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## Accounting Principles and the Statutes

BY HENRY RAND HATFIELD

In his valuable article *Stated Capital and Treasury Shares* which appeared in the March issue of THE JOURNAL OF ACCOUNTANCY, George S. Hills correctly says that, "very few lawyers or accountants understand the true nature of stated capital" (p. 202). This lack of understanding is not so damning an indictment of the two allied, but alas often dissonant, professions, as might at first appear. It is due rather to the fact that those who invented the term were not themselves quite sure of its meaning, and as a consequence it has ever since been used vaguely and inconsistently. One of the highest authorities on corporation law describes, if he does not define, stated capital as a "mathematical limitation." There is much in favor of this view and it avoids some of the difficulties arising from other, more specific, definitions. A mathematical limitation once determined by statute can not be altered by the whims or crotchets of a mere accountant. It is fixed and immutable save by the omnipotence of sovereignty. While different in content, it resembles in immutability the term "authorized capital." The amount authorized may of course be changed, but only by the authority that determined it in the first instance. Similarly with the term stated capital, if one adheres to the definition quoted above. But if this is the correct view one can not legitimately speak of any business transaction as impairing stated capital, as do Mr. Hills and the statutes of many states (but not California). A payment of cash or an unsuccessful course of business may create an accounting deficit but can not affect a "mathematical limitation."

Mr. Hills is more specific, saying that stated capital represents "an amount of dollars or dollar value . . . [which] must be maintained by a corporation for the benefit of creditors or shareholders and can not be reduced, paid out to shareholders or otherwise withdrawn except under statutory authority" (p. 205). If there has been an operating or any other deficit, obviously the "amount of dollars" has not been maintained and, willy nilly, that which can not be reduced *has* been reduced. For stated capital, according to Mr. Hills, is by implication something which in certain circumstances is capable of being "paid out," and that quantum

of payable values is no longer as great as before. To prevent misunderstanding it must be repeated that the abstract quantity used as a measure may not have been reduced, but the amount of dollars or dollar value, which is a protection to creditors, has been impaired and reduced.

Mr. Hills says: "It is an ingenuous defense to take the position that a book or balance-sheet deduction from stated capital is not the kind of 'reduction' of stated capital which is prohibited by law" (p. 210). There are two criticisms of this statement. The first is that if stated capital is a measure or limitation fixed by statute, obviously no mere figure printed on one side of the balance-sheet rather than the other can affect that which the statute has ordained, and hence does not run counter to a prohibition. The other more significant criticism is that the position referred to, far from being a sign of ingenuousness, is rather an indication of sophistication in regard to accounting technique, in which Mr. Hills, alas, does not participate.

In the naïve arithmetic of the grade school, if two apples are taken from five apples the three remaining units are also apples. But this is not true in accounting. The deduction of operating expenses from operating revenues does not alter or reduce such revenues; the deduction of the dotation of a sinking-fund reserve from net profits does not in any sense reduce net profits. It is similar with stated capital. Perhaps illustrations from the balance-sheet, instead of the income statement, would be even more pertinent. It is perfectly correct accounting (the question of its advisability may be waived) to show on the credit side of the balance-sheet:

Authorized capital stock . . . . .	\$100,000
Less unissued shares . . . . .	10,000

Outstanding capital stock . . . . .	\$ 90,000
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or, on the other side of the balance-sheet, to show:

Cost of building . . . . .	\$100,000
Less depreciation . . . . .	50,000

Cost less depreciation . . . . .	\$ 50,000
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Such deductions in the balance-sheet do not mean that either the authorized capital stock (a legal limitation) or the cost of the building (an historic fact) is anything else than \$100,000. No one can hold that there is any misrepresentation or, if the

statute states that the authorized capital can be changed only in some definite manner, that this exhibit performs a prohibited act. If Mr. Hills considers such a presentation as either incorrect or even ingenuous I regret that one who is a master in the field of corporation law, and shows, for a lawyer, such an unusually good grasp of many features of accounting, should yet be so unversed in its technique.

In just the same manner, if a corporation starts with stated capital represented by 1,000 shares of stock with a par value of \$100 a share, and in the course of its first year's business runs at a loss of \$10,000, having in the meantime borrowed \$15,000, the balance-sheet should show:

Assets . . . . .	\$105,000	Stated capital . . . . .	\$100,000	
		Less deficit . . . . .	10,000	\$ 90,000
		Notes payable . . . . .		15,000
	\$105,000			\$105,000

The alternative method of showing the deficit is too horrible to appear in the pages of THE JOURNAL. (While I could furnish what I consider a satisfactory title for the credit item of \$90,000, I purposely leave it unlabeled to avoid somewhat irrelevant discussion as to the appropriateness of my rubric.)

One thing is certain, the method here used does not mean that the stated capital, in the sense of a mathematical limitation-or of a measure for determining surplus, has been reduced. On the other hand it is equally certain that the stated capital, with Mr. Hills's connotation of "the amount of dollars or dollar value . . . which must be maintained by a corporation for the benefit of its creditors," has been reduced. For this reason the "mathematical limitation" concept seems preferable.

The situation is somewhat analogous to restrictions placed by law on national banks. This law establishes a "legal reserve" amounting to a certain per cent of deposits. What may be counted as reserve is somewhat arbitrarily, but definitely, fixed. To be sure, the amount of reserve changes from day to day, but at any given moment it is definite. It might have been made a percentage of the capital stock in which case, like stated capital, it would not be subject to daily fluctuations. The bank act does not require that the bank maintain the full legal reserve, but it prohibits certain transactions unless the legal reserve is on hand.

The recent corporation acts prohibit the purchase of the corporation's shares unless the net assets are in excess of the stated capital. In either case there is a legally determined measure by which the propriety of certain transactions is ascertained. The bank act does not require that bank balance-sheets show the legal reserve. (Perhaps it should do so.) The corporation acts do not all require that the stated capital be shown, though this is generally done. But if a bank showed that while the legal reserve requirement or measure was \$100,000 it actually had only \$60,000, such a showing would not be a violation of the bank act; nor is the deficiency in the reserve in itself a sign of illegality. It merely means that the bank must refrain from some otherwise permissible transactions. Similarly it is not illegal to show that not only is there no surplus, but that the net assets do not come up to the amount of stated capital; nor is the situation itself, if caused by unsuccessful business, one violating the law. But such a showing properly emphasizes the fact that the corporation may not purchase its own shares. When Mr. Hills speaks of a balance-sheet as an "appalling violation of the law regarding stated capital" he is either speaking carelessly or is in error.

Mr. Hills properly devotes more attention to the treatment of treasury shares than to the showing of a deficit. The statutes, in which stated capital is featured, generally require: (1) that the surplus be reduced and (2) that stated capital shall not be affected by the transaction. The first provision is somewhat illogical. Even Mr. Hills states that it is "obviously unwise" to decrease earned surplus coincident with the purchase of treasury shares (p. 214); although, under the statute, that seems imperative where the only surplus is earned surplus. The second provision is also illogical, unless stated capital is regarded merely as a "mathematical limitation."

But all the requirements can easily be met without violating the provision (which in California is equally binding) that the balance-sheet shall be in "a form sanctioned by sound accounting practice." To illustrate; a corporation may be assumed whose accounts show:

Assets . . . . .	\$120,000	Preferred stock . . . .	\$50,000
		Common stock . . . . .	50,000
			<hr/>
		Stated capital . . . . .	\$100,000
		Earned surplus . . . . .	20,000
	<hr/>		<hr/>
	\$120,000		\$120,000

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After the purchase of \$20,000 common shares the status could be shown as follows:

Assets . . . . .	\$100,000	Preferred stock . . . . .	\$ 50,000
		Common stock . . . . .	\$50,000
		Less treasury shares . .	20,000     30,000
			30,000
		Surplus applied to treasury shares . .	20,000
		Stated capital . . . . .	\$100,000

In this form there is no intimation that stated capital has not been reduced by the transaction, but it is clearly shown that the outstanding common stock has been reduced. This is decidedly better than the showing which is advocated by some writers, namely:

Assets . . . . .	\$100,000	Stated capital . . . . .	\$100,000
		(500 shares preferred stock par \$100)	
		(300 shares capital stock par \$100)	

The former statement is better because: (1) it does indicate that there is treasury stock on hand of \$20,000; (2) that in the event of liquidation, the value of assets being unchanged, there is a real surplus of \$20,000 to be shared by preferred and common shareholders in whatever ratio the articles provide.

Of course, some of these facts could be combed out of the form just given, but an explicit showing is certainly preferable. It is true that all of the facts including the existence of \$20,000 treasury shares could be shown, as some recommend, by a footnote; just as, instead of entering items in the ledger, they might be recorded on the bookkeeper's cuffs or on a blackboard in the president's private office. But if the balance-sheet "should show not only all assets and liabilities but also the existence or absence of any restrictions or qualifications applicable to either," footnotes and parenthetical explanations should yield to formal statements in the balance-sheet itself.

The dictum is expressed that the word "surplus" in the balance-sheet should represent a true surplus (p. 203). This is indisputable. It is just as true as that the terms "cash" and "bonded debt" should represent true cash and true bonded debt. But is the inference correct that there is a one-to-one correspondence between a true surplus and the amount legally available for

dividends or for purchase of shares? Mr. Hills asserts that such amount should be ascertainable "without combing the balance-sheet and disallowing items which should not be reflected in surplus." But surplus as defined by statute does not always determine the amount legally available for dividends. A contract with bondholders may require that part of "the excess of net assets over stated capital" must be retained as a sinking-fund reserve, even though it is still, indubitably, a part of surplus; a statute may provide, as is true in the case of our national banks, that dividends may not be paid, in early years, to the full amount of the surplus. Still more important are the restrictions against paying dividends to the amount of the surplus, if such payments would threaten the solvency of the corporation. To ascertain whether such a condition exists, the balance-sheet must be combed and with a very fine-toothed comb, to see how much of the actual legal surplus is available for dividends. Dividends, at least in the California statute, are usually limited, not by the amount of surplus, but by the amount of realized earned surplus. The two are not legally the same. The statute (sec. 346) distinctly recognizes "an earned surplus, representing unrealized profits," but such is not available for dividends.

In all of the above cases dividends may not be paid to the full amount of the surplus. On the other hand, dividends may, in some cases, legally be paid in excess of the surplus. In several jurisdictions (I think inadvisably) dividends may be paid "out of" current profits, although because of a previously incurred deficit there is no surplus, earned or unearned. And, more generally, dividends in the case of a "wasting asset" corporation may be paid where there is no surplus, even when the net proceeds of the year are less than the price paid for the mineral *in situ*. Mr. Hills fails therefore to distinguish carefully between surplus and the amount available for dividends. In some cases not all of the surplus is available for dividends; in other cases dividends may be paid in excess of the surplus.

One fundamental difficulty exists in the entire discussion. The responsibility for this in no way rests upon Mr. Hills but falls in the first instance on the financiers who have expressed the terms upon which shares may be repurchased. The law makers may share in the responsibility, for in framing the statutes "doubtless the legislative intent is inartistically expressed." (*People v. Gaus*, 92 N. E. 231.)

The difficulty is as to the precise meaning of the phrase "purchased out of surplus." Assume a corporation whose books show the following:

Plant . . . . .	\$120,000	Stated capital . . . . .	\$100,000
		(1000 shares at \$100 par)	
		Earned surplus . . . . .	20,000
	\$120,000		\$120,000

The directors decide to purchase 200 shares at par, but there is no (or insufficient) cash on hand—the assets, representing surplus as well as capital stock, consisting of investment in plant. It, therefore, issues \$20,000 bonds which, to put the case in the clearest form, are issued directly as payment for the shares. Are these shares purchased "out of surplus"? In the sense of the statute, yes. But must not one who considers that stated capital is an "amount of dollars" which, in certain circumstances, can be "paid out" also look upon surplus (which is closely akin to capital, although not stated capital) as something which it is possible to pay out? But in this case the dollar value is in the form of fixed or working assets, which could inconveniently be paid out. What is paid out is the issue of bonds. On the other hand, if (as I am inclined to prefer) stated capital (and presumably its close affinity, surplus) is a "mathematical limitation," the prohibition of paying anything out of a "mathematical limitation" can have at best only a highly esoteric meaning. One may pay out merchandise, or securities, or even parcels of real estate; one might have paid out gold dollars, and may pay out silver dollars, paper dollars, or even "rubber" dollars; but to pay out a "mathematical limitation" does indeed present a situation which the accountant is unable to handle. It is admitted that the best of accountants use similar expressions. But, as compared with law, accounting is an infant profession, and leniency should be shown if its untrained tongue has not yet learned always to use technical terms with the exactitude and nicety characteristic of the legal profession.

It does, indeed, rather gravel an accountant to be told that leading writers on accountancy, the federal reserve board, the American Institute of Accountants, the provisions of the federal income-tax administration, and those of the federal trade commission, all, are wrong (p. 203). It seems just a trifle like the soldier who declared that all the regiment, except himself, was out of step. But this paper, somewhat more modestly, makes



no wholesale or destructive criticism of Mr. Hills' article, which is a valuable presentation of important considerations. So much of it is so good that it seems desirable to show that not every statement contained therein is altogether good. On the other hand, two statements may be selected for especial commendation. One of these, concerning the lack of understanding of the nature of stated capital, has already been quoted. The other highly commendable statement is: "Lawyers who serve with accountants must [perhaps better "should"] understand and appreciate the laws which govern the application of accounting principles" (p. 213).