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# Accounting Questions: Creation of Capital Surplus to Eliminate Deficit, Treatment of Losses on Financial Statements,

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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.]

*CREATION OF CAPITAL SURPLUS TO ELIMINATE DEFICIT*

*Question:* A question has arisen relative to the frequent practice of creating capital surplus by reducing par value or number of shares of capital stock for the purpose of eliminating a deficit.

I have a client whose capital structure on December 31, 1933, was as follows:

| | |
|---|---|
| Capital stock outstanding 1,711 shares of a par value of $100... | $171,100.00 |
| Deficit | 62,950.12 |
| Net worth | $108,149.88 |

During March, 1934, the stockholders, by proper action, voted to reduce the par value of the capital stock of the corporation from $100. to $25. per share thereby creating a capital surplus of $128,325. They also voted to charge the deficit of $62,950.12 against the capital surplus of $128,325, leaving a capital surplus of $65,374.88.

In the preparation of future balance-sheets for this corporation, will it be necessary to state the capital structure as follows:

| | |
|---|---|
| Capital stock outstanding, 1,711 shares par value $25 | $ 42,775.00 |
| Capital surplus arising from reduction of capital stock | 128,325.00 |
| Deficit | 62,950.12 |
| Net worth | $108,149.88 |

Or would the following conform to good accounting practice:

| | |
|---|---|
| Capital stock outstanding, 1,711 shares par value $25 | $ 42,775.00 |
| Capital surplus | 65,374.88 |
| Earned surplus or deficit from operation since January 1, 1934.. | |
| | $108,149.88 |

*Answer No. 1:* Either plan is satisfactory, but on the first set of accounts the effect of the change should be fully noted either on the balance-sheet or in supplementary exhibits. For example:

Balance-sheet
(Liabilities)

| | |
|---|---|
| Capital stock outstanding—1,711 shares at par value $25..... | $ 42,775.00 |
| Capital surplus—arising from reduction in par value of capital stock from $100. to $25. per share less operating deficit to December 31, 1933 of $62,950.12.......................... | 65,374.88 |
| | $108,149.88 |

Subsequent accounts may be stated in less detail as shown in last paragraph of the question.

*Answer No. 2:* If, in the opinion of the accountant, all the necessary steps have been taken, no exception can be taken to the second form of presentation of the capital stock and capital surplus.

## *TREATMENT OF LOSSES ON FINANCIAL STATEMENTS*

*Question:* Will you kindly ascertain for us the usual accepted practice in the treatment of the following items in the preparation of annual statements:

1. Should losses arising from the dismantlement of plants and equipment be considered in the determination of net income for the year or should such amounts be carried directly against surplus? Would the manner of treatment differ if the amounts involved were very substantial?

2. Should losses on securities owned, realized or unrealized, be treated as charges against income or should the amount thereof be applied against surplus? Would the manner of treatment differ if the shrinkage in value occurred prior to the fiscal year in which the loss was recognized?

3. During the year 1934, it was determined that the reserve for uncollectible accounts receivable at December 31, 1933, was insufficient, since it did not provide for a number of accounts, material in amount, which have since become doubtful. These accounts are charged off during the year 1934. Should the amount of this loss be reflected in the determination of net income for 1934 or should it be charged against surplus?

Will you also inform us what practice is followed in treatment of such items in the preparation of quarterly earning reports.

*Answer No. 1:* Dismantlement losses and security losses customarily are taken against the net income if they arise from normal circumstances which might be expected to occur in any year. In order to apply such matters directly against surplus, the circumstances would have to be so unusual as to indicate a complete departure from ordinary operating routine by the company in that period. In the case of dismantlements such an extraordinary situation might be caused by the abandonment of an entire important process of manufacture or treatment which would involve dismantlement of a good portion of plant and equipment.

In the case of securities, unless some periodic routine provision is made for losses which builds up a reserve, no unrealized losses would be provided for through income account. Often extraordinary unrealized losses are provided for by setting up reserves which are charged direct to surplus. In the case of realized losses if they occur in the routine investment and reinvestment of surplus funds of the corporation, losses are obviously and equally routine current items. If securities are of the nature of investments, rather than the placing of surplus funds in marketable securities, the losses would apply against current income or surplus depending upon whether it was related to current operations or not.

The question whether the loss is of a substantial amount or not does not govern so much as the question of whether the loss is extraordinary or not.

For uncollectible accounts, provision is made at the date of the balance-sheet based upon the facts then known. The assumption is that the reserve is adequate at that date. Should it prove to be inadequate at some later date an adjustment as of the earlier date should not be made unless the circumstances were known or expected at that time. Bad debts written off or provided for through reserves, when determined bad or uncollectible during the period under audit, generally arise from sales of prior periods.

In the case of a business where a decided change has taken place in the method of collections, type of sales or clientele, it is conceivable that an adjustment might be made directly to surplus in relative accounts arising from sales of prior periods. This adjustment would be expressed as related to a type of operation no longer carried on, and it practically expresses the fact that an old set of transactions or operations ceased and a new set was instituted within the period. Circumstances such as these are infrequent and the auditors should not allow themselves to be persuaded too easily that they exist.

Modern practice as shown by the published accounts of representative companies in the last few years indicates that the distinction between charges to surplus and income is not as important as full and correct description of the transactions. Many representative companies prepare combined income and surplus accounts, and the income in some cases is only one of a number of items which represents the total change in surplus or net worth during the period. From many points of view this difference is the significant figure and, while accounting is always concerned with the division of business activities into more or less arbitrary periods, it is just as true that this attempt always fails and the so-called surplus adjustment recognizes that this distinction can not be completely carried out.