Journal of Accountancy

Volume 56 | Issue 4 | Article 9

10-1933

Accounting Questions: Place of Preferred Stock on Balance-Sheet; Paid-in and Earned Surplus on Balance-Sheet; Goodwill of Milk Dealer

American Institute of Accountants. Bureau of Information

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation

American Institute of Accountants. Bureau of Information (1933) "Accounting Questions: Place of Preferred Stock on Balance-Sheet; Paid-in and Earned Surplus on Balance-Sheet; Goodwill of Milk Dealer," *Journal of Accountancy*: Vol. 56 : Iss. 4 , Article 9.
Available at: https://egrove.olemiss.edu/jofa/vol56/iss4/9

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

PLACE OF PREFERRED STOCK ON BALANCE-SHEET

Question: Should preferred stock be listed as a liability or included in the net-worth section of the balance-sheet?

Answer: Preferred stock should in all cases appear in the net-worth section of the balance-sheet and should not be included as a liability. Inasmuch as there usually is no positive obligation for the retirement of the amounts represented by preferred stock to the preferred stockholders and inasmuch as the money contributed by the preferred stockholders is subject to the liabilities to the creditors of the company, it is obvious that preferred stock should not be ranked with the amounts due to creditors.

The answer to the inquiry is so obvious that the thought suggests itself that the inquirer must have some problem slightly different from that stated. He may have in mind the fact that provision is made in the issuance of preferred stocks looking to their gradual retirement through earnings. However, even in such event there is no obligation to retire the stock unless the profits are earned and the money contributed by the stockholders is always at the mercy of the business. It is customary, however, if such instalments become due and payable by reason of the requirements of their issue and the profitable operation of the business, to set aside out of surplus an amount sufficient to meet the instalment then due. In such a case the instalment which has definitely become due would, of course, have to appear among the liabilities in the same manner as a dividend declared but not paid.

PAID-IN AND EARNED SURPLUS ON BALANCE-SHEET

Question: The audit and annual report for a fairly large company whose stock is listed, have caused discussion between the company executives, the accountants and the attorney for the company as to the way in which the balance-sheet should show paid-in and earned surplus.

In this particular case, the paid-in surplus represents the earned surplus of the predecessor companies included in the present company. The present company has suffered substantial losses in the last three years which have exceeded the previous profits and, in fact, have exceeded the paid-in surplus.

The company has previously made a division on its balance-sheet between paid-in surplus and earned surplus, but the attorney states that in the current situation the distinction between paid-in and earned surplus is meaningless. The facts are that the operating deficit has exhausted the paid-in surplus, as well as the earned surplus, and that the company is left with merely a net deficit or impairment of capital. He states further that if the company makes earnings, it will only be necessary for the earnings to cover this net impairment of capital before dividends can be paid from a balance of earnings, and that whatever distinction there once was between paid-in and earned surplus has been wiped out by the operating deficit exceeding the paid-in surplus. He further states that, as a matter of accounting, the operating deficit should be charged on the books against the paid-in surplus and that both on the books and on the published statement there should be shown merely a net balance as deficit.

Answer: It would appear that the company in question resulted from the merger of certain predecessor companies and that at the time of merger there existed paid-in surplus representing the combined earned surpluses of the predecessor companies.

In cases of a true merger where the merging companies have earned surplus, it is our opinion that this earned surplus is still available to the stockholders of the new company and can be paid out in dividends. It follows, therefore, that if the company has losses which impair its capital as represented by its capital stock it would only be necessary to restore this impairment before it can continue to pay dividends. From an historical point of view we believe that it would be a mistake to merge the accounts on the books and in the statements. It is important to know the results of the operations of the new company from the date of its inception.

In an article by J. M. B. Hoxsey published in THE JOURNAL OF ACCOUNTANCY for October, 1930, entitled "Accounting for investors," a clear distinction is made between true merger, that is where the identity of the merged corporation continues, though in different form, and where the earned surplus of the merged company may be properly continued as such by the merging company, and the acquisition of the stock of one corporation by another. In the latter case no earned surplus of the acquired company as at the date of acquisition can be recognized as part of the earned surplus of the combined companies.

GOODWILL OF MILK DEALER

Question: Corporation A buys milk direct from the farmers and dairymen's league, going through the various processes necessary until it is bottled. The corporation sells all of its milk to corporation B. Corporation B sells direct to retail stores. The stockholders of both companies are almost identical. Corporation C is making overtures to corporation A and B, for the purchase of the business of both corporations. Goodwill is a factor to be considered by the stockholders of corporations A and B, and they have asked my opinion as to how they should estimate the value of their goodwill.

Answer: It should be borne in mind that one company has the retail outlets and, we assume, has a certain established trade name. The other company,

in turn, has an established source of raw material supply, although it is possible that because of the present low prices for milk, there may be some dissatisfaction among the farmers. While it is true that the value of goodwill may be measured by the amount which a purchaser will be willing to pay for it, in this instance, when a definite basis for measuring its value is desired, we would suggest that goodwill be valued at three years' purchase price of the average net profits of the last five years.