply a chapter in the company's history may lead to adoption of sounder policies.

If the base or normal-stock method is clearly explained in the annual reports, especially as is sometimes done, with tables showing the adjustments, a reader can compute for himself the approximate effects of the policy, and can adjust inventory and profit figures if he chooses. If a company can show a strong current ratio with inventories on the base-stock method, the ratio would be still stronger if they were stated on the usual basis. In these circumstances the base-stock method seems to be within the bounds of proper accounting principles. The policy of the Bureau of Internal Revenue in disallowing this method, while it may simplify the determination of income for tax purposes, is probably not a wise public policy in the long run. The subject of inventory valuation is further discussed in Part III, p. 73.

Similar considerations apply to other provisions for future losses and contingencies which, though but dimly seen, are known to be incidental to business operations, though their date and exact character are not known. Any reasonable provisions of this sort which the management may honestly consider necessary should be made, and will conduce to the financial stability of the company. If the anticipated losses are really imminent, and arise from conditions already operative, then it is reasonable to accumulate provision for them out of current income; otherwise the provision is more properly made by appropriation of surplus. The only other relevant accounting principle is that the accounts shall show in sufficient fullness what has been done.

It is not intended here to condone any accounting practices of an arbitrary or capricious character, even though fully disclosed. It is essential that the policy adopted be based upon careful consideration of all the circumstances of the business and be consistently followed.

This is one of the matters for which governmental administrative bodies are not likely to make adequate provision in their prescribed accounting rules. The Bureau of Internal Revenue and the Federal and state commissions for regulating utilities may have objectives in mind which are likely to lead to an adherence to rigid rules, an insistence upon the conditions of the year, or other statutory requirements, rather than to farsighted financial and accounting dispositions such as the prudent business man would wish to make.

VI. Statement of Earned Surplus

The income statement should be accompanied by a summary of the earned-surplus account. Either this may be incorporated in a single statement of income and earned surplus, or the earned surplus may be shown in a separate statement. In either treatment there should be shown:

Earned surplus at the beginning of the fiscal period.
Adjustments representing corrections or modifications of earlier entries.

Amount transferred to earned surplus from income.
Unusual gains or losses which have not been included in the current income account.
Appropriations charged to surplus for dividends or for other purposes.

There may also advantageously be shown a summary of capital surplus, especially when entries have been made in this account which affect the net worth of the enterprise, but which are not considered as pertaining to current or past earnings.

VII. Dividends [1] (Cash)

A. Legal Requirements

Dividends declared during the accounting period may be shown either at the end of the income statement as a deduction from the income of the period, or as a charge on a separate surplus statement. Whether a dividend was justified under the circumstances is a question, first, of law and, second, of financial policy, but the accountant may be required to comment upon both of these questions. This report is no place for a discussion of all the factors which should control policy with respect to dividends. But it is appropriate to state briefly the effect of the statutes and decisions which express that part of American corporation law applicable to dividends.

The principle which the statutes and decisions, for the most part, seek to effectuate is that no dividend may be paid unless after such payment the amount or value of the property of the corporation will be at least equal to the aggregate of (a) its liabilities and (b) the stated amount of its capital, i. e., the amount required by law to be invested by the stockholders [2] as a condition to doing business as a corporation with limited liability. Thus the amount of capital stock or stated capital operates as a limitation upon the payment of dividends.[3] The legal application of this principle will be treated on three assumptions as to conditions existing at the beginning of the period for which it is proposed to declare a dividend, namely: (1) the net worth of the corporation equals its capital stock or stated capital (there is neither surplus nor deficit); (2) the net worth of the corporation is less than its capital stock or stated capital (there is a deficit); and (3) the net worth exceeds the capital stock or stated capital (there is a surplus).

1. There is neither Surplus nor Deficit at the Beginning of the Period

(a) Legal rules for the determination of income available for dividends

In the first situation assumed, the question whether the corporation may lawfully declare a dividend, and the amount of it, will depend first upon whether the corporation shows an income for the period determined according to the legal rules for computing income available for dividends and the amount of such income. The statutes and judicial decisions have, in general, left to accounting principles and sound business judgment the determination of income available for dividends.[1] There are, however, a few matters relative to the determination of income which are dealt with specifically by legal rules; it is convenient to state them here, although they apply also to situations 2 and 3 dealt with hereafter.

(1) Depreciation. A few of the corporation acts specifically provide that depreciation must be deducted in determining the income available for dividends, but they do not attempt to set out the method by which the amount of depreciation shall be determined.[2] The typical requirement is that "proper allowance" shall be made for depreciation sustained.[3] Judicial opinions have, with few exceptions, recognized that depreciation should be taken into account.[4]

(2) Wasting assets corporations. In the case of corporations engaged in the exploitation of so-called "wasting assets," such as mines and oil wells, the payment of dividends may be made upon a computation of income without a deduction for depletion.[1] The California statute provides that no such dividend may be paid unless there is an adequate provision for meeting debts and the liquidation preferences of outstanding stock. Similar restrictions are contained in the statutes of Indiana, Louisiana, Minnesota, Pennsylvania, and Washington.[2] In the absence of a specific statute a few decisions have approved the payment of a dividend upon a computation of income without deduction for depletion.[3] On the other hand a Delaware court, prior to the amendment of the Delaware act to allow such a dividend, refused to permit it.[4]

(3) Unrealized profits or appreciation. The more recent corporation acts prohibit the payment of dividends in cash or property out of surplus arising from unrealized appreciation in asset values.[5] In the absence of statute the few reported judicial opinions express or imply the same doctrine as these recent acts.[6] The prohibition in most of the recent acts does not extend to stock dividends.[7]

(b) Types of statutes imposing general restrictions upon dividends

Having properly determined whether there is an income for the period available for dividends, and the amount of such income, the legality of a dividend payment will depend further upon certain general dividend restrictions designed to effectuate the principle that no dividend may be paid unless, after such payment, the value of the property of the corporation be at least equal to the aggregate of its liabilities and its capital stock or stated capital. There are four types of such restrictions.

(1) The first type of statute provides that dividends may be paid only from *surplus*, that is, only to the extent that the value of the property of the corporation exceeds the capital stock or stated capital.[1] This means, in the case assumed, that no dividends can be paid in the absence of surplus for the period.[2] If there is such surplus for the period, the assets will exceed capital stock or stated capital by the amount of such surplus and, in the absence of a contrary agreement with the stockholders or others, dividends lawfully may be paid up to that amount.

(2) In a few states dividends may be paid only from *earned surplus*, that is, only when the surplus has arisen through income.[3] If there is an income for the period available for dividends and if, as has been supposed, there were no earned surplus at the beginning of the period, dividends may be paid under this type of restriction up to the amount of such income.

(3) A third type of statute allows the payment of dividends out of *current income*, even though the transactions of past periods have resulted in a deficit, provided there is no stock outstanding having a preference upon the distribution of assets.[4]

(4) A fourth type of statute adds a general *insolvency* limitation to one or another of the three foregoing limitations.[5] Frequently the statutes do not make clear whether the term "insolvency" should be taken to refer to (a) the inability of the corporation to meet its debts as they fall due or (b) the excess of debts over assets.[6] Where the insolvency limitation exists and where it is taken to refer to the inability of the corporation to meet its debts as they fall due, the legality of a dividend will depend not only upon income or surplus for the period but also upon the liquidity of the assets of the corporation and the amount and maturity date of its debts.

2. There is a Deficit at the Beginning of the Period

The legal restrictions upon the payment of dividends in this situation will be discussed with reference to each of the principal types of dividend statutes just described.

(a) Under the type of statutory provision that dividends may be paid only from *surplus,*[1] no dividends may be paid unless there is a surplus for the period, determined in accordance with the legal rules for determining surplus for dividend purposes,[2] and such surplus is greater than the pre-existing deficit. If the surplus for the period, properly determined,[3] exceeds the amount of the preëxisting deficit, dividends may be paid, in the absence of a contrary agreement with the stockholders or others, up to the amount of such excess.[4]

(b) Similarly, under the second type of statute, providing that dividends may be paid only from *earned surplus,*[5] unless there is an income for the period[6] in excess of the pre-existing deficit, no dividend may be paid. Any income in excess of the pre-existing deficit will be "earned," and dividends up to that amount may be paid.

(c) Under the third type of statute, of which the Delaware statute is an example, dividends may be paid up to the amount of income for the period, though the result of the transactions of past periods has been a deficit.[7] Further, the Delaware statute allows dividends to be paid up to the amount of any income which the corporation may have earned in the preceding fiscal year and which has not already been used as a basis for dividends. The statute provides, however, that, if the value of the corporation's property has been reduced to an amount less than that represented by stock having a preference on liquidation, no dividend shall be paid until the deficiency has been repaired.

(d) The fourth type of statute,[8] which adds a general insolvency limitation to either the first or second type of limitation, requires that the liquidity of the corporation's assets and the amount and maturity of its debts must be taken into account in determining the amount up to which dividends may be paid. Subject to this restriction dividends may, in the given case, be paid up to the amount by which income for the period [1] exceeds the pre-existing deficit. In California and Minnesota the insolvency limitation is added to a provision similar to the third type above (the Delaware statute). Under these statutes dividends may, in general, be paid as stated in the immediately preceding subdivision (c),[2] subject to the insolvency provision.

3. There is a Surplus at the Beginning of the Period

In this situation dividends may be paid up to the amount of income for the period (determined according to the legal rules for dividend-income computation)[3] as in situation 1, whichever type of dividend restriction is in force. But the additional question is presented, whether, with or without income for the period, dividends may be paid up to the total of the pre-existing surplus and the income for the period. This question will be discussed with reference to the sources from which the pre-existing surplus may have arisen.

(a) Earned surplus. If the surplus arose from income for a past period or periods, which income was determined in accordance with the legal rules for computing income for dividend purposes,[4] dividends may be paid up to the amount of such earned surplus under any of the principal types of dividend statutes set out above, subject to the insolvency limitation where it exists.[5]

(b) Paid-in surplus. A number of the corporation acts deal specifically with the payment of dividends out of paid-in surplus. In California, Illinois, Michigan, and Pennsylvania dividends may be paid out of paid-in surplus only upon preferred stock; of these states Illinois, Michigan, and Pennsylvania require that when such a dividend is paid notice of its source must be given to the recipients.[1] In Minnesota dividends up to the amount of paid-in surplus may be paid upon common stock unless there is preferred stock outstanding, in which case such dividends may be paid only upon the preferred stock, and notice of the source of the dividend is required to be given to the recipients.[2] Louisiana, Ohio, and Virginia require notice of the source of the dividend to be given, but do not limit them to preferred stock.[3] The Indiana statute permits dividends up to the amount of paid-in surplus only if such surplus has been paid in in cash.[4]

In the absence of a specific statute, whether a dividend may be paid out of paid-in surplus will depend upon the general dividend restriction which is in force. Under the surplus limitation, courts generally have allowed the payment of dividends up to the amount of paid-in surplus.[5] The states which have a general restriction limiting dividends to the amount of earned surplus all deal specifically with the paid-in surplus problem.[6] The broad Delaware statute seems to allow dividends up to the amount of paid-in surplus.[7] Under the insolvency limitation, the legality of dividends out of paid-in surplus will depend upon the liquidity of the corporation's assets and the amount and maturity date of its debts.

(c) Surplus from reduction of capital stock. Except for a few states, the payment of dividends out of reduction surplus is regulated by a specific statutory provision which is separate from the sections of the corporation act relating generally to dividends. Subject to varying restrictions for the protection of creditors, these statutes allow dividends to be paid up to the amount of the reduction surplus.[8]

(d) Revaluation surplus. Whether dividends may be paid out of an unrealized increase in the value of property has been discussed above under "Legal Rules for the Determination of Income Available for Dividends."[9] In general, cash dividends may not be paid from such source.

Usually the power to declare dividends is vested in the board of directors. The power of the directors to declare dividends should be exercised by vote at a meeting of the board, at which a quorum is present. The calling and holding of the meeting of the board of directors at which the dividend is declared, the necessary quorum, and the manner of voting should all be in accordance with the statutes and with the articles of incorporation and/or by-laws of the corporation.[1]

B. Records in the Accounts upon Declaration of Dividend

The accounts and statements should clearly indicate whether a declared dividend is considered as a charge against:

1. Current income, thus emphasizing the extent to which current income exceeds the dividends.
2. Earned surplus, when the agreement with stockholders does not provide that dividends are to be paid only out of current profits.
3. Such other accounts as may be authorized by statute. Special care should be taken to distinguish between dividends based on earned surplus (including profits of the current year) and those which are either a return of contributed capital or a charge against capital surplus.

The statements should indicate, preferably by a footnote or similar explanatory statement:

1. The amount of unearned past dividends on cumulative stock.
2. The amount of undistributed profits allocable to non-cumulative preferred stock when the claim against profits for such stock does not lapse when the dividend is not declared for the period when earned.[2]

PART III

THE BALANCE-SHEET

PART III

THE BALANCE-SHEET

I. The General-Purpose Balance-sheet

Balance-sheets may be prepared in different forms for different purposes. But a balance-sheet is usually prepared for the purpose of showing to all concerned the financial condition of the business as a going concern. Such a balance-sheet is referred to as a general-purpose balance-sheet; it is sufficient under most circumstances and is the type most commonly used. To such a balance-sheet this part of the report is directed. Furthermore, the discussion is limited to the balance-sheets of corporations.

II. Nature of the Balance-sheet

The balance-sheet is a statement which purports to exhibit the financial condition of a business, including (a) the nature and amounts of the assets of the business, (b) the nature and amounts of its liabilities, i. e., its obligations to creditors, and (c) the nature and amount of its net worth. The balance-sheet purports to itemize and classify the assets, the liabilities, and the net worth in conformity with financial practice and the law applicable to the corporation for which it is prepared.

It follows that the balance-sheet should: (a) set forth all the resources of the business and all of its obligations, both to creditors and to stockholders, as fully as is compatible with reasonable brevity; (b) omit no contra assets and liabilities by offsetting them; (c) mention, either in the body of the balance-sheet or in footnotes, the pledging or hypothecating of any of the assets; (d) state the basis of the judgment determining all amounts about which there may be substantial question or misunderstanding.

Furthermore it follows, since the importance of a given class or type of assets varies from one industry to another and from one commercial enterprise to another, that an attempt to present the financial condition of a business on a uniform form of balance-sheet prepared for the use of all businesses would, in many cases, result in a misleading statement.

The practice of accountants in the preparation of balance-sheets has, in the course of time, hardened into a set of general conventions. These conventions are sometimes inconsistent with one another but they do, nevertheless, provide a way of presenting the significant aspects of the financial condition of a business. If a balance-sheet fails to present these aspects the failure is a result not of defects in the conventions but rather of failure to observe them with candor and sincerity. If a balance-sheet is not to mislead the reader he must understand these conventions.

The first of the conventions is that the balance-sheet is historical in character: it attempts a summary description of the financial aspects of transactions which have already taken place. Thus certain intangible assets, such as goodwill and organization value developed within a business, the creation of which, however, cannot be attributed to any particular past transaction, are omitted from the balance-sheet of the business which developed them. Omitted also are contingent liabilities so unlikely to become certain that, were the contingency to happen, the resulting liability would be attributed to the happening of the contingency rather than to the original transaction giving rise to the contingent liability.

The relation between the balance-sheet and the income statement results in large part from the historical character of both. The financial aspects of many of the same transactions are represented in both; for example many of the assets are deferred charges to income. The difference between the two statements is in the standpoint from which each is prepared. In preparing the income statement, one asks, what portion of the assets has been consumed during this period and is therefore a charge to income? In preparing the balance-sheet, the question is, what portion of the assets remains now on hand for effective service in future accounting periods?

The second general convention is that the balance-sheet is a statement of the financial condition of a going concern which has invested the greater part of its funds in the listed assets with a view to their consumption in operations or to their sale in the future. The statement shows the present status of the assets resulting from the consumption and conversion of the original assets.

The third convention, which follows from the two which have been stated, is that the original basis of fixed asset values is cost. Subsequent valuation of them is a process of apportioning their original cost over their useful lives. The amounts set opposite fixed assets in balance-sheets do not record the results of periodic appraisals which attempt to state the present price of the assets. The special rules, under which the value of certain assets, such as inventories, are sometimes set at an amount less than cost, are discussed below.

The fourth is that certain deferred charges to income, which are like assets only in that they are deferred charges, are listed on the assets side. Such deferred charges are of two classes: (a) impairment of net worth, particularly unusual or catastrophic losses which do not pertain to future operations but which the management decides to amortize gradually, instead of charging at once to current income or to surplus or absorbing as a reduction of capital stock; and (b) items of expense already incurred which do pertain to future operations, e. g., the cost of surface stripping of a mine. These are discussed below.

III. Balance-sheet Classifications

The common uses of the balance-sheet involve two main types of analysis:

(1) comparisons between two or more successive balance-sheets;

(2) internal comparisons, or analysis within a single balance-sheet.

It is important that the balance-sheet furnish a sound basis for these comparisons. The groupings of items for the several sections of the balance-sheet should be clearly indicated, accurately described and consistently maintained from year to year.

IV. Assets

The assets of a business comprise all its properties or resources. In general, three conditions apply to the listing of items as assets, (1) that the business in question *owns* them, (2) that the business has acquired them at a *cost,* and (3) that they are of *value* to the business.

A. Fixed Assets

One large group of assets includes those which the business holds more or less permanently, such as the physical property and plant which are the basis of its operations, intangible assets like goodwill, and, in the case of a parent company, investments in subsidiaries held for the purpose of maintaining effective control and ownership of them.

1. Property and Plant Assets

Land, buildings, machinery, and equipment form an important part of the assets of a manufacturing, transportation or utility company. Their distinctive characteristic is that they are not themselves for sale, but are used in the production of goods or services which are for sale. All such assets (land ordinarily being an exception) are consumed in the processes of production, at varying rates of speed, and ordinarily the only way in which the owner can recover the money he has spent on them is through the price received for their products.

Such assets are really in the nature of a deferred charge against the future income they will help to produce. The net income of any period cannot be correctly determined until appropriate charges have been made on account of the plant assets, these charges being for the amounts of the depreciation, depletion and amortization of the period. Since the property accounts are the vehicle for carrying the amounts invested in property until these amounts find their way into the income accounts of the several periods, they should show the cost of the property.[1] There is the further advantage in carrying such property at cost rather than at an estimated present value in that, while the determination of cost involves at times some difficult problems, it is generally capable of objective verification, and is free from the subjective element inherent in valuation by appraisal.

While cost to the present owner has generally been considered the proper basis for valuing plant, a modification has taken place in the field of public utilities where regulatory authorities have required that property shall be shown at "the actual money cost . . . at the time when it was first dedicated to the public use,"[2] the difference between this amount and the cost to the present owners being recorded in an adjustment account. In so far as this is designed to afford additional information to a regulatory body, it may be approved, though there are other ways in which this information might be supplied. But the procedure should not obscure the cost to the present owner.

Plant acquired in direct exchange for securities raises a difficult question. It has been the custom to state the plant at the amount of securities issued therefor. This would be correct if the nominal value of the securities issued agreed with the value of the plant. But the situation has too often been used to conceal the fact that the securities have been issued at a discount by giving inflated values to the acquired plant.[1] It is much to be desired that such transactions should be stated on something approaching a cash basis, as evidenced by a reasonable appraisal of the present sound values of the properties. Accounting statements which misrepresent the values cannot now be regarded as satisfying standard accounting principles. The valuation may properly include an amount representing an estimate of future earnings above the normal rate. But this factor should be stated separately as an intangible asset.

When plant assets are constructed by the company itself, the more conservative procedure is to charge to such assets only the direct costs of materials and labor, and actual supervision devoted to that work. It is permissible also to allocate to it a reasonable amount of general company overhead, but this should not be done to the extent of relieving the income account of charges which would normally be made against it.

In the case of timberlands and other natural resources held for a long time without operation, it is proper to add to the original acquisition cost such charges as insurance, cruising, and other carrying costs, up to the time when income is derived from operations.

The question of what to include in cost is thus a troublesome one. Broadly speaking, it is good practice to charge to property accounts not only the original and direct acquisition costs but also all costs of installation, and all expenses necessary to bring the equipment to the point of being an earning asset.

Conservative practice will naturally charge less to property for those additional and incidental costs, but the question of what is or is not conservative cannot be determined from this practice alone. That must depend upon a consideration of three factors taken in conjunction, namely, (1) the policy determining the original charges to property, (2) the policy determining the amount of actual maintenance done, and the allocation of this between property and expense accounts, (3) the rates of depreciation charged. It is possible for a company to be conservative in one of these respects and extravagant in another, with the net result of following an approximately sound policy. While, therefore, the responsible accountant will wish to develop a sound treatment of each of these matters considered separately, the essential thing is that all three of them in combination constitute sound practice. That practice may be expressed in the two principles: (1) the property account shall represent the original investment of the present owner in the properties now in its possession and (2) the corresponding reserve for depreciation shall reflect the net amount of such investment written off to income down to date.

The fact is sometimes pointed out that, in a going concern, the property and plant has a perpetual existence; it never comes to an end, is never entirely written off against income. Over periods of years replacements and maintenance make good the depreciation. But this does not change the fact that each unit of plant has its own life cycle and is charged to income during that cycle, with adjustments for salvage values; nor does it affect the desirability of carrying such assets at cost.

It follows that units of property retired will be subtracted from the property account at cost, and new units will be added to the account, whether they are replacements or new and additional items. Various difficulties are encountered in doing this, especially when records of the cost of individual units discarded are not available.

But there can be no question that in principle it is the correct thing to do. The pressure of taxing authorities seeking to arrive at a definite basis for depreciation makes it more and more a practical advantage to have the detailed records which make it possible.

Closely connected is the problem of which expenditures to charge to property as representing additions thereto, and which to charge to the income of the year as representing current maintenance. Every business must make its own working rules for dealing with this problem, but nevertheless there will be many cases calling for discretionary treatment by competent officials. It is reasonable to follow a conservative course in all situations of doubt, but constant effort should be made to deal with this problem in an even-handed way, to avoid on one hand an inflation of the property accounts by charging to them what should be charged to income and on the other hand an understatement of the property accounts and of income by following the opposite course.

A company making public reports to stockholders should include therein a brief statement of the working principles which it applies to this problem. If property is listed at cost in the balance-sheet that fact should be stated. Any change in accounting procedure which affects the comparison between one period and another should be described.

Question arises from time to time as to whether a special segregation is called for of plant not now operated, and as far as can be foreseen, not likely to be operated either because of an excess of capacity or relative obsolescence of some parts of the plant. If the amount involved is considerable, it is desirable to state separately the amount of the unused plant, with an intimation of the causes which have brought about the situation. The simplest statement would be to give two amounts for the plant, one the amount of plant in operation and the other the amount of plant not operated. This is appropriate especially where the inactivity arises from a cessation of demand, which, however, may reasonably be expected to revive at some time. If the situation is still more doubtful because obsolescence has already overtaken the idle plant or is likely to do so before it will again be placed in operation, this may be reflected by grouping the amount of such plant with the deferred charges. Some note might then well be given as to the plan for the ultimate disposition of this amount; in effect, it is a form of delayed or inadequate depreciation.

Occasions arise when a company wishes to make some statement about the present value of its plant, particularly when that appears to be larger than the book value. Such occasions are the issue of new securities and the valuation of public utilities for rate-making purposes. Whenever it does seem desirable to make any statement about present value, it seems eminently preferable to do so as a separate or parenthetical statement, without disturbing accounting figures for the original investment. The experience of the last twenty years indicates that such revaluations inject a disturbing element into accounts; they destroy comparisons and tend to reduce the acceptability of the balance-sheet generally. For the most part, accountants have opposed them, and should continue to do so.

(a) Reserve for Depreciation

The amount of depreciation accrued as a result of charging the depreciation expense account with the periodic amounts of depreciation is ordinarily recorded in a separate account known as "Reserve for depreciation." In public-utility accounts "Reserve for retirements" is the name frequently used.

A number of accounting writers, objecting to the use of the word "reserve" in so many senses,[1] have urged the use of other titles, preferably "Allowance for depreciation." There is much to be said for the latter term, but common practice has adhered to the older name.

In the balance-sheet the reserve for depreciation is most commonly shown as a direct deduction from the property and plant accounts on the assets side. This is the preferable method, since it indicates most clearly the significance of the item. A number of companies, however, chiefly public utilities using a retirement basis, show the item on the liabilities side.[1] By showing the item on the liabilities side and not as an item reducing the "value" of property and plant, they avoid preparing a balance-sheet which may be taken as asserting that the amount set opposite property and plant is a "valuation" by the company and which may be used against it in a proceeding before a regulatory body.

The primary function of the reserve for depreciation is to show the total amount which to date has been written off the property and plant accounts, and has been charged to operations during the years. By the end of the year, however, if all expenses (including depreciation) have been recovered out of gross income, new resources have been received to replace the value of property consumed in operations. The original source of these new assets is gross income, yet on account of the earmarking of a portion of the gross income as covering depreciation, it is a common thing to speak of the reserve for depreciation as the source of the new assets. But the reserve for depreciation by no means implies a segregated and specific fund of assets. If such a specific fund is required, it is necessary to appropriate cash or other suitable assets and to show it in some form as a separate item on the assets side.

Property units retired, if fully depreciated, should be charged against the reserve for depreciation. Amounts of property retired and not fully depreciated should be charged to a retirements account which in turn will affect either surplus or income.

It is not good practice to charge replacements directly against reserve for depreciation. The preferable method is to charge the units retired against the reserve, and then charge the new units to the property account. It is desirable that subsidiary property records be kept in sufficient detail to permit this to be done accurately.

The treatment of accrued depreciation in the balance-sheet involves a further question when the property amount has been increased by reappraisal, with a resulting credit to an appraisal surplus. What then will be the provision and record for depreciation, and what the subsequent treatment of the appraisal surplus? This question goes back to the question discussed under depreciation in the income statement section,[1] as to whether the amount of depreciation expense should be computed so as to cover original cost of the property or its replacement cost. Following the recommendation there made, only depreciation on the original cost should be charged to expense; but since the property has been written up to replacement value, future additions to reserve for depreciation should be on that basis, in order to afford the proper offset. The additional amount thus provided in the reserve should be charged against the appraisal surplus, which will thus be extinguished by the time the related assets are retired. This problem furnishes further evidence of the general undesirability of writing up the assets in the first place.

2. Intangible Assets

No adequate definition of this term is furnished by writers on accounting. The word "intangible" is not used in any literal sense, and the distinction between tangibles and intangibles does not turn upon their tangibility. Most of the intangibles represent legal rights which accord to their owner certain more or less exclusive privileges.

It is usual to define intangibles by enumerations. The Securities and Exchange Commission lists "14. Patents, trade-marks, franchises, goodwill, and other intangible assets".[1] The Federal Communications Commission includes, under telephone plant accounts:

201. Organization
202. Franchises
203. Patent Rights
207. Right of Way[2]

Organization expense is sometimes included in the property accounts and sometimes listed among the deferred charges.[3] The classification adopted is some indication of the intended policy with respect to writing off the item; listing it as a deferred charge conveys a stronger implication that it will be written off. The choice of classification is sometimes influenced by the regulations and rulings of the Bureau of Internal Revenue, under which most intangible items may not be written off as allowable deductions, whereas most tangibles may be written off by depreciation or amortization. The important question, however, is whether an item represents an asset or an expense and not whether an asset is tangible or intangible.

Three principal questions arise with respect to intangible assets: (1) the basis for determining their amounts, (2) their showing in the balance-sheet, (3) their subsequent amortization.

Like all long-time assets, the common basis for valuing them is cost to the present owner. In any case the basis should be indicated in the balance-sheet, whether original cost, cost less depreciation, appraisal, or other.

Intangible items should be shown separately from tangibles, whenever possible. This proviso is made necessary by the fact that in many mergers made years ago the tangibles and intangibles were not separated, and any separation now made is a purely arbitrary one. The Securities and Exchange Commission recognized this,[1] but the separation will in future be required.

Intangibles which clearly have a definite term, such as patents and copyrights, should be written off within that term. If the probable economic life is less than the legal life, the former should govern.

Goodwill is the most important and the typical intangible asset, so that discussion of it will in part serve for the group.

Goodwill is variously defined as follows:

(1) A legal definition is "the probability that the old customers will resort to the old place." [2]

(2) An accounting definition is:

> "Goodwill, in its commercial sense, is the present value of the right to receive expected future super-profits, the term 'super-profits' meaning the amount by which the future revenue, increase, or advantage to be received is expected to exceed all economic expenditure incidental to its production, plus a normal profit." [3]

(3) It is sometimes defined in a more general way as the excess of the total value of the assets of a going concern over that part of the value which can be allocated to specific assets.

In practical transactions the value of goodwill is based upon a more or less accurate estimate of prospective net earnings in excess of some assumed norm.

It is generally accepted that a value should be placed on goodwill in the books only when goodwill has been purchased. The corollary is that goodwill should not be entered in the books of the business which builds it up.

Two modifications of this general rule have appeared: (a) the cost of extensive advertising, expected to yield benefits for a long period, is sometimes considered an indirect purchase of goodwill; (b) the operating deficits of the early years of a business have at times (in some public utilities, for example) been regarded as a necessary expense of creating a going concern and, therefore, an indirect cost of goodwill.

It has been a not uncommon practice to value goodwill on such bases as (a) the excess paid in cash for a group of assets above the net value of the tangible items upon the books of the vendor, or (b) the same amount, paid in stock issued. It is desirable that, instead, the buyer place specific values on goodwill and the other assets at the time of the transaction.

There is marked difference of opinion and practice as to whether or not goodwill should be written off, and if so, by what steps. It is clear that goodwill itself suffers no actual decline as long as the earning power of the company remains unimpaired, but the pervasive feeling that the showing of goodwill does not add to the strength of the balance-sheet has led to much writing off, usually in a few large amounts rather than by systematic amortization. As a result, a considerable number of important companies now show goodwill at $1, and others at no value. Distrust of the goodwill item, so far as it exists, probably arose more from excessive valuations in the past than from question as to the reality of the item. A smaller number of companies show goodwill reduced by a reserve or allowance, but still at substantial amounts.

To summarize:

(1) Goodwill, like other assets, should be shown at its bona fide cost to the owner.

(2) To attribute to goodwill an excessive value, based on the par value of stock issued therefor or otherwise, is not good accounting.

(3) If there is no longer valuable goodwill, or if its value has been obviously impaired, it should be written

down. The resulting charge should be against capital or surplus, not against income.

(4) The regular amortization of goodwill is not considered imperative, as is the amortization of wasting assets. Such a treatment, however, is not considered objectionable. Strictly speaking, the amortization is a charge against income for the period during which the goodwill is supposedly effective, but the practice of charging capital or surplus instead of current income is approved by accountants.

Problems concerning goodwill arise most frequently in the preparation of consolidated statements, under which heading they are discussed further.

3. Investments for Control

Investments held for the purpose of controlling subsidiary corporations should be clearly distinguished from investments held as the equivalent of cash, or for income or for sinking-fund purposes. Investments for control should, therefore, be shown separately. Since they have a relatively permanent character, they may be regarded as a subdivision of fixed assets. It is, however, proper, if so desired, to show them elsewhere in the balance-sheet.

Question arises as to whether the book value of such investments should be permanently maintained at cost or be subject to adjustment for profits or losses of the subsidiary. Changes in the market value of the securities should ordinarily not affect the value at which they are carried. When the affiliated company has made profits, subsequent to the purchase of the securities by the holding company, some authorities approve of showing a proportionate increase in the book value of the held securities. This procedure, while having some logical basis, is of questionable propriety. It goes counter to the general objection to marking up the book value of any asset, and also there is some uncertainty as to whether the value of the investment has actually increased to the extent of the pro-rata share of the subsidiary's profits.

The investments should be marked down in the books of the holding company:

(1) If a dividend is paid
- (a) out of surplus held at time of purchase, and presumably reflected in purchase price;
- (b) out of capital, as a liquidating dividend;
- (c) out of current profits, where the book value of the investment had been previously marked up to show the interest of the holding company in such profits.

(2) When an operating deficit has occurred, which appears to be permanent.

(3) When a capital loss has occurred, which appears to be permanent.

The sale of such securities at a profit is similar to the sale of any capital asset. The gain arising from such a sale, while unusual in its origin, is realized profit or earned surplus. The view advanced by some authorities that it is to be considered capital surplus and, hence, possibly subject to restrictions applicable to capital surplus, is not well founded either in principle or in law.

B. Current Assets

The current assets are those assets which in the regular course of business will be converted into cash and those assets acquired with a view to their availability for conversion into cash. No rule of thumb can be laid down for the precise separation of current assets from fixed assets, and frequently there are border-line items. In their valuation, in contrast to the treatment of fixed assets, consideration is given to current values.

The nearest approach to a general rule for the valuation of current assets is that they be stated at (a) cost, or (b) current replacement values, or (c) realizable values, whichever is lowest. The more precise applications of this rule are indicated in the discussions of the several items. Doubts as to the *time* of realization into cash, and the *amounts* of such realization, require for their resolution all the information which can be brought to bear upon the subject, as well as the most competent and impartial judgment of the company's own accountants and of its auditors.

One purpose of the showing of the current assets is to afford a comparison between the current assets and current liabilities, especially with a view to computing the current ratio, or the number of times the current liabilities are covered by the current assets. For this comparison to be significant, the assets classified as current should be those presumably to be converted into cash in time to meet the liabilities classified as current. The making of the comparison is facilitated by introducing into the balance-sheet subtotals of current assets and current liabilities.

Another important aspect of the current assets is expressed by the term "working capital," or more precisely, "net working capital," which is the excess of the current assets over the current liabilities. A satisfactory amount and proportion of this excess of current assets represent, on the one hand, the freedom of the management from anxiety in the matter of meeting the company's obligations, and, on the other, their freedom to work out constructive policies for the company's welfare, with ample resources for the execution of them.

It is therefore of the first importance that, in the presentation of current assets and current liabilities, nothing shall be done which would, in respect of these comparisons and conclusions, convey to the reader a false impression.

1. Cash

Cash should not include amounts which are not in fact presently available for the making of payments. It should, therefore, not include amounts due from officers, employees, or others, nor deposits in closed banks. Time deposits and foreign balances may be included if they are in fact presently available. It is reasonable to admit foreign balances, although not readily transferable into dollars in this country, if liabilities outstanding in the same foreign currencies have also been included as current liabilities.

2. Marketable Securities

When included among current assets and placed next after cash and cash items, this term should represent securities which are almost as readily available to the company for current purposes as cash itself. The factors which seem necessary to justify the term "marketable securities" or "readily marketable securities" are: (1) that there should be a market in which the securities are customarily bought and sold; (2) that this market should be sufficiently stable to absorb an orderly liquidation of the particular securities held by the company without materially impairing the currently quoted values, or at any rate without reducing them below the prices at which the company carries them in its balance-sheet.

The balance-sheet description should indicate the basis on which the amount is stated, whether cost, current market, or other. If the balance-sheet amount is substantially different from the currently quoted values, then the amount of the latter should also be stated.

Reacquired shares of the company's own stock, securities issued by its subsidiaries and held for control, and securities held for the maintenance of business relations should not be included in the current assets section. Ordinarily the same rule will apply to the company's own issues of bonds. But a few bonds of a well-secured issue, upon reacquisition, if readily salable, may be carried as marketable securities.

3. Notes and Accounts Receivable

The rule that these shall include only amounts due from trade debtors in the ordinary course of business is a salutary one. Appropriate reserves should be provided to cover any difference between the book amount and reasonably probable realization. Amounts due from officers or directors should be shown separately.

4. Inventories

Accepting the rule stated above that the lower of cost or market is the primary guide, the accountant should apply this rule reasonably and consistently. If by different interpretations of the rule it is possible to arrive at substantially different results, then it is desirable to indicate the method employed and to follow that method consistently from period to period.

Accountants may properly arrive at "cost" on a basis of (a) first-in, first-out, (b) last-in, first-out, (c) average cost, or (d) base-stock method, as may be most appropriate for the industry. For raw materials "market" usually means the buying or replacement market; as to work in process and finished goods, "market" means the cost of reproduction or replacement, unless the realization prices are lower, in which case they would govern.

Discussions as to the auditor's responsibility for inventories should not obscure the fact that those who read the statements will in fact rely upon the inventory figures there given as a representation by the company's accountants and auditors. The latter are therefore bound to take reasonable and appropriate steps to ascertain that the inventory is as reported; if they know of any circumstances likely to invalidate conclusions drawn from the inventory figures, they are bound to endeavor to preclude the drawing of such erroneous conclusions, either by changing the figures themselves, or by suitable qualifications.

Rules like the lower of cost or market were devised as an aid to prudent business management and for the protection of investors, and not for tax purposes. But under these rules, cases have occurred of wide fluctuations of material prices resulting in losses of one period, followed by profits of another period, in which the latter were taxable without proper offset. In these cases such valuation methods as base-stock or last-in, first-out are intrinsically proper,[1] as well as being proper from a business point of view.

5. Other Current Assets

Any other items may be included which, to the satisfaction of the accountants, clearly meet the tests for current assets. Care should be taken, by the descriptive terms used, to indicate their nature.

6. Reserves against Current Assets

Since reserves against current assets are in effect subtractions from them, though estimated in amount, they are preferably to be subtracted directly on the assets side. If in other statements a company wishes, for good reasons, to show such reserves on the liabilities side, they should be clearly marked as being of a current nature. But this is not a satisfactory treatment when they are of relatively substantial amount, since it affects the current ratio.

Reserves against current assets should not be so merged with other reserves that they cannot be recognized or separated, unless they are so relatively small as to be negligible.

C. Deferred Charges and Prepaid Expenses

It is difficult to write definitions, based on practice, which draw a sharp distinction between the two groups. The common element, and the most important element, in both is that they are all amounts held in suspense, to be charged as expenses in subsequent fiscal periods; in the meantime, they are carried as assets in the balance-sheet. This common factor is the basis on which all such amounts are frequently shown in one total in the balance-sheet.

The two groups may, however, be differentiated by the broad characteristics of each. Prepaid expenses are mostly of short duration, are for services not yet received, but to be received in the near future, and are usually parts of ordinary recurring expenses, as appears in the following examples:

1. Unexpired insurance
2. Prepaid interest
3. Prepaid taxes
4. Prepaid rent
5. Prepaid selling expenses
6. Prepaid advertising
7. Inventories of expense supplies

Deferred charges, on the other hand, generally are of longer duration, and are for services already received though the benefits from them may accrue in the future; often they do not constitute parts of regular expenses, and sometimes are abnormal losses which it is not yet convenient to write off. Items which may be listed as deferred charges include:

1. Discount and expense on bonds
2. Organization expense
3. Experimental expense
4. Development expense—manufacturing, mining, or commercial
5. Minimum royalties paid in advance

6. Improvements on leased lands
7. Special deposits to secure privileges or services
8. Unusual losses carried forward to future fiscal periods

The principles which should govern the treatment of these items in the accounts will be indicated by a further subgrouping into the following three classes:

1. Those which have a definite time incidence, such as:

Unexpired insurance
Prepaid interest
Prepaid taxes
Prepaid rent
Bond discount

2. Those which depend, as to their incidence, upon a rate of consumption. This rate may not be definitely known in advance, but may be ascertainable as consumption takes place. This group includes such items as:

Inventories of expense supplies
Prepaid advertising
Developmental expenses
Minimum royalties paid in advance

3. Those which have an indeterminate incidence. An example is a capital loss which for some reason is being carried forward to be charged off later.

The appropriate principles may now be developed. The first question is the basis of charging these items to income. All of them should be charged to the several periods affected. Thus items of the first class mentioned above should be prorated on a definite time basis over the periods to which they apply. Items of the second class should be prorated according to their consumption or exhaustion. Items of the third class are allocated wholly upon competent judgment applied to the circumstances of the case. This prorating will automatically determine the amounts to be charged against current income, and the amounts to be retained as assets, respectively.

In no case, however, can the decision be left to purely arithmetical procedures; a cautious judgment must scrutinize all charges carried to future periods, to consider whether the benefits anticipated are well enough assured to justify the deferring of the charges. They must be "not only reasonable but safe" if an inflation of the assets is to be avoided. For items of considerable amount the basis of amortization should be stated in the published report.

A few companies include prepaid expenses among current assets. Considerations of conservatism and convenience have, however, resulted in a general practice of showing deferred and prepaid items in one group, in which case none of them is treated as current. This is generally the preferable practice.

The inclusion among deferred charges of losses already definitely sustained, for the express purpose of charging them against future income, is not to be commended as a general practice. In the usual case of this type the value of a piece of property has been suddenly and unexpectedly lost by some natural or economic catastrophe, with the result that there has not been time to complete the provision for depreciation in the ordinary way. There may be good reasons for not charging the entire loss against the current year's income, but for carrying the amount in the balance-sheet as a deferred charge to be prorated. Such reasons were frequently existent in the case of public utilities subject to regulation, which have not been permitted to include the loss in operating expense. As early as possible the amount should be written off against income or surplus, preferably the latter, and the circumstances should be made quite clear in the published accounts.

The treatment of all prepaid and deferred amounts should be consistent from year to year. While they are usually small relative to total assets, they may be considerable as compared with net income, so that any change in procedure between balance-sheet dates may seriously affect the amount of income shown. If any such change is found necessary, therefore, the bearing of it should be made plain in the published reports.

1. Bond Discount and Expense

The custom of carrying in the balance-sheet, as deferred charges, the balances arising from the issuance of long-term obligations at less than par, and from the expenses incurred in connection with such issues, is general and proper. It is not proper to include these balances in the value of property acquired, as was formerly common.

The discount is in a sense an offset to the liability from which it arises, having the mathematical effect of reducing that liability to its present worth. But the practice is well established of showing the bond liability at its face value. When, therefore, the bonds are issued at a discount, a contra item is involved. This is treated as a deferred charge to income, and its effect upon the income account is the most important consideration. It is an addition to the cost of borrowed money.

The amount of bond discount and expense, therefore, should be amortized during the life of the bonds in question by a charge against current income additional to the periodic charge for the interest paid on such bonds.

In exceptional cases it is permissible to amortize the entire amount of bond discount and expense in advance, or at a rate faster than the regular periodic amortization, provided the extra amortization is effected by charges to earned surplus.[1] Examples of such special cases arise when the amount of discount is quite small relative to total assets, or when it begins to appear that the bonds are likely to be retired before maturity. In general such practice should not be resorted to unless substantial grounds exist for it.

It is objectionable to write off such balances against capital surplus, since that proceeding relieves later income accounts and earned-surplus accounts of charges which properly should be made against them. It is still more objectionable to amortize these balances against capital surplus by devices which fail to disclose the full character of the proceeding.

When a debit balance remains in bond-discount-and-expense account after the related bonds have been retired by a refunding operation prior to their maturity, three options are open to the issuing company, viz.:

1. To write off the entire unamortized balance at once out of earned surplus.

2. To continue to amortize the old balance at the same rate as hitherto, thus completing amortization by the maturity date of the bonds now retired.

3. To combine the unamortized discount on the retired bonds with the discount or premium on the new bonds, the total to be amortized over the life of the new issue.

Retirement of the bonds has already been referred to as a condition permitting the first of the above methods. To the argument that this course omits proper charges to subsequent income statements, it may be replied that subsequent income statements will thus be charged with the effective interest rate incurred for those periods, and one in consonance with the then current market rates.

The second and third methods have the advantage of continuing to charge all this expense through the income accounts, thus avoiding overstatement of earnings by its omission. The second method is clearly more conservative than the third, and for this reason may be preferred. But if the removal of the unamortized balance be regarded as a cost incident to the new issue, then the third method is logical.

It is a proper exercise of the functions of management to choose which of the three methods shall be followed, provided the method chosen is clearly shown in the annual statements affected.

All that has been said as to the regular amortization of bond discount applies, conversely, to the accounting for bond premiums by the issuing company. In the case of premiums, however, it could not be regarded as good practice to anticipate the credits to income or to earned surplus.

The treatment of bond premium and discount by the holder of the bonds would naturally be the exact opposite of that by the issuer, except for one important factor. Whereas the principal sum is a debt certain for which the issuer must provide, it is not so certain that the bondholder will receive payment. Theoretically this circumstance should not, but in actual practice generally does, affect the records of the bondholder.

When a bondholder has paid a premium on a bond to be redeemed at par, the premium is a part of his actual investment. This part he will recover, not at maturity, but rather in instalments as part of his periodic interest coupons. Good theory and good practice both require, therefore, that he amortize the premium in regular instalments by the maturity date. A discount on a bond purchased is similarly an amount of deferred interest income; but sometimes conservatism has led to this additional income not being taken up by the holder until its realization is assured by actual receipt of the par value at maturity. Such uncertainty as to the security of the discount amount would, however, apply also to the principal itself, as indeed to all receivables. The proper method is, therefore, to amortize a discount as steadily as one amortizes a premium, but to set up reserves to cover any uncertainties as to the receipt of either principal or income.

The legal treatment of this problem has arisen chiefly in cases of conflict of interest between life tenant and remainderman. No very clear rule can be developed from these cases. The courts have for the most part been concerned, not with setting up economic or accounting definitions of principal and income, such as would automatically determine the treatment of discounts and premiums, but with discovering what a testator, donor, or other party intended by the words of a particular document.[1]

V. Liabilities

The first problem is to assure the inclusion of all liabilities, and the second is to classify them under proper descriptive titles. Little question is raised as to the amount at which liabilities are to be listed in the balance-sheet, as in the great majority of cases they appear at their face or par value. There may be occasion, however, to estimate the amounts of some liabilities, of an indeterminate or contingent character.

A. Long-Term Debt

Funded debt should be shown by issues, each properly described. The amount should be the face value of the bonds outstanding. Bonds held in the treasury are preferably shown in short-extension as a deduction from bonds issued or authorized unless they are held for special funds not related to the particular issue. In the latter case they may be shown as assets properly described as to purpose, and valued as other similar investments.

Early maturing amounts of funded debt are sometimes included among current liabilities. Generally it is sufficient to give clear notice of the maturities in the balance-sheet, or in a note thereto. In the normal course large funded-debt maturities are not met from current assets, but from refinancing.

B. Current Liabilities

It is necessary to state all current liabilities; the complete omission of any of them, or the showing of them outside the current section, is never acceptable. Contingent liabilities of a recurring nature, such as for returnable containers, should be included; more remote contingencies should be reflected either in reserves appropriately designated, or in balance-sheet notes.

Current liabilities should be subdivided into (a) trade obligations, (b) bank borrowings, (c) expense accruals, (d) borrowings from officers, and (e) other obligations.

Provision for taxes payable, under whatever name recorded, is a current liability and should be so classified; it should not be grouped with general reserves. If the amounts can be only approximately determined, the word "estimated" may be used. In the case of a tax such as that on undistributed surplus it may not be possible to make even an approximate estimate; a footnote should then state that a liability exists, but of indeterminate amount.

The total of all current liabilities should be indicated.

C. Contingent Liabilities

Contingent liabilities, such as those in connection with pending lawsuits or guarantees of various kinds, are rarely shown in the body of the balance-sheet. It is, however, good practice to call attention to the existence of material contingencies either parenthetically or in a footnote.

If the amount which will probably fall due, as for instance in the case of the liability to redeem trading stamps, can be estimated, that amount should appear in the balance-sheet not as a contingent but as an actual liability. It is a matter for nice judgment to determine when a contingency becomes sufficiently threatening to require entry in the balance-sheet proper. Moreover, a company is not called upon to publish a specific amount of liability if by so doing it would prejudice its own position in controversy.

When receivables are endorsed and discounted at a bank, the best treatment is that followed by the banks themselves of showing the item both as an asset and as a current liability. Alternative treatments which are recognized as proper are to show the amount of discounted notes (a) as a deduction from the notes-receivable asset item, (b) entered short in the body of the balance-sheet, or (c) as a footnote.

VI. Deferred Credits to Income

Amounts received from customers in advance in the regular course of business are, strictly speaking, a mixture of liabilities and profit. In so far as they call for merchandise or services to be rendered in the future, the cost of such merchandise or services represents a liability. If such cost is the predominant element in the amount received in advance and if the merchandise or services are to be rendered in the near future, there is much to be said for the general practice of not attempting to segregate the profit element from the cost and of showing the whole amount received as a current liability rather than as a deferred credit to income. If the cost of merchandise or services is only a small part of the amount received, the whole of that amount may properly be shown as a deferred credit to income rather than as a current liability. In other words, such amounts received in advance are deferred credits not to net income but to gross income.

VII. Reserves

The word "reserve" is in accounting made to mean too many things. Four distinct meanings may be noted:

1. Reserves in the nature of valuation reserves, being in main effect subtractions from asset amounts, have been discussed under the respective assets with which they are concerned.

2. Reserves which are in the nature of accrued expenses, and are called reserves only because the amounts have to be more or less estimated, are current liabilities, and have been dealt with under that head.

3. Reserves which represent appropriations or earmarkings of surplus. These are made to indicate the unavailability for dividends of the amount appropriated to indicate some special program involving surplus. They are subdivisions of surplus and are discussed thereunder.

4. The remaining category is of a mixed character. The typical case is the contingency reserve. To the extent that the contingency has happened there is either a reduction in the value of assets (as upon loss by fire, or decreased value of inventory, etc.) or the emergence of a liability (as upon the breach of a guarantee). The establishment of the reserve was akin to either (1) or (2) above. But if the contingency does not happen the reserve clearly represents surplus, as in (3) above, and properly reverts to the surplus account. Since the relative amounts of the three factors cannot be determined in advance, it is desirable to show contingency reserves as a separate category in the balance-sheet, intermediate between liabilities and surplus, indicating their nature as clearly as possible by description. In some cases specific disclosure may itself affect the outcome, such as with amounts in dispute or litigation; it is not then in the company interest, or in that of its stockholders or credi-

tors, to make such specific disclosure. The amount will then be combined with other reserves in a published balance-sheet, though it may be segregated in the accounts.

VIII. Net Worth

A. Capital Stock

1. Designation of Stock on the Balance-sheet

The balance-sheet should show the amount of capital stock (a) authorized as well as (b) issued. The fact that the company is or is not authorized to issue additional stock is of some significance to the stockholders. Only 30 of 500 balance-sheets for 1935 which were examined failed to state the amount of capital stock authorized. This number is a fourth less than those failing to state the authorized amount in 1934 and less than half of the number failing to do so in 1933. It should be noted that, presumably, in many of the cases in which the amount of capital stock authorized is not designated as such on the balance-sheet, all of the authorized capital stock has been issued and additional stock may not be issued to the prejudice of the stockholders. A few state statutes expressly require a showing of authorized stock in the balance-sheet.[1]

It is correct to show authorized capital stock in either of the following ways:

Authorized Capital Stock....	$100,000	
Less Unissued Stock........	10,000	
Capital Stock Issued........		$90,000

or:

Capital Stock Issued (Amount authorized $100,000)	$90,000

The description of the capital stock should include its par or stated value. Where more than one class of stock is issued, each class should be stated separately in the balance-sheet. Such separate statement is required by statute in California, Massachusetts and Michigan, as well as by the regulations of the Securities and Exchange Commission.[1]

2. Stock Premium and Discount

The premium received on an issue of shares should be shown in a special capital-surplus account and as a separate item in the balance-sheet. This practice may be followed consistently with the California statute which provides that premium on stock "shall be credited to paid-in surplus,"[2] and it is, of course, legally sufficient in the other states in which there is no statutory regulation of the matter.[3]

Stock discount should be shown in the balance-sheet as a subtraction from the nominal value of the stock. Such discount should be shown separately for each class of stock issued at a discount. This practice is not inconsistent with any statutory or common-law rules, it is believed. It is proper and should be followed whether, as in California, the statute provides that only the amount received for such discounted stock is to be credited to stated capital[4] or whether, as in Ohio, the statute requires that the par value be carried in stated capital, regardless of the stock having been sold at a discount;[5] and it should be followed whether the discounted stock has been legally issued as full-paid[6] or whether the agreement that the stock shall be considered as full-paid is unenforceable.[7]

In some cases part of a block of stock may have been issued at a premium and the remainder of the same issue at a discount. According to the rules of the Interstate Commerce Commission, discount and premium in such case offset each other.[8] This procedure appears to be well justified by the fact that, in the case of solvent corporations, it is difficult to conceive of conditions in which the separate showing of premium and discount would be material. In preparing a report of the condition of an insolvent company, it is possible to have a situation in which creditors and others might be interested in the fact and the amount of the discount.[1] In such a situation the report should make a separate statement of premium and discount.

Corresponding with the accounts for different classes of stock, there will, in the ledger, be separate accounts for premiums and discounts by classes of stock, though in the balance-sheet all may be combined in one net figure of premium or discount.

3. No-Par Stock and Stated Capital

When par stock is issued, capital stock should be credited with the amount which, under the statute, the corporation has designated or stated as the par value of the capital stock.[2] Similarly, when no-par stock is issued, capital stock should be credited with the amount which, under the statute, the corporation has designated or stated as capital. There is, thus, no essential difference in accounting for the issue of par stock and no-par stock. The introduction of shares without par value has not abrogated the distinction between the capital stock and surplus accounts; nor has it abrogated the use of the capital-stock account as a mathematical limitation on the payment of dividends.

The proportion of the consideration received for no-par stock which is to be credited to capital stock depends upon the statutes of the particular jurisdiction. Some states require that, of the consideration received for no-par shares, a stated minimum amount shall be credited to capital stock. The first no-par statute, that of New York in 1912, was of this type.[3] Other statutes require that the entire consideration received be so credited.[4] In still other jurisdictions the statutes require that only the amount designated as such by the directors shall be credited to capital stock.[5] Some confusion has arisen with regard to the use of the capital-stock account as a limitation on dividends where the statutes do not require that a substantial part of the consideration received from the sale of no-par shares be credited to capital stock.[1] It has been suggested that the entire amount of the consideration received for the no-par shares should be credited to capital stock.[2] But, within the limits of the several statutes, the amount to be credited to capital stock is a matter for the determination of the management.[3]

4. Losses as Deductions from the Capital Stock Account

Any deficit should be charged against earned surplus, if there be any, or, if not, against other surplus; in neither case will the deficit appear as a separate item in the balance-sheet. When there is no pre-existing surplus or when the amount of the deficit exceeds such surplus, the net deficit should appear as a deduction from capital stock. The rule of law that the statutory amount of capital stock is a fixed quantum which cannot be changed except by proceedings taken in accordance with the statute, and in consequence is not changed by a deficit (or indeed by any operating result), does not lessen the propriety of showing a deficit as a deduction from capital stock.

In the case of corporations engaged in the exploitation of wasting assets, it has generally been considered permissible to determine the amount distributable to the stockholders without taking into account the depletion of such assets.[4] This practice, however, does not mean that accounting should fail to disclose the fact that part of the dividend thus paid was, in reality, a liquidating dividend. An attempt should be made to calculate the amount of depletion which is included in the dividend and to show that amount as a subtraction from capital stock.

Here again it is of no consequence that the amount of the statutory capital stock is not reduced by such a dividend.

The so-called "capital losses" and "capital gains" are discussed in the section of this report dealing with the income statement.

B. Reacquired Stock [1]

1. Reacquired Stock Distinguished from Unissued and Canceled Stock

Reacquired stock, whether obtained by purchase or by donation, should be kept distinct in all records from stock which has never been issued and also from stock which, although once issued, has subsequently been canceled. The fact of reacquiring stock and holding it in the treasury does not relegate it to the status of unissued stock.[2] When stock is originally issued at a discount, there is a possibility that the holder thereof may be held liable to the corporation, at the instance of creditors, for the amount of the discount.[3] However, where reacquired stock is sold at less than par, the likelihood that the purchaser will be held liable for more than the purchase price is so small that the question is not likely to be raised.[4] Further, reacquired stock has been treated differently from that as yet unissued with regard to the conditions under which it may be sold by the corporation. It has been held that the sale of reacquired stock below par does not violate a provision of a state constitution that "no corporation shall issue stocks or bonds except for money, labor done, or property actually received; and all fictitious increase of stock shall be void," [5] and that the stockholders cannot complain that they were not given the first opportunity to purchase such stock.[6] The California and Ohio statutes provide that reacquired stock may be sold for any consideration which the directors may fix.[7] These distinctions make it clear that there should be a separate statement of unissued and reacquired stock in the records and on the balance-sheet.

2. Accounting Treatment

Reacquired stock is, strictly speaking, not an asset, but may indicate an instrument which may be used for obtaining assets. Reacquired stock should preferably be shown as a deduction from capital stock issued. It is unwise to make a fixed rule, however, since some circumstances seem to require, or at least to justify, its treatment as an asset. Such cases should, nevertheless, be regarded as exceptional.[1]

Out of 500 balance-sheets examined for four years, over 300 contained items of reacquired shares, shown as follows:

	1936	*1935*	*1934*	*1933*
Deducted from capital stock or net worth	221	217	215	197
Listed as an asset, in various forms	86	108	121	159
Total number of balance-sheets	307	325	336	356

While the statistics are not strictly comparable, the report prepared by Daniels in 1930 shows that treasury stock was treated as an asset in 61 per cent. of the balance-sheets in which that item appeared.[2]

Surplus arising from the sale of reacquired shares, whether by donation or purchase, is in general to be regarded as capital surplus. But when such profits or losses occur in small amounts, from the buying and selling of stock, it may be treated as earned surplus. In any case such items should be clearly and separately stated.

Dividends on reacquired stock should not be reported as income of the company.

The circumstances attending the donation, or purchase of the stock for a nominal amount, may be such as to call attention to the fact that the resulting capital surplus is a somewhat nominal item. Under such circumstances it may be preferable to show the reacquired stock at cost on the assets side, and thus avoid showing a surplus. If the reacquired shares are subsequently sold, the surplus then determined is definitely realized, and should of course be reported.

3. The Purchase of Treasury Shares "out of Surplus"

This phrase, which has crept into accounting literature and into business contracts, is misleading. The idea supposed to be expressed is that shares of the corporation cannot be purchased if the result of such purchase would be to reduce the net assets below the amount of stated capital. This is the usual statutory restriction.[1]

However, in the more recent corporation acts, purchases of a corporation's own stock made for specified purposes, such as to compromise a claim with a shareholder, to eliminate fractional shares, or to redeem shares subject to redemption, are not subject to this restriction.[2]

4. Readjustment of Plant Valuation

It has been said that a retransfer of stock to a corporation without any consideration is some evidence that the property for which the stock was originally issued was overvalued.[3] Some accountants have suggested that this idea be followed, by reducing the property value by the amount of any proceeds from the sale of treasury stock, and even more drastic adjustments are suggested by other accountants. But all these adjustments are inconsistent in implying that the stock was fully paid and that the plant was not worth the par value of the stock. There is the further result that the more the donated stock is sold for, the more the plant will be written down.

If the plant valuation has been exaggerated, that is a separate matter calling for direct treatment.

C. Surplus

1. Definition

Surplus in its broadest meaning may be defined as the amount by which the total amount of the equity of the stockholders of the corporation exceeds the amount of the legal capital.[1]

2. Surplus in the Balance-sheet

Surplus should be shown as a constituent part of net worth. It should, however, be kept distinct from capital stock. Surplus may be made up of several subdivisions. The subdivision of surplus most commonly made in published accounts is based on the differentiation between:

(a) earned surplus, and
(b) surplus other than earned surplus. Donated surplus, surplus from the sale of treasury stock, and surplus from reduction of capital stock are examples of this type of surplus. All are included within the general term "capital surplus."

The twofold division of surplus is recognized and required by the more recent corporation acts.[2]

The distinction between earned surplus and capital surplus is clear in principle, though sometimes difficult to maintain in practice. This difficulty may arise either from looseness in the past in making charges against or credits to one or the other, or from inherent difficulty in determining whether a doubtful item is properly a charge against earned surplus or capital surplus. It is of paramount importance that the annual reports should clearly state the nature of current charges and credits to both kinds of surplus.

(a) Earned surplus. Earned surplus is that part of surplus which has been earned by the corporation. It is not limited to earnings which have resulted from the main operations of the corporation. It should include not only the profit made by a factory in selling its product, but also interest received on outside or incidental investments, and also gain made by selling part of the fixed assets at a price greater than the cost.[1]

Earned surplus may, in turn, be subdivided into:

(a) appropriated, and
(b) unappropriated or free surplus.

An attempt is sometimes made to identify the free surplus with the amount available for dividends. This, however, is generally futile. Premium on capital stock issued is in no sense earned surplus, and yet in some jurisdictions is legally available for dividends. On the other hand, that portion of earned surplus which has been appropriated by being placed in a reserve for extensions is at least legally available for dividends. The same authority that credited the amount to reserve could cancel that segregation. There are too many factors, legal restrictions, contractual obligations, resolutions of directors, and financial expediencies, which enter into the question of whether surplus is available for dividends to make it practical to have a balance-sheet account indicating the amount available for dividends. The California statute provides that dividends may be paid "out of earned surplus."[2] Under this statute while there need be no item on the balance-sheet purporting to show the amount available for dividends, no item not legally so available should be entered as earned surplus.

(b) Surplus other than earned surplus. The most general term to describe that portion of surplus which is not earned is capital surplus, although other terms are not infrequently found in published statements. Capital surplus may be divided into (1) paid-in surplus, which is still further subdivided into premium on stock and donated or contributed surplus, (2) reappraisal surplus,[1] (3) surplus from restatement of capital stock, and (4) surplus from sale of reacquired stock.

3. Charges against Surplus.

(a) Items properly charged.

Legitimate charges against earned surplus are the following:

(1) Dividends.
(2) Operating deficit.[2]
(3) Adjustment because of wrong calculation of profits in earlier years.[3]
(4) Items not properly causing a reduction of earned surplus, but which, by statute or regulation, must be so charged.
(5) Appropriations for special purposes.
(6) Earned surplus transferred to capital surplus or to stated capital.[4]

Legitimate charges against capital surplus are the following:

(1) Dividends, when the statute authorizes and the directors indicate that the dividends are paid out of capital surplus.[5]
(2) Deficits remaining after earned surplus has been exhausted.[6]
(3) Amounts of capital surplus capitalized by stock dividends or otherwise.
(4) Appropriations for specific purpose not contrary to legal restrictions. Where capital surplus is available for dividends, the corporation might appropriate part of surplus as a reserve for extensions or for sinking fund, thus indicating that, in accordance with the policy of the directors, it should no longer be considered as available for dividends.[7]

(5) Organization expenses and initial deficits especially when the paid-in surplus is distinctly provided to cover such items.

(b) Items not properly charged against surplus.

Items which should be charged against income:

(1) those affecting the income of the current period.
(2) those which should be amortized by charges against the income of future periods.

(c) Items which should be charged not against *capital surplus* but against *earned surplus*.

Those relating to past income which have been incorporated in the balance of earned surplus.

4. Pre-existing Surplus of Acquired Subsidiary

The pre-existing surplus of acquired subsidiaries, as such, ordinarily should not appear in the balance-sheet of the holding company. If corporation A purchases all the stock of corporation B, paying $100,000 therefor, it is immaterial whether B's accounts showed capital stock—$100,000, or capital stock—$50,000 and surplus—$50,000. In neither case does the surplus shown on B's books appear on the accounts of A. A has paid $100,000 for that which is worth $100,000, assuming that the accounts of B are correct. Similarly, if the stock of B is purchased and paid for by the issue of $100,000 par value of A stock, it would be improper to show any surplus arising from this transaction on the books of A. If, however, (again assuming that the net assets are correctly valued in B's books) A purchases the entire block of the stock of B, but issues therefor only $50,000 par value of its own stock, A's books would show a surplus representing premium on its own stock of 100 per cent., that is, of

$50,000. This surplus of $50,000 is, however, not the same thing as the surplus of like amount appearing on the books of B. It merely represents the value received by A in excess of the par value of its issued shares. This is made clearer by assuming that the stock of B is purchased by the issue of $75,000 par value of A stock; the surplus due to premium on the issue of its stock would be a real capital surplus, but would be $25,000, clearly not representing the pre-existing surplus of B. The surplus shown on A's books would be a paid-in surplus, in no sense an earned surplus.

If, however, the purchase is purely formal, being merely a reorganization in which the stockholders of A are practically the same as those of B, it might be desirable, if the stock of B were acquired by the exchange of the stock of A, to show on A's books the pre-existing surplus as earned surplus. This would make it available for ordinary dividends, which would probably be entirely legitimate with the proviso given above that the purchase be purely formal. A few states have statutes specifically allowing the surplus appearing on the books of the constituent corporations to be entered as earned or paid-in surplus on the books of the surviving corporation.[1]

5. Surplus from Reduction of Capital Stock

Assuming that a reduction of capital stock is legally authorized,[2] the surplus created by the reduction is virtually paid-in surplus. Thus, in case a corporation with $100,000 fully-paid capital stock reduces its capital stock to $50,000, the situation is that the stockholders have contributed $100,000, that they hold only $50,000 par-value stock, and, assuming there is no shrinkage in the assets, there is a surplus, according to the definition given above, of $50,000. It is clear that this surplus was paid in by the stockholders and should be looked upon as any other paid-in surplus.[1] What items may be charged against this depends upon the statutes under which the corporation was organized. Subject to varying restrictions for the protection of creditors, the statutes allow surplus arising from a reduction of capital stock to be charged off by distributions of an equivalent amount of assets to the stockholders.[2] A few corporation acts provide that a surplus resulting from reduction of capital stock may be written off against a deficit arising from losses or diminution in the value of assets.[3]

6. Surplus and Deficits

It is inconsistent to show on the balance-sheet an operating deficit and, at the same time, an operating surplus, as one shows that the net proprietorship has decreased; the other that it has increased. Some statutes allow dividends to be paid out of the net earnings of the current fiscal period, without taking into account an offsetting or outweighting operating deficit incurred in preceding periods.[4] Where this is the case the deficit, which is properly the debit balance of the earned-surplus account, should be shown in the balance-sheet as a subtraction from capital stock. At the same time the earnings of the current period may be shown as an item of proprietorship.

PART IV

CONSOLIDATED STATEMENTS

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CONSOLIDATED STATEMENTS

I. Purposes of Consolidated Statements

The growth of systems of interrelated companies, all of which are under a single unified control, creates a need for a general picture of the entire system. The consolidated balance-sheet and the consolidated income statement have been devised to supply that need. Since in such cases the interests of most of the parties concerned are identified mainly with the financial welfare of the entire system, statements which will disclose the position and earnings of the system as a whole are indispensable. Such statements refer to no actual corporation, nor to any particular ledger, and for this reason rules which would be binding in regard to the statements of a single corporation are to some extent to be disregarded. The obvious danger in such statements is that the standing of interests identified exclusively with one corporate unit of the system may be concealed, either incidentally or intentionally, in the combined figures.

This situation points at once to the general rule that, while consolidated statements are useful and necessary in practically all cases of unified ownership and control, yet whenever there are important interests in a particular corporation, such as may not be fully reflected in consolidated statements, then separate statements for that corporation should be made available, in addition to the consolidated statements.

II. Conditions in Which Consolidated Statements Are Desirable

It is generally accepted that consolidated statements are to be used only when the holding company owns a controlling interest in the affiliated corporation. The usual interpretation of this, and the rule followed by the Securities and Exchange Commission, is that more than 50 per cent. of the voting stock must be so held.[1] As a matter of fact, control may be effective with ownership of less than 50 per cent. when the stock is widely distributed in small holdings. The consolidated statement may logically be used in cases where there is no stock control, but an entire plant is operated under a long-time lease, equivalent to effective ownership.

Practice is more rigid than the rules of the Securities and Exchange Commission, most of the larger holding companies requiring a percentage of ownership considerably higher than 50 per cent. Requirements of 75 per cent., or even 90 per cent. ownership are not uncommon as self-imposed rules.

The consolidated statements should be based on statements of subsidiary companies of approximately the same date.

The several statements entering into a consolidated statement should be prepared in accordance with reasonably uniform accounting principles, as otherwise there will result a combining of unlike quantities.

It is desirable that consolidated statements should show the basis on which subsidiaries have been included and excluded, as well as an explanation of the treatment of important items affected by consolidation. This procedure is followed by some corporations in their reports to stockholders.

III. Consolidated Balance-sheet

The consolidated balance-sheet should show all the assets and all the liabilities which make up the composite enterprise in net totals for the several items.

This implies that the liabilities of one member of the consolidation to another member which lists them as assets should be canceled out (eliminated) for both corporations.

It also requires that the full amounts of assets and liabilities held by the constituent companies be shown, and not merely the pro-rata share of the holding company. While the latter method has been recommended, it produces fragmentary and confusing results.

A. Valuation of Assets

The figures in the consolidated balance-sheet are generally based upon the amounts shown in the books of the several companies. But a difficulty arises because the stock of a subsidiary company is rarely bought at a price equal to its book value. The result is that the value of the subsidiary business in the parent books is greater or less than its value as shown in its own books.

1. Where Amount Paid Exceeds the Net Book Value of Subsidiary

In the past it has been quite common to leave this difference unallocated, as regards specific assets of the subsidiary, at the time when the parent acquired the subsidiary stock. But the question must be faced immediately when a consolidated balance-sheet is prepared.

The usual assumption, in such circumstances, has been that any amount paid for stock in excess of its book value represented goodwill. Sometimes the aggregate amount of property has been shown, at the parent or larger valuation, and described as "property, plant, and goodwill," thus avoiding the necessity for allocating the excess of parent valuation as between tangible and intangible property. Where this practice has been followed for many years, it becomes impossible to make any such segregation, except by the exercise of arbitrary judgment. The Securities and Exchange Commission has recognized this situation by allowing such companies to continue to use the heterogeneous item.[1]

But such practice would not be satisfactory in new consolidations. When the subsidiary stock is first acquired by the parent, it should be determined at what amounts the parent is valuing the tangible and intangible properties, respectively, and some record made which will enable future consolidated balance-sheets to be properly prepared.

If the increased valuation, or part of it, is attributed to tangible property, some accountants make it a rule to write up the value of that property in the subsidiary books, before they will consent to show the tangible property at increased value in the consolidated balance-sheet.

When it is not convenient or possible to allocate the excess holding value to specific items, it may be shown in the consolidated balance-sheet, or in a capital surplus schedule, as a separate item under a title such as: Excess of cost of stocks of subsidiary companies over the net values on the books of that company at date of acquisition.[1]

2. Where Amount Paid Is Less Than the Net Book Value of Subsidiary.

This case resolves into two alternatives:

(a) the subsidiary assets are over-valued in the subsidiary books, or

(b) that which has been given for them is worth more than its book amount.

In the former of these two cases the treatment indicated for the consolidated balance-sheet is to write down the values as shown in the subsidiary books. If the amount of such devaluation cannot be attributed to specific assets, it may be stated separately under such a title as: Excess of book value of subsidiaries' securities over carrying value of investment therein. In the premises this would be equivalent to a reserve for depreciation.

The second case stated above can result only when the subsidiary securities were paid for in stock issued by the parent company; the excess is then a paid-in premium to the parent company. In those conditions the item excess of book value of subsidiaries' securities over carrying value of investment therein is properly a paid-in or capital surplus in the consolidated balance-sheet.

B. Pre-existing Surplus

The purchase price of subsidiary stocks, has in fact purchased an equity in the subsidiary represented by both its capital and its surplus. In the consolidated balance-sheet the carrying value is therefore logically to be eliminated against both capital and surplus of the subsidiary. Thus subsidiary surplus prior to consolidation has no place in the consolidated balance-sheet.

On the same basis, dividends received by the parent from a subsidiary, out of surplus accumulated prior to consolidation, are not true income to the parent, but are a return of capital. The logical treatment is therefore to credit such dividends to the carrying value of the subsidiary stock in the parent books.

C. Minority Interests

Minority interests should be shown in the consolidated balance-sheet and should include both capital and surplus. The amount of each should be separately shown.

The practical solution which most accountants have given to the difficulty of making a proper showing of minority interests in the consolidated balance-sheet is to show them at the value at which they are recorded in the books of the subsidiary. Since the consolidated balance-sheet shows all the assets held by the constituent companies and not merely the pro-rata share of the holding company, the statement of minority interests at their book value on the books of the subsidiary may result in showing a disproportionate equity in the net assets allocable to the minority interests. The writing up of assets in the books of the subsidiary at the time of consolidation, with a corresponding increase in the book value of the stockholders' equity, would avoid such a disproportionate showing; but it would show unrealized surplus, and might introduce goodwill not actually purchased, on the books of the subsidiary.

IV. Consolidated Income Statement

Intercompany sales and intercompany profits are to be eliminated from the consolidated income statement.

The consolidated income statement should state what treatment has been accorded to intercompany transactions.

Intercompany profits of a subsidiary in which there are substantial minority holdings should be retained in the consolidated income statement to the extent that the goods sold are still in the inventories of other companies in the system. This will involve valuing the inventories accordingly.

PART V

COMMENTS AND FOOTNOTES IN FINANCIAL REPORTS

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COMMENTS AND FOOTNOTES IN FINANCIAL REPORTS

The wide range of information sought to be conveyed in financial statements may require explanations outside the statements proper. While it is not desirable that the officers of the company undertake the interpretation of its financial condition, they can, nevertheless, often throw additional light on matters expressed baldly in the statements. These explanations take the form of either (a) narrative comments, (b) supplementary schedules, or (c) footnotes. The comments, schedules, and notes referred to are to be distinguished from information not of an accounting nature which is often contained in reports to stockholders and in prospectuses.

Narrative comments on the principal features of the balance-sheet and income statement are likely to be helpful. Explanation is especially in order with respect to the movement of profits, changes in current position, and new or unusual items appearing in the statements.

Whenever substantial analysis of some item would be helpful, it may be furnished in a supplementary schedule. Schedules are especially appropriate for plant, depreciation reserves, investments, and inventories in the balance-sheet, and for sales, cost of goods sold, and some expense items in the income statement.

No new principles of accounting are involved in the preparation of schedules. They present additional materials from the ledger, supplementing the aggregate items in the balance-sheet and income statement.

Footnotes constitute a less elaborate vehicle for conveying additional information. They are of two main types: (1) notes explanatory of specific items contained in the statements and (2) those calling attention to items which, because of uncertainty as to their amount or nature, cannot be included within the statements, though they may at some time have a bearing upon financial condition.[1] While necessary footnotes should be appended, it should be remembered that, if carried to unreasonable length or complexity, they tend to obscure the significance of the statements.

PART V

COMMENTS AND FOOTNOTES IN FINANCIAL REPORTS

PART VI

SUMMARY OF ACCOUNTING PRINCIPLES

The following enumeration of accounting principles is to be read as a very general summary of the report. Each proposition is to be construed in the light of the relevant discussion in the body of the report.

I. General Principles

A. Accounting should make available all material information of a financial nature relating to (a) the financial condition or status of the business, (b) its progress in earning income.

B. Transactions which add to or subtract from capital must be distinguished from those which add to or subtract from revenue, and, where both kinds of change occur in one transaction, the extent of each must be shown.

C. A reliable historical record must be made of all transactions of the business; but this record must also be analytical, or susceptible to subsequent analysis, to preserve the necessary distinction between capital and income.

D. The use of long-term assets involves the apportionment of capital and income over the several accounting periods; the accuracy of the accounts depends in large measure upon the exercise of competent judgment in making these apportionments.

E. The basis of the treatment applied to the several items should be adhered to consistently from period to period; when any change of treatment becomes necessary, due attention should be drawn to the change.

F. The possible extent of unforeseen contingencies of adverse character calls for a generally conservative treatment of items to which judgment must be applied.

II. Income Statement Principles

A. The income statement should show, for the period it covers, (a) income from all sources, (b) costs and expenses of all kinds, and (c) net income.

B. Only income realized by the sale of goods or rendering of service is to be shown in the income statement. Unrealized income should not be recorded, nor utilized to absorb proper charges against earnings.

C. Income from sources other than the main operations of the business should be stated separately.

D. Costs and expenses must include:

- (a) all current operating costs,
- (b) inventory losses of the period,
- (c) provision for losses on other current assets, which have become imminent in the period,
- (d) proper allocations for the depreciation, depletion, or amortization of all capital assets subject to those processes.

E. Nonrecurring items should be reported in terms which indicate their nature.

F. As far as possible net income should be so determined that it will need no subsequent correction. When, however, such correction becomes necessary, it may be made through current income only if it is not so large as to distort the statement of that income; otherwise it should be made through earned surplus.

III. Balance-sheet Principles

A. A balance-sheet should show (a) the nature and amounts of the assets, (b) the nature and amounts of the liabilities, (c) the nature and amounts of the invested capital, (d) the amounts of earned and of capital surplus.

B. With reference to fixed or capital assets in the balance-sheet:

1. The amounts should be based upon the amounts invested in such assets.
2. Reserves for depreciation, depletion, and amortization should show the cumulative progress of prorating their cost over their useful lives.
3. Proper distinction should be made between (1) tangible assets, (2) intangibles, and (3) investments.

C. The proper showing of current assets requires:

1. that inclusion or exclusion of particular items be determined on the same time basis as is applied to current liabilities;
2. that the values in general be the lowest of cost, replacement market, or realization, as may be applicable for the several items;
3. that reserves be plainly associated with the current assets to which they apply;
4. that separate mention be made of items not in the ordinary course of business.

D. Particular care must be given in reporting deferred charges:

1. to the distinction between charges inuring to the benefit of future periods and losses actually sustained;
2. to the basis of amortization, which in general should be the periods to be benefited by the deferred charges.

E. Contingent liabilities should be noted in the balance-sheet or in a footnote, if they are material, imminent, and of reasonably determinable amount.

F. Reacquired stock should be shown as a deduction from capital stock, unless exceptional circumstances justify showing it as an asset, when the reason should be given.

G. The restatement of capital assets at higher values results in capital surplus. Restatement at lower values may result in a subtraction from capital, capital surplus, or earned surplus, depending on circumstances.

H. Capital surplus should not be utilized to relieve either earnings or earned surplus of charges which should be made against them.

IV. Consolidated Statements

A. Consolidated statements should include only units which are effectively controlled by the parent company.

B. The amount at which the stock of a subsidiary is carried in the parent company books constitutes in effect a revaluation of the subsidiary properties, either tangible or intangible, and is reflected as such in the consolidated balance-sheet.

C. Surplus of subsidiaries existing at the time when control of them was acquired by a parent company should not be shown in the consolidated balance-sheet.

D. Minority interests in subsidiaries may be shown in the consolidated balance-sheet at their net value in the subsidiary books.

V. Comments and Footnotes

A. Comments, footnotes of reasonable length, and supplementary schedules may be used to elucidate items in the statements calling for explanation, or to supplement the statements.

NOTES

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1. "He (the accountant) knows as well as any one how many guesses lurk behind the figures to which he has given mathematical exactitude." (Professor Nathan Isaacs, in *Harvard Law Review,* Vol. XLVI, No. 5, p. 786.)

"Mathematical accuracy in the balance-sheet is a delusion," remarked a leading banker in conversation.

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1. 1 S. E. C. 46.

Page 16

1. Andersen, Arthur, "Present-day Problems Affecting the Presentation and Interpretation of Financial Statements," *Journal of Accountancy,* November, 1935, p. 341.

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1. The showing of unrealized gain from appreciation as income is disapproved. See *infra,* pp. 39–40.

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1. *Schedule VIII of Form 10* of the Securities and Exchange Commission is an example.

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1. A line of English cases of which the leading one is *Verner* v. *General & Commercial Investment Trust* (1894), 2 Ch. 239, frequently is discussed in connection with capital gains and losses. However, these cases deal with such gains or losses in relation to the payment of dividends. They do not bear directly upon the problem of the inclusion or exclusion of capital gains and losses in the income statement. These cases are discussed in the section of this report dealing with dividends.

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1. The dividends which are discussed here are distributions made to stockholders while the corporation is a going concern and ex-

pected to continue as such. There is no discussion of distributions made to creditors or stockholders upon dissolution.

2. See Ballantine, "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws," 23 *Cal. L. Rev.* 229, 233 (1935).

The English cases seem to disregard this principle in their doctrine with respect to "fixed capital" and "circulating capital." That doctrine allows the payment of dividends from current income computed without deducting a loss of "fixed capital." See *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch. D. 1; *Verner* v. *General & Commercial Investment Trust* (1894), 2 Ch. 239; *Wilmer* v. *McNamara & Co., Ltd.* (1895), 2 Ch. 245; *City Property Investment Trust* v. *Thorburn*, 25 Ct. of Sess. Cas. 361 (1897); *Ammonia Soda Co., Ltd.* v. *Chamberlain* (1918), 1 Ch. 266; *Hill* v. *Permanent Trustee Co. of N. S. W., Ltd.* (1930) A. C. 720. For a discussion of the English cases see Ballantine, *supra* p. 252; Weiner, "Theory of Anglo-American Dividend Law," 28 *Col. L. Rev.* 1046 (1928).

3. The amount paid in by stockholders which must be regarded as "capital stock" or "stated capital" is discussed in the section of this report entitled "Capital Stock."

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1. See Ballantine, "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws," 23 *Cal. L. Rev.* 259 (1935). The Michigan statute provides: "In determining what is earned surplus the judgment of the board of directors shall be conclusive unless it shall be shown that the directors acted in bad faith or were grossly negligent." Mich. P. A. 1931, No. 327, §22, as amend. P. A. 1935, No. 194. Under the Maryland statute "good accounting practice" is the criterion. Md. Code Ann., §87, as amend. L. 1931, c. 480.

2. Idaho Code (1932), §29–129; Ia. B. C. A. (1928), §26; Minn. B. C. A. (1933), §21; Ohio Gen. Code, §8623–38; Pa. B. C. L. (1933), §701, as amend. L. 1935, Act 361; Vermont Pub. Laws (1933), §5850.

3. See for example the Pennsylvania statute cited *supra*, Pa. B. C. L., §701.

4. *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, 13 (1909); *Whittaker* v. *Amwell Nat'l Bank*, 29 Atl. 203, 205 (1894); *People* v. *State Board of Tax Com'rs*, 89 N. E. 581, 586 (1909), modifying 112 N. Y. Supp. 392, 395 (1908); *People* v. *State Board of Tax*

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Com'rs, 120 N. Y. Supp. 528, 531 (1909), aff'd 92 N. E. 1098 (1910); *Boothe* v. *Summit Coal Mining Co.*, 55 Wash. 167, 172 (1909); *People* v. *Stevens*, 96 N. E. 114, 118 (1911), rev'g 128 N. Y. Supp. 440, 447 (1911). *Exceptions are: Eyster* v. *Centennial Board of Finance*, 94 U. S. 500, 503 (1876); *U. S.* v. *Kansas Pacific R. R. Co.*, 99 U. S. 455, 459 (1878); *Guaranty Trust Co.* v. *Grand Rapids, G. H. & M. Ry. Co.*, 7 F. Supp. 511, 520 (Mich. S. D. 1931).

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1. Ark. L. 1931, c. 255, §25; Cal. Civ. Code, §346; Del. Gen. Corp. L. (1935), §34; Idaho Code (1932), §29–129; Ind. Gen. Corp. Act (1929), §12; La. B. C. A. (1928), §26; Mich. P. A. 1931, No. 327, §22 as amend. P. A. 1935 No. 194; Minn. B. C. A., §21; Ohio Gen. Code, §8623–38; Pa. B. C. L. (1933), §701, as amend. L. 1935, Act 361; Wash. Rev. Stat. (Remington, 1932), §3803–24; W. Va. Code (1931) c. 31, Art. I, §70 as amend. L. 1935, c. 24.

2. *Ibid.* The California and Minnesota statutes further require that notice be given the stockholders that the dividend which they are receiving is based on income determined without deducting depletion.

3. *Excelsior Water and Mining Co.* v. *Pierce*, 90 Cal. 131 (1891). See also *People ex rel.* v. *Roberts*, 156 N. Y. 585 (1898); *Dealers' Granite Corporation* v. *Faubion*, 18 S. W. (2d) 737 (Texas, 1929); *De Brabant* v. *Commercial Trust Co.*, 113 N. J. Eq. 215 (1933).

4. *Federal Mining & Smelting Co.* v. *Wittenberg*, 15 Del. Ch. 409 (1927).

5. Cal. Civ. Code, §346; Ill. B. C. A., §41 (c) (No dividend from unrealized appreciation in value or from a revaluation of assets); Ind. G. C. A. (1929), §12 (unrealized appreciation or revaluation); La. L. 1928, Act 250, §26 (unrealized appreciation or revaluation or unrealized profit except that which has accrued on readily marketable securities); Idaho Code (1932), §29–129 (unrealized appreciation or revaluation or unrealized profit except that which has accrued on readily marketable securities); Mich. P. A. 1931 No. 327, §22 as amend. P. A. 1935, Act 194 (unrealized appreciation); Minn. B. C. A. (1933), §21 (unrealized appreciation except readily marketable securities); Ohio Gen. Code §8623–38 (unrealized appreciation); Pa. B. C. L. (1933), §701, as amend. L. 1935, Act 361, §§702–3 (unrealized appreciation or revaluation); Wash. Rev.

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Stat. (Remington, 1932), §3803–24 (unrealized appreciation except readily marketable securities). But *cf.* Wis. Stat. (1931), §182.19.

6. *Kingston* v. *Home Life Insurance Co.,* 11 Del. Ch. 258, 271–272 (1917); *Southern California Home Builders* v. *Young,* 45 Cal. App. 679, 695 (1920). See Weiner, "Theory of Anglo-American Dividend Law," 30 *Col. L. Rev.* 330, 341–2, citing a holding of the Supreme Court of New York, *Wilson* v. *Barnett, N. Y. Law Jour.,* Aug. 2, 1928. In California and possibly in Minnesota the statutes do not prohibit a stock dividend on the basis of unrealized appreciation.

7. See the statutes cited *supra,* note 5.

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1. For the reasons given by Ballantine, "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws," 23 *Cal. L. Rev.* 240, it is believed to be a reasonable opinion that the following statutes, notwithstanding their obscure and diverse language, enact this type of restriction: Ark. L. 1931, c. 255, §25; Fla. Comp. Gen. Laws (1927), §6549; Idaho Code (1932), §29–129; Kans. Rev. Stat. (1923), §17–608; La. B. C. A. (1928), §26; Me. Rev. Stat. (1930), c. 56, §37, as amend. L. 1933, c. 53; Mont. Rev. Code (1935), §5939; Nev. Comp. Laws (1929), §1625, as amend. L. 1931, c. 224, §8; N. J. Comp. Stat. Supp., §§47–30, 47–47, (1930); N. Mex. Stat. Ann. (1929), c. 32, §135; N. Y. S. C. L., §58; R. I. Gen. L. (1923), c. 248, §§38, 41; S. Dak. Rev. Code (1919), §8789; Tenn. Code (1932), §§3737, 3886; Vt. Pub. Laws (1933), §5850; Va. Code (1930), §3840 as amend. L. 1932, p. 132; Wash. Rev. Stat. (Remington, 1932), §3803–24; Wis. Stat., §182.19.

2. In some states, in addition to the general restrictions upon dividends, there are statutes specifically regulating the payment of dividends out of paid-in, reduction, and re-appraisal surplus. See §3b, c, and d, pp. 50–51 *infra.*

3. Mich. P. A. 1931, No. 327, §22 as amend. P. A. 1935, No. 194; Pa. B. C. L. (1933), §§701, 702, 704 as amend. L. 1935, Act No. 361. The Michigan and Pennsylvania statutes allow dividends to be paid from other than earned surplus on preferred stock only and require that in case of such a payment notice shall be given to the recipients that the dividend is not based on income.

4. Del. Gen. Corp. L. (1935), §34.

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5. Calif. Civ. Code, §346 as amend. L. 1933, c. 533, §49; Colo. Comp. L. (1921), §2270; Ill. B. C. A. (1933), §41; Ind. Gen. Corp. Act (1929), §12; Iowa Code (1935), §8378; Ky. Stat. (Carroll, 1930), §548; Md. Code Ann., §87 as amend. L. 1931, c. 480; Minn. B. C. A., §21; Mo. Rev. Stat. (1929), §4942; Ohio Gen. Code, §8623–38; Oregon Code (1930), §25–219; W. Va. Code (1931), c. 31, Art. I, §§78, 70 as amend. L. 1935, c. 24; Wyo. Rev. Stat. (1931), §28–131. See also Conn. Gen. Stat. (1930), §3386. In a few states the insolvency limitation stands alone. Mass. Gen. Laws (1932), c. 156, §37; Miss. Code (1930), §4149; N. H. Pub. Laws (1926), c. 225, §79; Texas Rev. Stat. (1925), Art. 1347. The North Carolina statute contains a limitation that a dividend shall not be paid if the debts of the corporation exceed two thirds of its assets. No. Car. Code (Michie, 1931), §1179 as amend. L. 1933, c. 354, §1.

6. See *ibid.* and the discussion by Weiner, "Theory of Anglo-American Dividend Law," 29 *Col. L. Rev.* 461, 463 *et seq.*

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1. *Supra,* p. 48.
2. *Supra,* p. 46.
3. *Supra,* p. 46.
4. It should be noted that the application of this and the following types of dividend statutes may vary where the "wasting assets" doctrine, discussed *supra,* p. 47, obtains. If the pre-existing deficit, supposed in the present discussion, had arisen wholly or in part through deducting depletion of wasting assets in determining income for prior periods, and, if, in the particular jurisdiction the legal rules for determining income for dividend purposes do not require that such a deduction be made, the pre-existing deficit may be disregarded, to the extent that it arose through the deduction of depletion, in determining the amount which may be paid as dividends.

It might be believed that, if there were an income for the period, the above conclusions could not be sustained under the statutes which phrase this first type of restriction in the alternative form that dividends may be paid from "net earnings or surplus" or "surplus or net profits." Statutes so phrased in the alternative seem to permit income for the period (despite a pre-existing deficit) as one of the measures, alternative to "surplus," of the amount up to which dividends may be paid. However, the better opinion is that these statutes do not authorize dividends up to the amount of income

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for the period (despite a deficit) but that the alternative form of expressing this type of restriction indicates merely that the amount which is placed as a limitation on the payment of dividends includes income for the current period as well as pre-existing surplus. For a discussion of this question see Ballantine, *supra* note 2, p. 45, at page 241.

5. *Supra*, p. 48.
6. *Supra*, p. 46.
7. *Supra*, p. 48.
8. *Supra*, p. 48.

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1. *Supra*, p. 46.
2. Cal. Civ. Code, §346; Minn. B. C. A., §21. The California statute limits such payments to the amount of income for the "preceding accounting period which shall not be less than six months nor more than one year in duration." The Minnesota act allows dividends up to the amount of income for the "current or for the preceding fiscal year" subject to a provision for the protection of outstanding stock having a preference upon liquidation.
3. *Supra*, p. 46.
4. *Supra*, p. 46.
5. The statutes containing the solvency limitation are cited *supra*, note 5, p. 48.

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1. Cal. Civ. Code, §346; Ill. B. C. A. (1933), §41; Mich. P. A. 1931, No. 327, §22, as amend. P. A. 1935, No. 194; Pa. B. C. L. (1933), §704.
2. Minn. B. C. A., §21.
3. La. B. C. A. (1928), §26; Ohio Gen. Code, §8623-38; Va. Code (1930), §3840 as amend. L. 1932, p. 132.
4. Inc. Gen. Corp. Act (1929), §12.
5. See the discussion by Weiner, "Theory of Anglo-American Dividend Law," 29 *Col. L. Rev.* 461, 471 *et seq.* and cases there cited.
6. *Supra*, note 5, p. 50; note 2, p. 51.
7. Del. Gen. Corp. L. (1935), §34.
8. Twelve states, Alabama, Arizona, Kansas, Kentucky, Michigan, Mississippi, New Jersey, New Mexico, North Carolina, Oregon, Pennsylvania, and Vermont, place no specific statutory restrictions on the distribution of reduction surplus. In New Jersey

the courts have said that such a distribution must not affect the rights of creditors nor impair the capital of the corporation. *Continental Securities Co.* v. *Northern Securities Co.*, 66 N. J. Eq. 274 (1904). This general restriction appears in the statutes of Nebraska and Virginia. Nebr. Comp. Stat. (1929), §24–103; Va. Code (1930), §3781, as amend. Laws 1932, p. 131. A larger group of states make "solvency" the limit beyond which such a distribution may not extend. Ark. Laws, 1931, c. 255, §24; Conn. Gen. Stat. (1930), §3420, as amend. Laws, 1935, c. 53, §1; Fla. Comp. Gen. Laws (1927), §6548; Idaho Code Ann. (1932), §29–148; Ill. Rev. Stat. Ann. (1934), c. 32, §157.60; Ind. Stat. Ann. (1929), §4851; La. Gen. Stat. (1932), §1126; Md. Ann. Code (Bagby, 1924) Art. 23, §32, as amend. Laws, 1931, c. 480, as amend. Laws, 1937, c. 504, §6; Mass. Gen. Laws (1932), c. 156, §45; Minn. Stat. (1936), §7492–38; Nev. Laws, 1931, c. 224, §7 (there is also a provision that the assets remaining must be sufficient to pay debts, the payment of which has not been otherwise provided for); N. H. Pub. Laws, 1926, c. 225, §47; N. Y. S. C. L., §38, as amend. Laws, 1926, c. 310 and Laws, 1934, c. 764, §4; Ohio Gen. Code, §8623–40 (with the additional provision that there shall be no such distribution if there is reasonable ground to believe that the corporation is, or will be, unable to satisfy its debts); R. I. Gen. Laws, §3518, as amend. Laws, 1932, c. 1941, §3; Tenn. Code (1934), §3736; Wash. Rev. Stat. Ann. (Remington, 1935), §3803–40. A few statutes provide that the assets remaining must be "sufficient to pay any debts, the payment of which has not been otherwise provided for." Colo. Comp. Stat. (1932), §2281; Del. Rev. Code, c. 65, §28, as amend. Laws, 1933, c. 91, §5; Me. Rev. Stat. c. 56, §51, as amend. Laws, 1931, c. 183; Nev. Comp. Laws, above; W. Va. Laws, 1935, c. 26. A few states provide that the capital stock, as reduced, must exceed existing liabilities. Mo. Stat. Ann. (1932), §4948; Mont. Rev. Code Ann., §5927; Utah Rev. Stat. Ann. (1933), §18–2–44 (must exceed liabilities by 50 per cent.); Wyo. Rev. Stat. Ann. (1931), §28–136; also, D. C. Code (1929) tit. 5, §290. The California statute is unique in the provision that "no distribution or withdrawal of such reduction surplus may be made under the authority of this section unless the board of directors determine that by such distribution or withdrawal the corporation will not be rendered unable to satisfy its debts and liabilities when they fall due and that the assets of the corporation after such distribution or withdrawal taken at their fair present value will at least equal one and one-quarter times its debts

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and liabilities." Civ. Code, §348 b, as amend. Laws, 1933, c. 533, §52. For a further discussion see Callahan, "Statutory Regulation of Reduction of Capital Stock," (1935) 2 *O. S. U. Law Jour.* 220.

9. *Supra*, p. 46.

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1. The more relevant of the statutory provisions are collected in Nos. 26, 27, 32, and 34 of the current edition of the *Corporation Manual.* For a discussion of the manner of holding meetings, the sufficiency of a quorum, etc., see 1 Morawetz, *Corporations* (2nd Ed.), §§474–490, 505–507, 510–511, 531–533, 536; 3 Cook, Corporations (8th Ed.), §§588–608; Fletcher, *Cyclopedia of Corporations* (1932), Vol. 2, §§391–433, 526, Vol. 5, §§1996–2024. The relevant provisions of the articles of incorporation and by-laws must be determined by an examination of those instruments.

2. See Berle, A. A., "Non-Cumulative Preferred Stock," 23 *Columbia Law Review* 358.

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1. It is to be noted that in a period of inflation to state plant unit costs in terms of the pre-inflation dollars, and to combine this with other items whose cost is expressed in inflated dollars constitutes an addition of unequal units. It is, of course, a debatable matter as to the degree of inflation which makes it expedient to make adjustment in the accounts because of a change in the monetary unit. In the United States accountants have generally ignored changes in the price levels, and some have even denied their signficance.

2. Federal Communications Commission, *Uniform System of Accounts for Telephone Companies,* issue of June 19, 1935; Instruction 3–S. 1. This regulation has been upheld by the United States Supreme Court. *American Telephone and Telegraph Co. et al.* v. *United States et al.,* 299 U. S. 232 (1936).

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1. Many states have statutes prohibiting the issuance of stock at a discount and/or providing that where stock is issued for property the judgment of the directors shall be conclusive as to the value of such property in the absence of fraud. Ark. L. 1931, c. 255, §10; Conn. Gen. Stat., §3393; Del. G. C. L. §14; Fla. Comp. Gen. L. (1927), §6537; Idaho Code (1932), §§29–120–122; Ill. B. C. A., §§17, 18; Ind. G. C. A. (1929), §6; Iowa Code (1935), §8412; Me. Rev. Stat. (1930) c. 56, §18; Md. Code. Ann. (Bagby, 1924), §42,

as amend. L. 1927, c. 581; Mass. Gen. L. (1932) c. 156, §15; Mich. P. A. 1931, Act. No. 327, §§18, 21; Minn. L. 1935, c. 117, §2; Nev. Comp. L. (1929), §1611; N. Y. S. C. L., §69; N. Car. Code (Michie, 1931), §§1157, 1158; N. Dak. Comp. L. (1913), §4527; Pa. B. C. L. (1933), §603; Tenn. Code (1932), §3725; Vt. Pub. L. (1933), §5830; W. Va. Code (1931) c. 31, Art. 1, §§25, 28; Wis. Stat., §182.06. In several states there are constitutional provisions that no corporation shall issue stock except for money, labor done or property received and all fictitious increase of stock shall be void. Ariz. Const. Art. XIV, §6; Colo. Const. 1876, Art. XV, §9; Idaho Const., Art. XI, §9; La. Const. Art. XIII, §2; Mo. Const. Art. XII, §8; Mont. Const. Art. XV, §10; Neb. Const. Art. XII, §6; N. Dak. Const. Art. VII, §138; Okla. Const. Art. IX, §39; S. Car. Const. Art. IX, §10; S. Dak. Const. Art. XVII, §8; Utah Const. Art. 12, §5. These constitutional provisions have been held to prohibit the issuance of stock at a discount, e. g., *Rolapp* v. *Ogden and Northwestern R. R. Co. et al.* 37 Utah 540 (1910). See also *Bivens* v. *Hull*, 58 Colo. 338 (1914); *Garrett* v. *Kansas City Coal Mining Co.*, 113 Mo. 330 (1892).

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1. See *infra*, Reserves, pp. 84–85.

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1. Analysis of 500 balance-sheets for 4 years shows:

RESERVE FOR DEPRECIATION OR RETIREMENTS—HOW SHOWN

	1936	*1935*	*1934*	*1933*
Reserve shown, deducted on asset side..	371	365	359	348
Reserve shown on liability side (about 60 being utilities).................	89	80	86	96
Reserve indicated, but amount not shown, as asset is stated net........	23	26	26	27
	483	471	471	471
None shown, no property asset........	22	29	29	29
	* 505	500	500	500

* Some had more than one item

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1. See *supra*, pp. 31–32.

PAGE 66

1. *Instruction Book for Form 10,* 1937, p. 19.

2. *Uniform System of Accounts for Telephone Companies,* issue of June 19, 1935, p. 47.

3. S. E. C., *Instruction Book for Form 10,* 1937, p. 19.

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1. *Instruction Book for Form 10,* 1937, Schedule IV, Note 2.

2. Lord Eldon in *Cruttwell* v. *Lye,* 17 Ves. 335, 346 (1810). This definition has been repeated frequently, e. g., *Bell and Harrison* v. *Ellis,* 33 Cal. 620, 625 (1867); *Myers* v. *Kalamazoo Buggy Co.,* 54 Mich. 215, 222 (1884); *White* v. *Trowbridge,* 216 Pa. 11, 20 (1906); *Duke* v. *Allen,* 204 Ala. 15, 17 (1920); *Hines* v. *Roberts Bros.,* 117 Kans. 589, 594 (1925); *Jones* v. *Stevens,* 112 Ohio St. 43, 52 (1925). Some courts have said that "goodwill" should be defined to include every possible advantage that has been acquired by a firm in carrying on its business and that Lord Eldon's definition is too narrow. *Ginesi* v. *Cooper & Co.,* 14 Ch. Div. 596, 600 (1880); *Rowell* v. *Rowell,* 122 Wis. 1, 17 (1904); *Hilton* v. *Hilton,* 89 N. J. Eq. 182, 185 (1918). See also *Goetz* v. *Ries et al.,* 123 N. Y. Supp. 433, 435 (1907); *Pfleghar Hardware Specialty Co.* v. *Blair,* 30 F. (2d) 614, 616 (C. C. A. 2d, 1929).

3. American Institute of Accountants, *Accounting Terminology* (New York: The Century Co., 1931), p. 67.

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1. They have not, however, been accepted by the Treasury Department.

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1. The accounting system of the Federal Communications Commission, effective January 1, 1936, allows this. Instruction 15 (C), p. 10.

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1. See *Gartenlaub* v. *Union Trust Co. of San Francisco,* 198 Cal. 204 (1926); *New York Life Ins. & Trust Co.* v. *Baker,* 165 N. Y. 484 (1901); *McLouth* v. *Hunt,* 154 N. Y. 179 (1897); *Shaw* v. *Cordis,* 143 Mass. 443 (1886); *Hemenway* v. *Hemenway,* 134 Mass. 446 (1883).

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1. E.g., Calif. C. C., §358, as amend. L. 1933, C. 533, §57. See also Mass. Gen. Laws c. 156, §47; Mich. P. A. No. 194 (1935) as

amend. P. A. No. 350 (1937). The California requirement relates to annual balance-sheets submitted to shareholders; those of Massachusetts and Michigan to the annual report filed with the Secretary of State. The rules of the Securities and Exchange Commission require the separate statement of shares authorized and shares outstanding in applications for registration. *Instruction Book for Form 10,* 1937, p. 20. The absence in most jurisdictions of statutory requirements creates no objection to the separate showing of stock authorized and stock issued. There appear to be no decisions relating to the balance-sheet treatment of authorized and issued capital stock.

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1. The requirements that each class of stock should be separately stated are contained in the statutes cited in note 1, p. 85. Such separate statement was approved by way of dictum in a recent Delaware case. *Sapperstein* v. *Wilson & Co.,* 182 Atl. 18 (Del. Chancery, 1935).

2. California C. C., §300b, as amend. L. 1933, c. 533, §9.

3. The handling of stock premium in the balance-sheet has not, it is believed, been the subject of judicial decision. For a discussion of stock premium as an account against which to charge the payment of dividends, see the section of this report dealing with dividends.

4. California C. C., §300b, as amend. L. 1933, c. 533, §9.

5. Ohio Gen. Code, §§8623–16, 8623–37.

6. Under the rule of *Handley* v. *Stutz,* 139 U. S. 417 (1891), a corporation, which is in straitened financial circumstances and in urgent need of funds, may issue its stock for the best available consideration and the purchaser will not be liable for the discount. This rule has been incorporated into the statutes of a few states (Calif. C. C., §299; Ohio Gen. Code, §8623–16) and it has been accepted by the courts in most of the other states unless the statute clearly cuts off all discretion in the matter. Bonbright, "Shareholders' Defenses Against Liability to Creditors on Watered Stock," 25 *Columbia Law Rev.* 408 (1925).

7. See note 1, p. 60.

8. I. C. C., *Uniform System of Accounts for Steam Roads,* revised to Jan., 1936, Wash., D. C., p. 137, §2.

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1. The likelihood that holders of shares issued at a discount will

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be held liable for the amount of the discount is small. See Bonbright, *supra,* note 6, p. 86. That the holders of the shares will be held liable for the amount of the discount, when the premium on other outstanding shares equals or exceeds the total discount on all shares, is even less likely. But except when the discount is nominal, creditors are likely to raise the question even though the likelihood of success is small.

2. As to the showing of stock discount, see *supra,* p. 86.

3. N. Y. Laws, 1912, ch. 351. Under the original statute it was required that the certificate of incorporation state the amount of capital with which the corporation would carry on business which must include five dollars or a multiple of five dollars for every no-par share. Under the present New York statute the corporation may (a) allocate to the capital stock account a stated amount, which may be one dollar or more, for each share of no-par stock, or (b) allocate to capital stock the aggregate of the consideration received for no-par shares. S. C. L., §12, as amend. Laws, 1924, c. 441, §4. The Michigan statute requires that at least fifty per cent. of the consideration received for no-par shares shall be determined to be capital. P. A. 327 (1931), §20, as amend., P. A. 194 (1935).

4. Conn. Gen. Stat., §3453; Wis. Stat., §182.14.

5. Del. Rev. Code, c. 65, §14, as amend. Laws, 1929, c. 135, §6; Ill. B. C. A., §19 (which provides that in case any of the no-par shares have a liquidation preference the amount of stated capital represented by such shares must at least equal the amount of such preference); Calif. C. C., §300b, as amend. Laws, 1933, c. 533, §9 (entire consideration to be credited in case of a liquidation preference); N. J. Comp. Stat. 121, as amend. Laws, 1930, c. 120, §4; Ohio Gen. Code, §8623-37. Under the Ohio Statute a minimum stated capital of $500 must be maintained. Other statutes prescribe a minimum capital stock with which a corporation may begin business, e. g., Del. Rev. Code, c. 65, §5, as amend. Laws, 1931, c. 129 ($1,000).

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1. For discussions of the problem see Ballantine, *Corporations* (1927) p. 694; Berle, "Problems of Non-Par Stock," 25 *Columbia Law Rev.* 43 (1925); Bonbright, "Dangers of Shares Without Par Value," 24 *Columbia Law Rev.* 449 (1924); Mitchell, "Capitalization of Corporations Issuing Shares Without Par Value," 11 *A. B. A. Jour.* 377 (1925); Wickersham, "The Progress of the Law on No-Par Stock," 37 *Harvard L. Rev.* 464 (1924).

2. See Wickersham, *supra*, note 1. "Inasmuch as the stock has no fixed par value, its sale is recorded for what it fetches. There can be neither discount nor premium." Kester, *Advanced Accounting* (3rd ed., 1933), p. 475.

3. The matter has been summarized as follows: "Where the corporation is organized under a provision calling for stated value non-par shares, all questions of capital may be simply solved by treating the non-par shares as though they had a par value equal to the amount stated as their value in the certificate of incorporation. Where the corporation is organized under any other type of statute, the expressed intent of the corporate directors in pursuance of which payments for non-par stock are made, ordinarily governs the amount of the capital fund." Berle, *supra*, note 1 at p. 51.

4. This practice, first approved in an English decision, *Lee* v. *Neuchatel Asphalte Company*, L. R. 41 Ch. Div. 1 (1889) is sanctioned by statute in twelve states. Ark. Laws, 1931, c. 255, §25; Calif. C. C., §346, as amend. Laws, 1933, c. 533, §49; Del. Rev. Code, c. 65, §34, as amend. Laws, 1929, c. 135, §16; Idaho Code (1932), §29–129; Indiana G. C. A., §12; Louisiana Laws, 1928, Act. 250, §26; Mich. P. A. 1931, Act. No. 327, §22 as amend. P. A. 1935, No. 194; Minn. B. C. A., §21; Ohio Gen. Code, §8623–38; Pa. B. C. L., §701 as amend. Laws, 1935, Act. No. 361; Wash. Rev. Stat. (Remington, 1932), §3803–24; West Va. Code (1931), c. 31, Art. 1, §70, as amend. Laws, 1935, c. 24. The Pennsylvania statute cited above is typical: "A corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents, or other wasting assets, or organized solely or substantially to liquidate specific assets, need not make any deduction for the depletion of such assets by lapse of time, consumption, liquidation, or exploitation in computing the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of shareholders of different classes."

American decisions touching the point are few. The California court approved the doctrine before the statute cited above was enacted. *Excelsior Water and Mining Company* v. *Pierce*, 90 Cal. 131 (1891); a New York case, *People ex rel.* v. *Roberts*, 156 N. Y. 585 (1898), intimated that it might be accepted; and the doctrine has been supported by dicta in two recent cases: *Dealers' Granite Corporation* v. *Faubion*, 18 S. W. (2d) 737 (Texas, 1929); *De Brabant* v. *Commercial Trust Co.*, 113 N. J. Eq. 215 (1933).

1. Many states specifically grant to corporations power to acquire their own shares. Ark. Laws 1931, c. 255, §7; Calif. Civ. Code, §342, as amend. Laws 1933, c. 533, §45; Colo. Comp. Laws (1921) §2260; Conn. Gen. Stat., §3423; Del. Rev. Code, c. 65, §19, as amend. Laws 1929, c. 135, §10; Fla. Corp. Law (1925), §8; Ill. B. C. A., §6; Ind. G. C. A., §3; La. Laws (1928), Act. 250, §23; Md. Ann. Code (Bagby 1924) Art. 23, §50, as amend. Laws 1931, c. 480, as amend. Laws 1937, c. 504, §9; Mich. P. A. 1931, Act. 327, §10, as amend. P. A. 1935, No. 194; Missouri Rev. Stat. (1929), §4940; Nev. Comp. Laws (1929), §1608, as amend. Laws 1931, c. 224, §6; N. Dak. Comp. Laws, §4531; Ohio Gen. Code, §8623–41; Okla. Stat. (1931), §9747; Pa. B. C. L. (1933), §302 (7); R. I. Gen. L., c. 248, §5, as amend. Laws (1928) c. 1182, §1; S. Dak. Rev. Code, §8777; Tenn. Code (1932), §3722; W. Va. Code c. 31, Art. 1, §39; Wyo. Rev. Stat. (1931), §28–122. The statutes of some states recognize the power of a corporation to acquire and hold its own shares only through the provision that shares so held shall not be voted. N. Mex. Stat. Ann. (1929), §32–144; N. Car. Code (Michie, 1931), §1174; Utah Rev. Stat. (1933), §18–2–43; Va. Code (1932), §3802; Wash. Rev. Stat., §3803–28. In other states the statutory recognition of the power is limited to purchase by the corporations at a sale in default of assessment. Idaho Code, §29–156; Maine Rev. Stat. c. 56, §46; Mont. Rev. Code (1921), §5985. Similarly, in Kentucky and Vermont the acquisition by a corporation of its own stock is limited to the situation where such acquisition is necessary in order to prevent loss on a debt previously contracted; and the length of time for which stock so acquired may be held is limited. Ky. Stat. (Carroll, 1930), §544 (limit of one year); Vt. P. L. 1933, §5814 (limit of five years).

It has been held that where the statutes are silent on the matter, a corporation may purchase its own stock. *O'Brien Mercantile Co.* v. *Bay Lake Fruit Growers' Assn.*, 178 Minn. 179 (1929); *Copper Belle Mining Co.* v. *Costello*, 11 Ariz. 334 (1908); *Howe Grain & Mercantile Co.* v. *Jones et al.*, 51 S. W. 24 (Texas, 1889); *Shoemaker et al.* v. *Washburn Lumber Co. et al.*, 97 Wis. 585 (1897); *Iowa Lumber Co.* v. *Foster*, 49 Iowa 25 (1878); *City Bank of Columbus* v. *Bruce and Fox*, 17 N. Y. 507 (1858). See also, *Brown* v. *Little, Brown & Co.*, 269 Mass. 102 (1929) and cases there cited. Restrictions as to the fund available for the purchase by a corporation of its own stock are discussed *infra* under "The Purchase of Treasury Shares 'out of surplus.'"

2. This distinction is recognized specifically by the statute of Colorado which provides that treasury shares shall not be deemed canceled or extinguished unless the directors take appropriate proceedings for the decrease of capital stock. Colo. Comp. Laws (1921), §2260. There is a similar provision in Louisiana, La. Laws 1928, Act. 250, §23. See also Calif. Civ. Code, §342a, as amended, Laws 1933, c. 533, §46.

3. See the section of this report dealing with capital stock.

4. There have been few decisions on the question of the liability of a shareholder who purchases a corporation's reacquired shares at less than par. The following statement appears in Clark and Marshall, *Corporations* (1902) p. 561: "It is too clear to admit of question, that, when stock has been once issued and fully paid for, there is nothing to prevent the stockholders from returning the whole or a part thereof to the corporation, or to a trustee for its use, to be disposed of for its benefit; and in such a case the corporation or trustee may dispose of the stock at less than its par value without violating statutory or constitutional provisions regulating the issue of stock and without rendering purchasers thereof liable to creditors beyond the price which they agree to pay." It will be noted that this statement seems to be limited to the case in which the stock was reacquired by the corporation through donation. In *Enright* v. *Heckscher,* 240, Fed. 863 (C. C. A. 2d, 1917) stock was issued to a director for overvalued property and then turned back as treasury stock. Subsequently it was sold to the defendant at half of its par value. The corporation became bankrupt and the trustee attempted to recover from the defendant the difference between the price paid and the par value. Recovery was allowed, the court finding that the stock was never in good faith issued as full paid and that the defendant had notice of this. In its opinion the court said: "The cases hold that a corporation may sell such (treasury stock) at the best price that can be obtained for it and the purchasers are not liable beyond the agreed price even to creditors. That this is the law we concede, and no citation of authorities is necessary." Apparently the stock was acquired by donation. However, in at least one case, the statement has been made that the same rule applies when the stock has been repurchased by the corporation: In *Pullman* v. *Railway Equipment Co.,* 73 Ill. App. 313 (1897) the defendants had purchased stock at one-half of its par value. Creditors, attempting to hold the defendants for the remaining half were unsuccessful. The court said, "It will not and cannot be questioned that

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if the stock . . . had been once fully paid for and had subsequently passed to the corporation by purchase, then there would be no liability."

5. *Osage Oil & Refining Co.* v. *Haller,* 280 Fed. 693 (C. C. A. 2d, 1922); *Davis Bros.* v. *Montgomery Furnace Co.,* 101 Ala. 127 (1892).

6. *Borg* v. *International Silver Co.,* 11 F. (2d) 147 (C. C. A. 2d, 1925).

7. Calif. C. C., §342 b as amend. Laws 1933, c. 533, §47; Ohio Gen. Code, §8623–18. It may well be argued that when the reacquired stock has been purchased rather than donated, a corporation should not be allowed to sell such stock for less than the purchase price since this, in effect, results in a reduction of capital stock.

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1. The Securities and Exchange Commission states that reacquired stock preferably should be shown as a deduction somewhere in the net-worth section and requires a reason to be furnished when reacquired shares are listed as an asset. *Instruction Book for Form 10,* 1937, pp. 18, 21. The Illinois statute provides that reacquired shares shall not be included in "net assets" for the purpose of determining the right of the corporation to pay dividends or to purchase its own shares. Ill. B. C. A., §2, as amend. Spec. Sess. 1933–34, p. 146. The Michigan statute requires that the record of reacquired stock shall be kept "in such a manner as to clearly indicate the cumulative effect of such purchases, 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." Mich. P. A. 1931, Act No. 327 §10, as amend. P. A. 1935, No. 194. The Ohio statute requires that such stock be carried on the books as "treasury shares" but there is no requirement as to where it shall appear on the balance-sheet. Ohio Gen. Code, §8623–41.

Certain writers make the distinction that if the stock is held for subsequent sale, it may be regarded as an asset; if not so held it should be shown as a deduction from net worth.

2. Daniels, Mortimer B., *Corporation Financial Statements,* Michigan Business Studies, 1934, p. 85.

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1. "No such purchase or acquisition shall be made at a time when the net assets of the corporation are less than its stated capital, or which would reduce its net assets below its stated capital." Pa. B. C. L., §302 (7). See also, Md. Ann. Code (Bagby, 1924) Art. 23, §50 as amend. Laws 1931, c. 480 as amend. Laws 1937, c. 504, §9. "No such corporation shall use its funds or property for the purchase of its own shares of capital stock when such use would cause any impairment of the capital of the corporation." Del. Rev. Code, c. 65, §19, as amend. Laws 1929, c. 135, §10; Ind. G. C. A., §3; Mich. P. A. 1931, Act 327, §10, as amend. P. A., 1935, No. 194; R. I. Gen. Laws, c. 248, §5, as amend. Laws 1928, c. 1182, §1, "No corporation shall purchase any of its own stock when it is insolvent or by such purchase shall render itself immediately insolvent." Conn. Gen. Stat. §3423. The New York Penal Law makes it a misdemeanor for a director, "to apply any portion of the funds of the corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock." N. Y. Penal Law, §664, as amend. Laws 1924, c. 221. Where there is no statutory power to reacquire shares, the courts, in holding that such power exists have sometimes added a general restriction by way of dicta: "provided it does so in good faith without intending to injure, and without in fact injuring, its creditors." *O'Brien Mercantile Co.* v. *Bay Lake Fruit Growers' Assn.*, 178 Minn. 179 (1929); *Shoemaker et al.* v. *Washburn Lumber Co. et al.*, 97 Wis. 585 (1897) "—provided the transaction is *bona fide* and not in fraud of creditors." *Iowa Lumber Co.* v. *Foster*, 49 Iowa 25 (1878) "—subject to the right of creditors upon a showing that they have been injured." *Copper Belle Mining Co.* v. *Costello*, 11 Ariz. 334 (1908).

The California statute is exceptional in requiring that "upon any purchase of such shares out of earned or paid-in surplus when authorized under this section, the earned or paid-in surplus shall be reduced by an amount equal to the purchase price of such shares, but the stated capital shall not be affected thereby." Calif. Civ. Code, §342, as amend. Laws 1933, c. 533, §45.

2. Calif. Civ. Code, §342, as amend. Laws 1933, c. 533, §45; Ill. B. C. A. (1933), §6; Ohio Gen. Code, §8623–41. Under the California act, purchases, except for the specified purposes, are limited to earned surplus. Note that when shares are acquired out of stated capital under the special provisions of the California statute, they are restored to the status of authorized but unissued shares

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and the stated capital may then be reduced by the amount attributable to such shares by resolution of the board of directors.

3. *Douglass* v. *Ireland*, 73 N. Y. 100 (1878). But in *Speer* v. *Bordeleau*, 20 Col. App. 413 the court held the contrary view.

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1. Typical of the definitions of "surplus" in judicial opinions is the one given by Brandeis in *Edwards* v. *Douglas*, 269 U. S. 204 (1925): "The surplus account represents the net assets of a corporation in excess of all liabilities including capital stock," or, "Surplus is merely a balance figure ascertained by deducting the sum of the par or stated value of the capital stock and the other liabilities from the value of all assets." *Landesman-Hirchheimer Co.* v. *Comm. of Int. Rev.* 44 F. (2d) 521 (C. C. A. 6th, 1930). Only one state, Louisiana, has attempted to define "surplus" by statute: " 'Surplus' means the excess of assets over all liabilities plus capital stock." La. Laws, 1928, Act. No. 250, §1, as amend. Laws, 1932, c. 65, §1.

2. "A corporation shall at all times keep its books in such manner as to indicate clearly the divisions of the surplus accounts between surplus arising from earnings and surplus arising from other sources and it shall likewise indicate clearly such items in its annual reports to the state and its annual reports to its shareholders." Mich. P. A. 1931, No. 327, §20, as amend. P. A. 1935, No. 194. See also, Calif. Civ. Code, §§300b, 348b and 358 as amend. Laws, 1933, c. 533, §§9, 52 and 57; Ill. B. C. A., §2 as amend. Spec. Sess., 1933–34, p. 146; Ohio Gen. Code, §§8623–23, –40.

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1. See *supra*, p. 39.
2. Civ. Code, §346, as amend. Laws, 1933, c. 533, §49.

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1. Montgomery's fourfold classification of surplus is as follows:

(1) earned
(2) capital or paid-in
(3) reappraisal
(4) appropriated

This classification is unsatisfactory in that the items are not mutually exclusive. While item (4) generally is a part of earned surplus, it might be a part of paid-in surplus as it would be quite possible for the directors of a corporation to appropriate the premium received on its stock as a reserve for extensions or for dividends upon preferred stock. Item (3) is generally regarded as a part of capital surplus although it is not a part of paid-in surplus. It might, however, be looked upon as a surplus which is earned but not yet realized. If fixed assets appreciate and are sold, the excess received over cost is earned surplus; if appreciated but not sold, and the excess is nevertheless to be regarded as any kind of surplus, it has been earned through lucky or wise purchases.

2. See discussion under "Capital Stock" (pp. 88–89).

3. Opposing this view is Arthur Lowes Dickinson who states that earnings and expenses omitted in previous years should be entered in the current income account of the year in which the error is discovered. This he recommends in order that the sum of the earnings of successive years will show the total earnings. The showing of any understatement of earnings in the preceding year would thus be offset by a showing of excess earnings in a subsequent year. See his *Accounting Practice and Procedure,* N. Y., 1914, p. 67.

4. Statutes generally require the capitalization of surplus to be effected by amendment to the articles. Del. Rev. Code, c. 65, §26 as amend. Laws 1929 c. 135, §12; Laws, 1931, c. 129; Laws, 1933, c. 91, §3; Laws, 1935, c. 148, §4; Ill. B. C. A., §52; Md. Ann. Code (Bagby, 1924) Art. 23, §28; Mass. Gen. Laws, c. 156, §41, as amend. Laws, 1932, c. 136; N. J. Comp. Stat., §27 as amend. Laws 1926, c. 318, p. 535, Laws 1927 c. 28, Laws 1929, c. 352, Laws 1931, c. 220; N. Y. S. C. L., §36 as amend. Laws, 1924, c. 441, §§8, 9, and 10 Laws 1926, c. 310, §§1 and 2; Laws 1927, c. 396, §2; Laws 1929, c. 600, §4 and c. 652, §§1, 2, 3, and 4; Ohio Gen. Code, §8623–14. The California statute allows a transfer of surplus to stated capital upon resolution of the board of directors. Civ. Code, §348c.

5. The more recent statutes authorizing such dividends require that notice of the source be given to the shareholder. Calif. Civ. Code, §346, as amend. Laws, 1933, c. 533, §49; Ill. B. C. A., §41 (b); Mich. P. A. 1931, Act. 327, §22, as amend. P. A. 1935, No. 194; Ohio Gen. Code, §8623–38. In most states the statutes contain no such special authorization, and there is no conclusive body of decisions on the question whether, in the absence of such authorization, dividends may be paid from surplus other than that resulting from earnings of the business. See Weiner, "Theory of Anglo-American Dividend Law," 29 *Col. L. Rev.* 461 at 471–2; Weiner, "The Amount Available for Dividends where No-Par Shares Have Been

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Issued," 29 *Col. L. Rev.* 906 at 906 and 908. A few decisions have expressed, by way of dicta, the opinion that dividends may be paid from paid-in surplus; but these cases seem to turn upon the fact that the company was, in each case, already a going concern when the surplus was received. *Smith* v. *Cotting,* 231 Mass. 42 (1918); *Equitable Life Assurance Society* v. *Union Pacific R. Co.,* 212 N. Y., 360 (1914). See Reiter, *Profits, Dividends and the Law,* 1926, p. 228; *Miller* v. *Payne,* 150 Wis. 354 (1912). On the other hand, a California court held that surplus so acquired could not be distributed as dividends. *Merchants and Insurers' Reporting Co.* v. *Schroeder,* 39 Cal. App. 226 (1918) (The Calif. statute then forbade dividends except from "surplus profits.")

6. See the discussion of deficits under "Capital Stock."

7. Specific power to appropriate capital surplus to reserves is given by the Ohio statute. Gen. Code, §8623–38.

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1. Calif. Civ. Code, §361(6), as amend. Laws, 1933 c. 533, §59; Ill. B. C. A., §69; Ohio Gen. Code, §8623–38; Pa. B. C. L., §907. The Illinois, Ohio and Penn. statutes refer to that portion of surplus available for dividends rather than to surplus as a whole.

2. The statutes require for such authorization a vote of a majority, or, in some states, two-thirds, of the outstanding shares. See e. g., Conn. Gen. Stat., §3420, as amend. Laws, 1935, c. 53, §1; Calif. Civ. Code, §348 as amend. Laws, 1933, c. 533, §51; Del. Rev. Code, c. 65, §28, as amend. Laws, 1933, c. 91, §5; Ill. B. C. A., §59; Md. Ann. Code (Bagby, 1924), Art. 23, §29; Mass. Gen. Laws, c. 156, §41, as amend. Laws, 1932, c. 136; N. J. Comp. Stat., §27, as amend. Laws 1926, c. 318, p. 535, Laws, 1927, c. 28, Laws 1929, c. 352, Laws 1931, c. 220; N. Y. S. C. L., §37, as amend. Laws 1927, c. 396, §3, Laws 1929, c. 652, §5; Ohio Gen. Code, §8623–39.

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1. A few of the corporation acts recognize the surplus arising from a reduction of capital stock as paid-in surplus: "The surplus, if any, created by or arising out of the reduction of the stated capital shall be deemed to be paid-in surplus, . . ." Ill. B. C. A., §60, as amend. Spec. Sess. 1933–34, p. 146. "Such excess of assets shall be passed to and added to the surplus of the corporation and thereafter shall be subject to disposition by the board of directors in all respects as surplus paid in by shareholders." Ohio Gen. Code,

§8623–40; the California act requires that the amount by which the capital stock is reduced shall be transferred to a "reduction surplus account." Calif. Civ. Code, §348 b, as amend. Laws, 1933, c. 533, §51. Note the Michigan statute, *supra*, note 2, p. 92, which requires that surplus arising from earnings be shown separately from other surplus.

2. Twelve states, Alabama, Arizona, Kansas, Kentucky, Michigan, Mississippi, New Jersey, New Mexico, North Carolina, Oregon, Pennsylvania, and Vermont place no specific statutory restrictions on the distribution of reduction surplus. In New Jersey the courts have said that such a distribution must not affect the rights of creditors nor impair the capital of the corporation. *Continental Securities Co.* v. *Northern Securities Co.*, 66 N. J. Eq. 274 (1904). This general restriction appears in the statutes of Nebraska and Virginia. Nebr. Comp. Stat. (1929), §24–103; Va. Code (1930), §3781, as amend. Laws 1932, p. 131. A larger group of states make "solvency" the limit beyond which such a distribution may not extend. Ark. Laws, 1931, c. 255, §24; Conn. Gen. Stat. (1930), §3420, as amend. Laws, 1935, c. 53, §1; Fla. Comp. Gen. Laws (1927), §6548; Idaho Code Ann. (1932), §29–148; Ill. Rev. Stat. Ann. (1934) c. 32, §157.60; Ind. Stat. Ann. (1929) §4851; La. Gen. Stat. (1932), §1126; Md. Ann. Code (Bagby, 1924) Art. 23, §32, as amend. Laws, 1931, c. 480; Mass. Gen. Laws (1932) c. 156, §45; Minn. Stat. (1936), §7492–38; Nev. Laws, 1931, c. 224, §7 (there is also a provision that the assets remaining must be sufficient to pay debts, the payment of which has not been otherwise provided for); N. H. Pub. Laws, 1926, c. 225, §47; N. Y. S. C. L., §38, as amend. Laws, 1926, c. 310 and Laws, 1934, c. 764, §4; Ohio Gen. Code, §8623–40 (with the additional provision that there shall be no such distribution if there is reasonable ground to believe that the corporation is, or will be, unable to satisfy its debts); R. I. Gen. Laws, §3518, as amend. Laws, 1932, c. 1941, §3; Tenn. Code (1934), §3736; Wash. Rev. Stat. Ann. (Remington, 1935) §3803–40. A few statutes provide that the assets remaining must be "sufficient to pay any debts, the payment of which has not been otherwise provided for." Colo. Comp. Stat. (1932), §2281; Del. Rev. Code, c. 65, §28 as amend. Laws, 1933, c. 91, §5; Me. Rev. Stat. c. 56, §51, as amend. Laws, 1931, c. 183; Nev. Comp. Laws, above; W. Va. Laws, 1935, c. 26. A few states provide that the capital stock, as reduced, must exceed existing liabilities. Mo. Stat. Ann. (1932), §4948; Mont. Rev. Code Ann., §5927; Utah Rev. Stat. Ann. (1933),

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§18–2–44 (must exceed liabilities by 50%); Wyo. Rev. Stat. Ann. (1931), §28–136; also D. C. Code (1929) tit. 5, §290. The California statute is unique in the provision that "no distribution or withdrawal of such reduction surplus may be made under the authority of this section unless the board of directors determine that by such distribution or withdrawal the corporation will not be rendered unable to satisfy its debts and liabilities when they fall due and that the assets of the corporation after such distribution or withdrawal taken at their fair present value will at least equal one and one-quarter times its debts and liabilities." Civ. Code, §348b, as amend. Laws, 1933, c. 533, §52. For a further discussion see Callahan, "Statutory Regulation of Reduction of Capital Stock" (1936), 2 *O. S. U. Law Jour.* 220.

3. Calif. Civ. Code, §346c; Ill. B. C. A., §60a, added Spec. Sess. 1933–34, p. 146; Ohio Gen. Code, §8623–38. The provision that a surplus arising from reduction of capital stock shall be treated as paid-in surplus must be read with the Illinois and Ohio statutes. See note 3, p. 96.

4. Calif. Civ. Code, §346 as amend. Laws, 1933, c. 533, §49; Del. Rev. Code, c. 65, §34, as amend. Laws, 1929, c. 135, §16; Minn. B. C. A., §21.

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1. Securities and Exchange Commission, *Instruction Book for Form 10,* 1937, p. 14.

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1. *Ibid.,* Note 2 to Schedule IV.

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1. The Securities and Exchange Commission requires this amount to be shown as a statistical figure, not in connection with the balance-sheet. See *Instruction Book for Form 10,* 1937, p. 15.

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1. The Securities and Exchange Commission, under the heading of "Balance-sheet notes," alludes to contingent liabilities, which must be "given due consideration"; to arrears of cumulative dividends, and to defaults in bond provisions, as to both of which the facts must be stated. *Instruction Book for Form 10,* p. 21. See the discussion of these items above under "Contingent Liabilities," pp. 82–83.