Journal of Accountancy

Volume 58 | Issue 4 Article 8

10-1934

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American Institute of Accountants. Bureau of Information

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Recommended Citation

American Institute of Accountants. Bureau of Information (1934) "Accounting Questions: Expenses on Property Acquired Through Foreclosure, Determination of Earnings and Surplus With Regard to Dividends," *Journal of Accountancy*: Vol. 58 : Iss. 4 , Article 8.
Available at: https://egrove.olemiss.edu/jofa/vol58/iss4/8

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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 members of the American Institute of Accountants who are 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.]

EXPENSES ON PROPERTY ACQUIRED THROUGH FORECLOSURE

Question: An institution of a charitable and educational nature has its funds invested in bonds and mortgages which include a certain proportion of real-estate first mortgages. Let us say that most of the real-estate mortgages were acquired in 1928 or prior thereto and the face amount did not exceed 60 per cent. of the fair appraised value at that date, and in most cases the fair appraised value today is considered to be considerably in excess of the mortgage.

There is a question as to the proper handling of taxes paid, repairs and other expenses where it has been necessary to acquire the properties. As the institution will ultimately sell the properties acquired, is it not proper to add all taxes, repairs and foreclosure expenses paid to the cost of the property?

In certain instances there has been an assignment of rentals with the authority given the institution to make necessary repairs or alterations where required. In a case of this kind where the outlay is in excess of the rentals received in closing the accounts at the end of the year, the institution carries this excess as an account receivable from the mortgagor and if it afterwards becomes necessary to acquire the property, this amount would be added to property cost.

The institution also sets up an account for "Advances on properties under foreclosure" and includes in this account expenditures made until such time as property is finally acquired, when the amount is added to the cost of the particular property.

In preparing financial statements the balance in this advance account would be included as part of the property cost.

Answer No. 1: Your letter indicates that your correspondent is an institution of a charitable and educational nature. It is therefore apparent that the income-tax regulations and rulings may be considered as secondary to what may be considered as sound accounting principles in this case.

It is clear that the foreclosure of property represents an exchange of indebtedness of the previous owner for an equity in the real estate acquired by the foreclosure proceedings. On such exchange, the property acquired should be

recorded at its fair value when received and if it is reasonably considered that such fair value equals the amount of the mortgage, plus accrued interest thereon together with back taxes and other expenses of foreclosure, the property may quite properly be recorded at the total of such amounts. On the other hand, if a conservative appraisal of the property would be less than this figure, the property should be taken over at the appraised value and the difference should be written off.

In the case of rent assignments it is proper to consider any excess of expenses over income as a charge against the mortgagor until the property is foreclosed or title thereto acquired. At this time the same procedure should be followed as outlined above for foreclosures of property generally.

Answer No. 2: It is our opinion that the treatment proposed is quite supportable in accordance with approved procedure.

In reaching this conclusion it is noted that in most cases the fair appraised value today of the properties acquired is considered to be considerably in excess of the mortgage and, we take it, such value has been established by recognized authority. We assume further that the exceptions are relatively unimportant.

DETERMINATION OF EARNINGS AND SURPLUS WITH REGARD TO DIVIDENDS

Question: I would appreciate what information you can give me on a question involving good accounting practice in the determination of earnings and surplus and the right of directors to declare dividends.

A corporation with no-par-value stock with a book value of say $10,000,000 has an operating deficit of $2,000,000. It is proposed to change the no-par-value capital stock to stock having a par value totaling $4,000,000, transferring the balance of $6,000,000 to surplus. Against this surplus would be charged the operating deficit of $2,000,000, leaving a surplus of $4,000,000.

Assuming that the company in its next year of operations loses $1,500,000 and in the following fiscal year makes $1,000,000 in net profits, can the directors at the close of the second year declare a dividend of say $600,000 out of the net profits?

Would it be good accounting practice to charge against the initial surplus of $4,000,000 after the reorganization of the capital structure the first year's loss from operations of $1,500,000, reducing the surplus to $2,500,000 and if this is done can that in effect be considered the final result of all previous years' operations, and can the company in effect start afresh with the following year, in which we are assuming earnings of $1,000,000, and pay a dividend of $600,000 out of those earnings without paying any attention to the operating deficit of earlier years?

In asking this question I am assuming that all necessary legal details have been covered, and the only answer desired is as to accounting practice usual in such cases and whether there would be a technical accounting objection to the payment of this dividend of $600,000 out of the profit of $1,000,000.

I realize the distinction that should be made between capital surplus and earned surplus, but would like an opinion as to whether it would be technically correct to charge the first year's operating loss against the capital surplus (which would be the only surplus then existing), leaving the balance of capital surplus at the net figure of $2,500,000, and whether it would be proper to set up

the earned surplus at the end of the second year at $1,000,000 for the earnings, less the $600,000 of dividends paid out of those earnings, or a net surplus from earnings of $400,000. Is it, on the contrary, necessary to have the earned surplus represent the accumulated history of the company from the beginning, showing the accumulated results from earnings, less any dividends paid from earnings, ignoring the facts of proper legal charges of operating deficits against capital surplus?

Answer No. 1: We do not think it would be good accounting practice to charge against the initial or capital surplus of $4,000,000, the first year's loss from operations of $1,500,000. On the contrary, we think that the capital surplus should be carried forward in one account, and the loss on operations should be carried forward in the balance-sheet in a separate account. We do not believe that the net amount of $2,500,000 can be considered as representing the final result of all previous years' operations. The remainder of the question in which it is assumed that in the subsequent year earnings of $1,000,000 are realized and a dividend of $600,000 paid out of those earnings, presumably is a legal, rather than an accounting, question, inasmuch as the applicant inquires whether this dividend can be declared "without paying any attention to the operating deficit of earlier years." However, he goes on to say that the only answer desired is as to the accounting practice usual in such cases, and whether there would be a technical accounting objection to the payment of the dividend of $600,000 out of the profit of $1,000,000. We know of no accounting objection to showing the dividend as being paid out of the profits and, indeed, without a resolution of the directors to the contrary, we think that from an accounting point of view the dividend would be considered as having been paid out of the current year's profits.

We understand that the New York stock exchange for some time past has requested that listed companies show in their balance-sheets the earned surplus representing the accumulated results from operations, less any dividends paid therefrom. Therefore, in the event that the previous operating deficit of $2,000,000 is charged against the capital surplus, we think a notation to that effect should be carried forward in the balance-sheets for succeeding years.

Answer No. 2: The question as to whether or not a company can pay dividends when there is an operating deficit at the beginning of the year is a legal question, to be settled under the laws of the state in which the company is incorporated.

The accounting question involved is what, in the circumstances, the balance-sheet should disclose. It is our opinion that at the close of the period in which the change of stock from no par to par value is made, the transfer from capital-stock account to surplus and the charge against surplus of the operating deficit should be clearly shown. It is assumed that proper corporate action would have been taken about these items. If the company, in its next year of operations, loses $1,500,000 and the directors of the company formally authorize the offsetting of such loss against the capital surplus account, this should be clearly shown in the report for the year. If in the following year the company makes $1,000,000 in net profits and the directors legally declare dividends of $600,000 out of such net profits, it is our opinion that the surplus of net profits over dividend should be shown in the balance-sheet as earned surplus, provided it was designated as "earned surplus from January 1, 193–."

Answer No. 3: Fundamentally the rules are, or were, simple and it was safe to say that dividends could be declared only out of the accumulations of earned surplus; capital could not in any circumstances be encroached upon and had to be held intact. This simple rule, however, has been invaded in recent years by statutory changes in many states, particularly where there is no-par stock or stock of a nominal or stated value, the surplus in excess of such stated value being, even when of the nature of paid-in surplus, available for distribution in dividends. This, however, does not alter the economic error involved in the paying of dividends out of paid-in or capital surplus and, broadly speaking, the correct accounting practice should follow the economic law. In accounts, however, it is impossible to ignore the statutory law, and where statutes permit the payment of dividends out of paid-in capital the accounting officers can only bow to the statute, making clear, however, the facts.

If a deficit should, however, have accumulated in the past so that the capital is actually impaired, the correct procedure would be, particularly in the case of a par-value stock, to go through the formalities necessary to reduce the capital stock and, provided the facts were made clear to the stockholders taking such action, the surplus arising from such reduction could with propriety be used to wipe out the deficits referred to effecting, for all practical purposes, a reorganization and starting the profit-and-loss and surplus account anew from zero.

Applying these rules now to the particular problems enunciated in your communication, and of course having in mind that what may be here stated is subject to modification by reason of special state laws, it would appear that it would be entirely proper to reduce the capital from $10,000,000 to $4,000,000, but the balance of $6,000,000 should, strictly speaking, be transferred to capital surplus. As, moreover, this capital surplus of $6,000,000 is distinctly, it is assumed, made available for the liquidation of past losses, the accumulated operating deficits of $2,000,000 could then be charged against it, which would leave a surplus of $4,000,000. This, however, should be regarded as a capital surplus and not, generally speaking, available for division in the form of dividends or even for the liquidation of later losses, although if a special provision were made for the utilization of the $4,000,000, or any part of it, to liquidate later losses, probably to the extent of such provision passed upon by the stockholders, no exception could be taken. The statutory and legal rights of creditors would, however, have to be properly secured.

The propriety of permitting each year's transactions to stand on its own basis so that dividends be declared out of the surplus earnings of any one year, irrespective of whether a deficit is brought forward from prior years or not, opens up another question and the law in various states and countries is not uniform. The local law must, of course, govern, but again looked upon as a purely accounting question I would not regard it good practice to declare dividends if there is an accumulated balance of operating deficit still unliquidated, with the exception, of course, that after a reorganization, or what amounts to a reorganization, there would be propriety in starting, as I have already indicated, once more from scratch, ignoring all previous deficits wiped out by the reorganization.