Journal of Accountancy

Volume 55 | Issue 4 Article 9

4-1933

Accounting Questions: Payment of Dividends from Net Earnings, Valuation of Treasury Stock or Profits,

American Institute of Accountants. Bureau of Information

Accounting Questions

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PAYMENT OF DIVIDENDS FROM NET EARNINGS OR PROFITS

Question: The "A" company has net earnings or profits for the year of $100,000, as shown by the books and the profit-and-loss account. There has been charged out to Profit and Loss, on account of depreciation, the sum of $35,000, which has been credited to the depreciation reserve. There has been charged to the same reserve the sum of $10,000 during the year, for renewals and replacements. There has been expended for additions and betterments and charged to capital accounts the sum of $60,000, all of which has been paid for out of earnings.

How much of the net earnings or profits of $100,000 is really available for the payment of dividends?

There appears to be three methods of solving this problem as follows:

	1	2	3
Net profits	$100,000	$100,000	$100,000
Less capital charges....................		60,000	60,000
			$ 40,000
Plus; net credit in depreciation reserve....			25,000
Available for dividends.................	$100,000	$ 40,000	$ 65,000

Under number one, no account is taken of the capital charges paid for out of earnings. As, however, these charges are invested permanently in the property, they can not be paid out as dividends, and should be deducted from the net earnings to arrive at what is available for dividends. In the commonly spoken of phrase "earnings per share" used in financial tables and publications, nothing is ever said of the capital charges paid for through earnings, and the impression that what is earned is the same as that available for distribution is erroneous.

Under number two the full amount of the capital charges had been deducted, leaving the available amount $40,000.

Under number three, not only the capital charges have been deducted, but the net credit to the depreciation reserve for the year, or $25,000 has been added, as this amount of the capital charges has been considered to have been paid for out of the depreciation reserve. In other words, the accumulation of current assets representing the net increase in the depreciation reserve has been considered as being invested in permanent improvements.

Answer: According to the question, the net profits of "A" company for the year amounted to $100,000. Depreciation of $35,000 had been charged to profit and loss, reserve for depreciation being credited, and during the year renewals and replacements had been charged against the depreciation reserve, while the capitalized expenditure for additions and betterments, "all of which has been paid for out of earnings," amounted to $60,000.

The question proposed is: How much of the net earnings or profits of $100,000 is really available for the payment of dividends?

Your correspondent offers three solutions:

Available for dividends:

(1) The full amount of the profits		$100,000
(2) The profits	$100,000	
Less—capital expenditure	60,000	40,000
(3) The profits	$100,000	
Less—capital expenditure	60,000	
	$40,000	
Add—depreciation reserve	25,000	65,000

With regard to (1) it is said that $60,000 of the profits, having been permanently invested in the business, would not be available for dividends, a condition corrected in (2) while in (3) the profits, less capital expenditure, have been increased by the depreciation reserve, on the theory that the accumulation of current assets, representing the net increase in the depreciation reserve, has been considered as being invested in permanent improvements.

The difficulty under consideration, it would seem, is largely one of terminology. Subject to whatever restrictions there may be in its articles of association or arising out of contract, e.g., with bondholders, the "A" company, having earned $100,000 may legally declare dividends up to that amount. The full amount of the profits is therefore available for the stated purpose, but it would probably not be practicable actually to distribute anything like that sum. In other words the full earnings are available for dividends but the capacity to distribute is conditioned by the availability of the necessary cash.

Thus availability of profits and capacity to distribute are two separate, though related, ideas. The former is not affected by the extent of the capital expenditure out of funds provided by profits, but such expenditure does of course impair the capacity to distribute.

Again, the reserve for depreciation may be reflected in increased assets, current or fixed, but consideration of the foregoing shows that the profits available for dividends are not thereby affected.

Where, as in the instant case, relatively large sums have been expended on capital assets, it is desirable to make a suitable appropriation from earned surplus so that the balance-sheet will then show that while—taking the figures of the case submitted—profits amounting to $100,000 have been earned and are legally distributable $60,000 thereof have been appropriated for additions to plant, leaving the unappropriated surplus available for dividends at $40,000, thus:

Earned surplus:		
Appropriated for plant extensions	$60,000	
Unappropriated	40,000	$100,000

With regard to the comment on "earnings per share," there is no impropriety in so stating the earnings, even though part of the funds provided by operations have been applied to capital expenditure.

The phrase "earnings per share" indicates earning capacity: it does not purport to mean that dividends of an equal amount have been, or can be, declared and paid. In brief, the statement that a company has earned $2 per share is but a fragment of the information and financial statements, consideration of which are necessary for a proper understanding of a particular case. The erroneous impression, then, is really due to fragmentary information and the mistaken attempt to equate earnings with dividends.

VALUATION OF TREASURY STOCK

Question: Information is requested regarding the valuation of treasury stock after declaration of preferred stock dividend.

In 1931 company "A" purchased 47 shares of its own common stock (at $180) for $8,460. In 1932 a preferred-stock dividend was declared, 20 shares par $100 being allotted to the treasury stock. The preferred stock was sold out of the treasury at $100 the same day it was issued, and it is desired to place a value on the 47 shares common, remaining in the treasury.

It is claimed by company "A" that no profit or loss arises out of the transaction, and that the stock remaining in the treasury is merely reduced in value by $2,000.

Answer: In our opinion, the contention of the company, that no profit or loss arose out of the transaction, is correct. The effect of what happened, as far as the company is concerned, is that it sold 20 shares of preferred stock at its par value, $2,000. The stock will, of course, be set up as a liability at $2,000, and that amount of cash was received. We do not, however, agree that "the stock remaining in the treasury is (merely) reduced in value by $2,000." As a matter of fact, the value of the common stock is not changed at all, because although the common stockholders became subject to a prior lien on the assets in the form of preferred stock, they received the par value thereof in cash.

The foregoing, we believe, covers the question of the effect upon the value of the treasury stock of the declaration of the stock dividend. It may be questionable, however, as to whether it is proper to carry the treasury stock at its cost of $180 a share. This would depend to some extent upon whether the stock is to be resold or not, and if so, at what price. Unless there is a fairly definite intention to resell it, and at a price not less than its cost, it should not be carried at the amount in excess of its par or stated value—possibly not in excess of its current market value.