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Accounting Questions: Capital Stock Without Par Value, Contingent Liabilities on Balance-Sheet, Funds of an Endowed College

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Accounting Questions

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CAPITAL STOCK WITHOUT PAR VALUE

Question: The facts are that this corporation, as a result of a reorganization changed over from ordinary nominal par stock to no-par stock, securing a new charter for the reorganized company. In making the application to the state of Pennsylvania 50,000 shares no-par stock of the stated value of $1,000,000 were specified.

In addition to the no-par-value stock there was certain preferred stock of the old company outstanding which was taken over and assumed by the new company.

When the company came to issue the no-par stock it actually issued it on a basis of $25 a share stated value, issuing only about 36,000 shares. About the same time it has sold 400 shares for $25,000 and has since sold quite a lot of the other stock to employees for $25 a share. At the present time the total cash actually received from the sale of the capital stock is slightly less than $1,000,000.

The lawyer contends that the books should show the capital stock at $1,000,000 constantly, regardless of how many shares have been sold and regardless of how much money is received from the sale of the stock. He says that, as in the application to the state of Pennsylvania it was set forth that stated capital was $1,000,000 it must be maintained at $1,000,000 and no more.

I have put the following hypothetical case to him, viz.:

Suppose a company with 50,000 shares no-par stock stated in its application that the stated value of this stock was $1,000,000. It issued 20,000 shares for $1,000,000 assets. Later on it sold the remaining 30,000 shares for $1,500,000. What does the $1,500,000 constitute—stated capital or surplus available for dividends. He answered me that it represented surplus available for dividends and might be distributed as a dividend the day it was received.

I understand there have been a number of decisions in Delaware which differ from this lawyer's view but that there have been no Pennsylvania cases.

Answer No. 1: The questions as to what constitutes the stated capital of a corporation and as to whether the excess of the amount paid in against the issuance of no-par-value stock over the stated capital is available for dividends or not are primarily matters of law.

So far as accounting opinion is concerned, the amount paid in against the issue of no-par-value stock is capital to the company, to be credited to the account "capital stock" and so shown in the company's balance-sheet, with a parenthetical notation as to the amount of the stated capital.

If, however, counsel insists on carrying the excess of the amount received for capital stock sold, over the round figure of stated capital mentioned in the application, as a separate account, it would be proper to do so, provided this excess (which in the instance given amounts to $1,500,000) is clearly earmarked in the balance-sheet as "Capital surplus, being the excess of amounts received from the sale of capital stock over the stated capital," or some similar wording, the point being, of course, that any amounts received from the sale of capital stock are of the nature of capital. The question whether or not this excess can be paid out in dividends, as already indicated, is purely a matter of law and should be left to counsel. The accountant's sole concern in these circumstances would be to have the accounts so drawn as to make the source of the dividend absolutely clear.

Answer No. 2: Our answer is predicated on certain assumptions of facts which are not clearly stated in the question, namely, that the preferred stock is par stock and that the no-par stock is all common stock.

The statement of facts shows that a certain Pennsylvania corporation, in making application for stock authorization, specified its proposed stock issue as "50,000 shares no-par stock of the stated value of $1,000,000."

This we understand to mean that the stated capital value of 50,000 shares could never exceed $1,000,000. Until such time, however, as the amount of capital received had reached $1,000,000 and the number of shares issued had reached 50,000, it would be correct to show the actual number of shares outstanding at the amount received for them. The lawyer whose contention is contrary might be asked what asset serves to increase the capital from the amount actually received to $1,000,000.

In the hypothetical case presented, we are of the opinion that the amount of capital received in excess of the stated capital of $1,000,000, properly would be credited to capital surplus and probably might not be distributed as cash dividends without violating the Pennsylvania corporation statutes. Provided the corporation in question is a Pennsylvania corporation, it does not seem necessary to search for support on this point beyond the Pennsylvania corporation statute, which reads as follows:

"No corporation having shares without nominal or par value, issued under the provisions of this act, shall declare or pay any dividend out of capital or out of anything except net profits or surplus earnings."

CONTINGENT LIABILITIES ON BALANCE-SHEET

Question: We are asking that you give us an opinion with respect to the handling of certain items in the balance-sheet outlined:

The company is a manufacturer. Its annual business approximates $10,000,000. The current asset position is $4,000,000 current to pay $1,000,000 current. The total assets are $11,500,000 to pay $3,400,000, which includes a bond issue of approximately $2,200,000.

This is a consolidated statement and includes the results of a subsidiary with a volume of $75,000 a year. This subsidiary sells approximately $40,000 in instalment sales. The instalment sales contracts are discounted, primarily for the purpose of getting the benefit of the collection organization of the discount house rather than for financial assistance, as the balance-sheet readily indicates.

Of these $40,000 sales, $23,000 were outstanding at the date of the balance-sheet. The "performance record" with respect to these is abnormally high. The character of the merchandise is such that in the event of a default there can be only a nominal loss, as there is no depreciation involved because of the nature of the merchandise and on those contracts on which a small number of payments have been made the repossession frequently results in a profit.

We stress, first, the strong financial position of the company; second, the small percentage of sales with respect to total volume of business; third, the small amount of contracts discounted in proportion to the total assets at the balance-sheet date and, fourth, the nominal loss, if any, involved in repossession.

The point on which we desire an opinion is whether in view of these circumstances the accountant should show in some form on the balance-sheet the contingent liability or whether in view of the comparatively small amounts involved this should be disregarded.

Answer: In our opinion, even though the contingent liability be merely a small amount in comparison with the total volume of business and there is little or no prospect of actual loss, the best practice calls for a notation of the contingent liability on the balance-sheet. We believe also that banks to which the balance-sheet may be submitted for credit purposes would expect the contingent liability to be shown, even though it be a relatively small amount.

FUNDS OF AN ENDOWED COLLEGE

Question: I have had submitted to me a balance-sheet of an endowed college. The endowment is in the form of a trust fund from which the college receives the income only and the college has no control over the principal of the fund. The balance-sheet submitted shows:

Assets:	
Trust fund	xxxx
Plant and equipment	xxxx
Total assets	xxxx
Liabilities:	
Trust fund	xxxx
Plant and equipment	xxxx
Total liabilities	xxxx

You will note from the above that the trust fund over which the college has no control whatever is shown as an asset and also shown as a liability, and that the plant and equipment which the college owns is shown as an asset and also as a liability. It is pretty hard for me to see that a trust fund of very substantial proportions represented by gilt-edge securities, which are not in possession of the college, can be an asset belonging to the college, and I fail to see how such securities in the hands of a trustee can be a liability of the college. Neither can I understand how the plant and equipment can be at the same time both an asset and a liability.

I am free to confess that statements of endowed colleges in the west are few and far between and that we practitioners of the west seldom come in contact with them.

My own idea of the situation is that the trust fund is not an asset of the college, neither is it a liability, and it should not be shown upon the balance-sheet at all, except in a subsidiary statement to show that the trust fund has been preserved and is intact properly managed. In the income account the income from the trust fund should be shown.

Further, the plant and equipment is of course an asset subject to depreciation, but in no circumstances could it be a liability for which the college is responsible.

Answer No. 1: In the example submitted there are two peculiarities. It is somewhat unusual to establish a trust fund, the principal of which is not under the control of the board of trustees. Occasionally, however, endowment is given to an institution with the provision that the investment of the securities is to be handled by an agency, such as a trust company, not directly connected with the institution. If the trust fund in question is irrevocable and the income will be paid to the college forever, it is quite proper for the securities to be shown as an asset in the balance-sheet at market value at date of gift.

The second peculiarity is that there are no operating assets in the balance-sheet, such as current cash, receivables, etc. This I do not understand.

The two funds shown under liabilities are not liabilities. They represent the net worth of the institution and correspond to capital stock and surplus in a commercial enterprise. Strictly speaking there should be four self-balancing sections in a fund balance-sheet—endowment funds, plant funds, expendable funds and current funds. The balancing figure in each section will be the fund account or the net worth of that section. The sum of these four items of net worth is the net worth of the institution. Sectional balances are maintained for various reasons, one of which is to prevent the misuse of endowment funds without appearing in the balance-sheet. All of this is explained in Arnett's book, *College and University Finance*, although Mr. Arnett only advocates the keeping of three sections.

Incidentally, it is an accepted principle in college and university accounting that no depreciation need be taken on educational plant. The theory is that the educational buildings and equipment to be used in educating students of a particular generation should be financed by gift and not through increased tuition fees.

Answer No. 2: In our opinion the financial report of the endowed college should contain:

(a) Balance-sheet showing the plant and equipment asset, a properly denominated surplus and a depreciation reserve.

(b) A separate statement in respect of the trust fund.

This assumes that such accounts in no way conflict with the terms of the deed of trust. Endowment is commonly understood to mean not the buildings or sites but the providing of a fixed revenue for support. If this is an executed trust wherein the limitations of the equitable interest are completely and finally stated in the deed of trust (perhaps in even so remote a contingency as that the college may cease to exist) the college should conform its financial reports to the terms stated.

The plant and equipment, if legally owned by the college, presumably arose either from a gift or from application of income. In either case the college would have something in the nature of a surplus—akin to paid-in or to earned—which would decrease as the relative asset depreciated or was exhausted.

Out of the profusion of law and court decisions on trusts we gather that the fund is not an ordinary asset of the college. The beneficiary has equitable title in the trust fund and is, in fact, a qualified owner of the fund, and the equitable estate is property in a limited sense, but the trustees have legal title to the trust fund and are absolute owners. Ownership implies some power of disposal—which the college presumably has not. The beneficiary has no right to possession of the trust securities: its right is in the trust—not of it. The word "endow" carries rather the idea of a gift; the donor usually gives the income, which is a right in property—not the property itself. The trustee is obligated to keep accurate accounts and the beneficiary has the right to inspect such accounts.