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Treasury Stock

By Raymond P. Marple

So much has been said and written concerning the proper accounting treatment of treasury stock that it may appear an imposition again to introduce the subject. But there has been discernible recently a tendency to take a new view of the handling of this item—a view that gives more emphasis than formerly to matters of corporation law as affecting treasury stock. It is this view that I wish to discuss.

While one finds now and then a revival of the argument as to whether treasury stock represents an asset or a deduction from capital, it is probably safe to say that a majority of accountants would favor the latter treatment for most purposes. It is not intended here to consider the theoretical and practical considerations that have led most accountants to feel that a corporation acquiring stock in itself is reducing its assets and capital, rather than exchanging one asset (cash) for another asset (treasury stock). A statement of these considerations can be found in any advanced accounting text. Time can be better spent in discussing the proper treatment of treasury stock in the net worth section of the balance-sheet and, more specifically, the effect of stock acquisitions on surplus.

It seems probable that this new view of the treatment of treasury stock has developed as a result of studies of the problems connected with no-par-value stock. Writing in The Journal of Accountancy for April, 1926, Percival F. Brundage reviewed certain court decisions and said, "It is quite evident from these rulings that the purchase of treasury stock is recognized to be a return of capital to the stockholders surrendering their shares, and that the rights of creditors must be protected. It follows that the capital or trust fund should not be reduced and that the purchase should not be made unless the surplus is sufficient to absorb the whole cost thereof."

An even stronger statement was made by Carl B. Robbins in his treatise on *No Par Stock*, published in 1927. "No corporation," says Robbins, "may reduce the amount of its stated capital without the approval of corporate creditors and the consent of the state. The amount of stated capital can not be reduced except by

cancellation of the stock certificates. This requires state consent and automatically decreases the amount of capital authorized. Stock that has been canceled has gone out of existence; it is not treasury stock. Obviously, then, the acquisition of treasury stock can not effect a reduction in the amount of stated capital. This fact must be considered in accounting for treasury stock."

Somewhat later in their book on *Capital Stock without Par Value*, Wildman and Powell said that, when "in the acquisition of treasury stock a corporation parts with assets, the effect is a reduction of capital. How, then, can a corporation reduce its capital and meet its legal requirements with respect to stated capital? While the question has not been adjudicated so far as is known, grave doubt has been expressed by well-regarded legal talent that a corporation may acquire its own shares without impairing its stated capital, unless there is in surplus an amount equivalent to the value at which the stock is acquired."

But the strongest indictment against the current method of accounting for treasury stock was contained in a speech by Fletcher Lewis, made before the Michigan Society of Certified Public Accountants in March, 1933, when he said, "It is my contention that a balance-sheet should not only clearly reflect the actual effect upon the assets of the corporation resulting from the repurchase of issued shares, but that accountants, under penalty of possible liability for damages, have no licence to adjust the capital account of a corporation in violation of statutory provisions. Time and again officers, directors and shareholders have been misled by the practice. . . . The principle involved is that the capital of the corporation is an amount determined by law and subject to change only following the procedure prescribed by statute for the formal reduction of capital. A corporation does not effect a reduction of its legal capital by the act of purchasing or acquiring its own shares for the treasury, except in those cases where, depending upon the provisions of the statute and charter provisions, preferred shares upon being acquired by the issuing corporation are ipso facto retired and canceled. The purchase or acquisition of common stock for the treasury is not one of the formal methods provided by law for the reduction of capital."

While the authors above quoted are not the only ones to recognize the need for better methods of accounting for treasury stock, they have been cited because their statements show a continuing demand from 1926 to the present time for a recognition of legal

provisions in accounting for treasury stock. Probably the latest development in this direction is the recognition by Professor Kester in the new edition of his second volume of the necessity of reserving surplus equal to the cost of treasury shares acquired.

Does the acquisition of its own stock by a corporation constitute a reduction of capital? Before attempting to answer this question it would seem well to inquire into what is meant by the term "capital." If we mean capital in the broadest sense as synonymous with net worth or total proprietorship, it appears that the return to a stockholder of a part or all of his investment does reduce the capital or net worth of the corporation. But if we mean capital in the more restricted legal sense as represented by the par or stated value of shares issued, and as shown on the balance-sheet under the head of "capital stock," there is ample reason to believe that a different answer must be given.

Capital stock or legal capital in the sense used above is a legal fact, and if the accountant is to set up his statements correctly he must refer to corporation law to determine the legal facts applying to each case. The laws affecting corporations vary widely as between states, and in any individual case the law of the particular state involved will need to be followed, but it is felt that there is enough uniformity in legal theory, statutory law and judicial decisions in this case to warrant certain generalizations.

One of these generalizations is that in most states the acquisition by a corporation of its own stock must not reduce the legal capital, i.e., capital stock of the corporation.

To substantiate this statement, let me quote from a number of state laws.

Section 23 of the Louisiana business corporation act of 1928 states that, "unless the articles otherwise provide, a corporation may purchase its own shares of any class issued by it, but only out of surplus available for dividends." The code of South Dakota contains the rule, in section 8,777, that "a corporation may, out of its surplus funds, by resolution of its stockholders or by their unanimous consent in writing, purchase, hold and transfer shares of its own stock in such manner and for such price as may be by them agreed upon." Section 8 of the Florida corporation act of 1928 contains the provision that ". . . no such corporation shall purchase its own shares of capital stock except from the surplus of its assets over its liabilities including capital." Similar provisions

appear in section 3,722 of the code of Tennessee, 1932, and in section 7 of the Arkansas corporation act.

The New York penal code, section 664, contains this provision:

> "A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended:
>
> . . . . .
>
> 5. To apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock,
>
> Is guilty of a misdemeanor."

Under subdivision 7 of section 30 of the annotated code of Maryland, 1924, it is provided that "no . . . corporation shall purchase any shares of its own stock unless the assets of the corporation remaining immediately after such purchase shall be not less than the debts of the corporation plus the amount of its issued capital stock." California, Illinois, North Dakota, Ohio and Oklahoma can be added to this list of states holding that, with certain specific exceptions, treasury stock may be acquired only out of surplus. Nine other states—Colorado, Delaware, Indiana, Michigan, Missouri, Nevada, Pennsylvania, Rhode Island, and West Virginia—provide that the purchase of treasury stock must not impair the corporation's capital, which would seem effectively to limit such acquisitions to surplus.

So far we have considered only those states with definite statutory provisions on this subject. But as Professor L. L. Briggs said in an article in the May, 1933, issue of THE JOURNAL OF ACCOUNTANCY, "More than half of our jurisdictions have sketchy and inadequate statutory laws relative to treasury stock, while the legislative enactments of nearly a third of our states and territories contain no reference to this subject." In dealing with corporations chartered in these states it is necessary to study the court decisions to determine the law involved. In this connection we find in *Corpus Juris* the following statement:

> "It has been held, as a protection for creditors and non-assenting stockholders, that a purchase of stock to be valid must be made from surplus funds or profits, and this is required in some jurisdictions by statute."

In the Alabama case of *Hall* v. *Henderson* (126 Ala. 449, 1899) the principle was stated that "a corporation having no surplus profits can not purchase shares of its own stock." Percival F.

Brundage reports the Illinois case of *Fraser* v. *Ritchie* (8 Ill. app. 554, 1881) as holding that "the right of the corporation to purchase its own stock is subject to certain restrictions, one of which is that it shall not be done at such time or in such manner as to take away the security upon which the creditors of the corporation have the right to rely for the payment of their claims, or, in other words, so as not to diminish the fund created for their benefit." Judge McSherry said, in a Maryland case:

"If a corporation be incompetent to release subscribers to its capital stock whose subscriptions have not been paid, it is equally without authority to expend the fund represented by the capital stock to purchase shares held by a stockholder who has paid for them."

It is apparent from the citation just made that in most states a corporation may acquire its own stock only out of surplus and must not impair its legal capital thereby. In the states with no statutory provision or compelling judicial decision as a precedent, it is felt that the following arguments would prevail:

1. The par or stated value of all shares of stock issued and not canceled constitutes legal capital.
2. The legal capital of a corporation, according to statutory provisions, can be reduced only in certain specific ways and with the consent of the state (usually by amendment of articles of incorporation).
3. To allow a corporation to reduce its legal capital through the acquisition of its own stock would permit capital reductions outside the provisions of the law.
4. Such permission would amount to blanket authority to the management to return to stockholders any part of, or all, the capital fund, thus leaving the creditors to bear all of the risks of the enterprise.

What does this mean to the accountant? Since treasury stock may be acquired only from surplus, it follows that surplus is reduced by such acquisitions. If surplus is reduced, surely it is the duty of the accountant to show such reduction on the books and in the financial statements. Unless this is done, directors, stockholders and other readers of the balance-sheet will be misled as to the true surplus, and there is always the possibility that directors will incur personal liabilities by declaring dividends out of surplus which has already been used for the acquisition of

treasury stock. Such action, resulting in an actual impairment of capital might have the effect of subjecting concurring directors to personal liability. There might also arise some question as to the personal liability of the accountant, who has certified to a surplus, part of which has been used to acquire treasury shares.

A study of this matter has convinced me that accountants are making a grave error in treating treasury stock acquired as either an asset or a deduction from capital stock. In place of these current practices I suggest the following:

1. When treasury stock is purchased, an entry should be made debiting a surplus offset account and crediting the account of the asset given for the stock. For example, if 100 shares of $50 par value stock were acquired for $4,000 an entry would be made as follows:

Surplus applied in acquisition of treasury stock.........	$4,000	
Cash		$4,000

On the balance-sheet "Surplus applied in acquisition of treasury stock" would be shown as a deduction from the earned-surplus account, while the capital-stock account, representing legal capital would not be affected. Let us assume in the case cited that, prior to the purchase of the 100 shares, there had been 2,500 shares outstanding, issued at an average price of $60 a share, so as to create a capital surplus of $25,000, and that an earned surplus of $30,000 existed. The net-worth section of the balance-sheet after giving effect to the entries above would appear as follows:

Net worth

Capital stock:			
Issued	2,500 shares — Par $50		$125,000
In treasury	100 shares		......
Outstanding	2,400 shares		$125,000
Capital surplus			25,000
Earned surplus		$30,000	
Less: Surplus applied in acquisition of treasury stock..		4,000	26,000
Total net worth			$176,000

2. When treasury stock is sold, the sales price would be recorded as a debit to cash (or other asset) and a credit to "Surplus applied in acquisition of treasury stock." Any balance remaining in the latter account would then be transferred to either earned or

capital surplus. If the above-mentioned stock were disposed of for $3,800, the proper entries would be:

Cash	$3,800	
Surplus applied in acquisition of treasury stock		$3,800
Surplus	200	
Surplus applied in acquisition of treasury stock		200

This last entry charges surplus with the loss resulting from the purchase and resale of the treasury stock.

If, on the other hand, the stock were sold for more than cost, say $4,500, the $500 excess over cost would represent additional contributed capital and be credited to capital surplus:

Cash	$4,500	
Surplus applied in acquisition of treasury stock		$4,500
Surplus applied in acquisition of treasury stock	500	
Capital surplus		500

3. In the case of donated treasury stock, since the corporation has not parted with anything of value, there is no need for a formal entry. However, a memorandum entry should be made stating the number of shares acquired in this way, and this information should be posted to the explanation column on the debit side of the capital-stock account.

4. When donated treasury stock is sold, the entire proceeds represent contributed capital. The proper credit, therefore, is to capital surplus. To illustrate, assume 400 shares of no-par-value stock donated to a corporation and afterwards sold for $450. The entry for the sale would be:

Cash	$450	
Capital surplus		$450

This seems preferable to the usual method of setting up capital or donated surplus when the stock is donated and adjusting the donated surplus account at the date of resale, since it seems obvious that the new capital comes into the concern at the time the shares are sold and not when they are donated.

One question that might be raised concerning these entries relates to the use of capital surplus in place of earned surplus in recording the purchase of treasury shares. It would seem desirable to determine just what is meant by the term "capital surplus" before going into this question. I think of capital surplus as an excess of contributed capital over legal capital. An illustration or two will make this clear. If a corporation issues $50 par

value shares for $55, there arises a capital surplus, or excess of contributed capital over legal capital of $5 for each share issued. If this corporation, through charter amendment, should change its stock to no par, with a stated value of $25 a share, there would again arise a capital surplus, this time of $25 a share. Capital surplus, then, is capital contributed by stockholders in excess of the amount which the law requires the corporation to carry as the fixed or legal capital. From an economic viewpoint it is capital, from a legal viewpoint surplus.

Before considering any legal limitations on the use of capital surplus for the purchase of treasury shares it seems desirable to inquire into the propriety of such transactions. Suppose a corporation without sufficient earned surplus does acquire shares of its own stock out of capital surplus. Does not such a transaction amount to a return to certain stockholders of some of the capital contributed by them and result in a reduction of actual, if not legal, capital? Should the accountant hide behind the lax laws of some of our charter-selling states and contend that because the law allows a corporation which sells its stock at $50 a share to set up a legal capital of $5 or even less per share, that the $45 excess is surplus and not capital and is available for the directors to do with as they please? In spite of most state laws to the contrary, capital surplus as here defined is capital and not surplus; it is principal and not accumulated income and should no more be used for the purchase of treasury stock than should legal capital.

It is probably on the basis of such reasoning that Illinois, California, Minnesota and six other states have placed certain restrictions on the use of capital surplus for the acquisition of treasury shares. The Illinois provision is contained in section 6 of the new business corporation act, passed in 1933, which reads as follows:

"A corporation shall have power to purchase, take, receive, or otherwise acquire, hold, own, pledge, transfer, or otherwise dispose of its own shares, provided that it shall not purchase, either directly or indirectly, its own shares when its net assets are less than the sum of its stated capital, its paid-in surplus, any surplus arising from unrealized appreciation in value or revaluation of its assets and any surplus arising from surrender to the corporation of any of its shares, or when by so doing its net assets would be reduced below such sum."

The California law allows the purchase of treasury shares out of capital surplus for specific purposes only. Under the new Minne-

sota rule, only preferred shares may be acquired from capital surplus when both common and preferred shares are outstanding; but beyond this there is no restriction on the use of capital surplus for the acquisition of treasury shares. None of these laws was on the statute books at the beginning of 1933. Their enactment seems to indicate a reversal in the trend of corporate law toward a full application of the trust-fund doctrine.

In concluding it would seem well to quote from an actual case as related by an eminent corporation lawyer in the *Accounting Review* for June, 1933:

"In this case a corporation client repurchased a substantial block of common stock from a certain shareholder who was out of sympathy with the business policies of the company. The purchase required the use of funds equivalent to practically all the available surplus. We advised against the purchase because it was apparent that the company was faced with further losses before its business could again show a profit on operations. The president of the company then consulted his accountant, a partner of a well recognized accounting firm, who advised him that the purchase would not affect the surplus item in the company's balance-sheet. Against our advice the purchase was made, and the accounting method which was adopted charged the purchase price, which approximated the original issue price, to capital. Since that time, losses have more than wiped out the real surplus remaining after the purchase. There is today an actual impairment of capital to the extent of approximately $50,000, but the balance-sheet still reflects a fair sized surplus account. The company has an issue of preferred shares entitled to cumulative dividends, and the next step will be that the directors will declare and pay this dividend out of the apparent surplus, whereupon it is not unlikely that they will be called upon to face a charge of personal liability for the declaration and payment of that dividend at a time when the capital was actually impaired. If they should be held liable, then the question will be squarely presented as to whether this firm of accountants can be made to respond in damages."