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Accounting Questions: Earned Surplus After Declaration of Stock Dividend, Assignment of Note Payable on Balance-Sheet, Stock of Subsidiary on Balance-Sheet of Parent Company, Freight, Royalties, Packing and Shipping as Expenses

American Institute of Accountants. Bureau of Information

Accounting Questions

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EARNED SURPLUS AFTER DECLARATION OF STOCK DIVIDEND

Question: A corporation, in 1922, capitalized $20,000,000 of its earned surplus by the declaration of a stock dividend. Since that date operating losses have created a deficit of about $5,000,000. It now proposes to reduce the par value of its capital stock by $20,000,000. After consummation of the latter transaction what is the earned surplus considered to be and how should the surplus accounts be stated on the balance-sheet?

Answer No. 1: We would say that at first thought it would seem that the proposed reduction of the par value of capital stock by $20,000,000 would restore that amount of earned surplus, leaving $15,000,000 available for dividends. Such is not the case. The effect of the declaration of a dividend, even of a stock dividend, is not to be so lightly set aside. The $20,000,000 of stock dividend taken out of earned surplus has removed that sum just as effectively and permanently as though a cash dividend in the same amount had been declared. It can not now be restored to earned surplus by any action of the corporation or of its directors.

The proposed reduction of the par value of the capital stock will create a capital surplus. If a dividend may be declared legally from such surplus the stockholders should be advised as to the source from which it is paid, lest they be led to believe that it is being paid out of earnings.

Accordingly, the surplus when created should be earmarked as "surplus arising from reduction of par value of capital stock." The deficit should not be absorbed in it for balance-sheet purposes, but, on the contrary, both the new surplus and the deficit should be stated specifically, unless subsequent results of operations carried to earned surplus or deficit be earmarked by describing such account on the balance sheet as: "Earned surplus or deficit from January 1, 1934."

ASSIGNMENT OF NOTE PAYABLE ON BALANCE-SHEET

Question: I have a corporation as a client the majority of whose stock is owned by one individual. The corporation also owes this individual $75,000 in the form of a note. The corporation also owes the local bank $30,000, which note has been endorsed by the principal owner, and a further considerable amount is owed to trade creditors. The local bank has taken an assignment of the note due the owner of the company as additional security for their loan.

I have put a footnote on the balance-sheet to the effect that the bank is secured by an assignment of this note, and both my client and the bank criticize handling the matter in this way. Neither feels that it is an item which should appear on the report in any way. I feel that it constitutes a preference and should be commented upon.

Answer No. 1: A is a corporation indebted under notes payable to B, the owner of the business, and to C, a lending bank. D represents other unsecured creditors.

It is stated that B has endorsed A's note to C and also has assigned to C the note due B from A. It is stated, furthermore, that both B and C object to the disclosure of the aforementioned assignment by a footnote in the balance-sheet of A.

In our opinion, the assignment need not be disclosed. The situation must be viewed in the light of the interests of the four parties aforementioned. One should seek to avoid the concealment of any material fact, but it must be borne in mind that the balance-sheet in question is that of the corporation A. While the fiduciary relationship of the principal stockholder of the corporation distinguishes him from other creditors, he is, nevertheless, a creditor as well as a stockholder. One may assume that the indebtedness of the corporation to him has arisen normally and is not in fact capital. (Promises to other creditors of the corporation by the principal stockholders proposing to subordinate his position as a creditor to that of other creditors would result in impounding such debt as effective capital.)

The assignment referred to in the instant case differs intrinsically from a transaction whereby an asset belonging to the corporation is pledged. The assignment of the note payable involves an agreement which is distinctly separate and apart from any relationship existing between the corporation and its general creditors in so far as the ultimate payment of such creditors depends upon the realization of the assets of the corporation.

Were one to insist upon the disclosure of the assignment in question the next step would be to require the disclosure of the endorsement. Both of these are simply collateral facts which imply that the bank does not consider the corporation a good risk on an unsecured basis. Followed through to absurdity, one should for the same reason disclose similar facts, for example: that certain ordinary creditors have required the personal guarantee of the principal stockholders before extending credit to the corporation. The accountant could not object to such disclosures, but his duty is limited to the disclosure of material fact inherent to the balance-sheet which is the subject of his report.

Answer No. 2: We can well imagine that a creditor and a heavy stockholder might each consider the company's note in a different light, and we therefore believe inasmuch as the auditor is aware of the assignment, that he should have a footnote on the balance-sheet mentioning it.

STOCK OF SUBSIDIARY ON BALANCE-SHEET OF PARENT COMPANY

Question: Corporation "A", no par value, capital $5,000,000 has a wholly owned subsidiary which we will call corporation "B".

Corporation "B" holds stock and securities in other companies domestic and foreign including the stock of corporation "A".

Corporation "A" buys the stock of "B" and corporation "B" buys the stock of corporation "A" therefore "A" through its ownership of "B" is buying its own stock and it should be noted that corporation "A" has no surplus but has liquid funds and comparatively small debts to general creditors.

The question is: Should we show on the balance-sheet of corporation "A" merely the cost of its stock in corporation "B" or should we show on the face of "A" balance-sheet that it owns its own stock? The only method that occurs at this writing is to earmark the wholly owned subsidiary stock on the balance-sheet of the parent company, "A", by saying "B" corporation stock including so many shares of corporation "A". This would be an incomplete showing objectionable to the management although it would give notice of the number of shares held through the subsidiary.

One other question would be as to whether the wholly owned subsidiary could be included in the item of stocks and bonds of other companies or stated separately as being wholly owned.

The "A" corporation stock is not now listed on any exchange. The management who hold the majority of the "A" corporation stock would prefer to simply say stocks and bonds of other companies, although their responsibility must be met not alone to stockholders but to banks and other creditors including federal reserve banks.

Answer No. 1: It is our opinion from the facts submitted that a consolidated balance-sheet should be prepared of company A and its wholly owned subsidiary company B, the latter company's holdings of the parent company's stock thus being treated as treasury stock and described as A's stock held by subsidiary.

If, however, a consolidated balance-sheet be not prepared, even though such a presentation seems proper, then we suggest that the "legal" balance-sheet of company A be supplemented by a balance-sheet of its subsidiary, the parent company's investment in its subsidiary being specifically so described, B's investment in company A being identified by description in like manner.

The alternative outlined is, we may say, permissive rather than desirable.

Dealing with the further question, it would be improper to include the investment in the subsidiary in the item described as "stocks and bonds of other companies." Such investment should appear as a separate item properly described. Of course, this question does not arise if the accounts are consolidated.

Answer No. 2: We favor showing the situation as follows:

Investment in shares (cost) of wholly owned subsidiary which in turn owns .... shares of blank company.. $————

FREIGHT, ROYALTIES, PACKING AND SHIPPING AS EXPENSES

Question: The question of the correct treatment of certain expenses has come up in connection with my practice and I should greatly appreciate any assistance you can give me in the matter.

The first question is the proper allocation of the cost of freight outward. I have deducted this cost from gross sales but I notice that a number of accountants consider this as a selling expense. Could you advise me the best practice with respect to the allocation of this expense?

Another matter is the question of the proper allocation of royalties paid. In this case a corporation manufactures candy and pays royalties to another corporation for the use of a name which is trade-marked, and the royalties are paid on the number of cartons sold. I have treated the cost of royalties as a selling expense but the corporation for whom I do the work wishes me to regard this expense as a deduction from gross sales. In your opinion, which is the correct allocation of this expense?

Another matter which has come up is the proper treatment of packing and shipping supplies and packing and shipping labor. I have treated these items as a selling expense but the management of the corporation believes that these expenses should be regarded as manufacturing costs. I have held that these items should be allocated to selling expenses.

The corporation maintains certain branch offices in the West from which offices sales are made to customers in adjacent territories. I believe that all the expenses of these branch offices, including the office salaries, postage and office expenses, are correctly allocated as a selling expense. Will you please advise me if you consider this a proper allocation?

Answer No. 1: The first question refers to the proper allocation of cost of freight outward. We believe that the correct procedure is to deduct such freight from the proceeds of sale rather than to consider it as a selling expense because, as a matter of fact, it is not a selling expense.

The second question has to do with royalty payments. The logical thing in this case is to charge the royalties paid to cost of sales and not as a selling expense because it is, in fact, an expenditure for the privilege of making and selling its product and not part of the expenses incurred in selling.

The third question has to do with packing and shipping supplies and packing and shipping labor. These expenses are also part of the cost of sales; they are neither manufacturing cost nor selling expense.

The fourth question refers to the expenses of a branch office. Inasmuch as the branch office is established and maintained for the purpose of selling, this expense may logically be included among selling expenses.