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Some Phases of the No-par-value-stock Problem*

By F. H. Hurdman

Problems arising through the issuance of no-par stock have perplexed accountants and business men since the enactment of the first law authorizing its use. Apparently lawyers form the only interested group which does not realize these difficulties. Accordingly, laws have been placed on the statute books which permit unconservative practices in relation to the capital structure of corporations and in no wise correct the evils for which the no-par-value idea was to furnish the cure.

On several occasions I have ventured the opinion that many of the accountant's difficulties with no-par stock were imaginary, but in fairness it must be admitted that some of the perplexities arising are real enough.

The problem of the accountant is to harmonize good accounting practice with legislation which appears to have been enacted without a proper understanding of its meaning or effect and is often inconsistent in its terms.

As an instance, the New York law may be cited. It appears, if a stated value has been assigned to no-par stock, that there is then no legal objection to the disbursement of all paid-in capital in excess of that stated value as dividends. If such action is possible it seems that we have completely lost sight of the common-law and common-sense rule that dividends should represent only distribution of earnings.

If we leave out of consideration banking and insurance companies, it has always been considered to be the duty of the accountant to record as capital the value of all moneys and properties paid in or services rendered in consideration of the issuance of capital stock. However, if, under existing statutes, when such capital stock has no par value, a corporation is allowed to consider that only a limited amount of such capital paid in is in reality fixed capital and that the balance represents a fund from which dividends may be paid, then not only is our sense of accounting propriety violated, but we are presented with perplexing problems which are difficult of solution.

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It is not my intention to touch upon all the vagaries of the no-par-stock statutes nor to discuss all the problems with which the accountant may be faced. However, it will be of interest to address ourselves to a few of the more common difficulties which arise in the presentation of a financial statement of a corporation having stock of no par value. It is evident that these all have to do with setting forth a true picture of the capital structure with proper differentiation between the interests of the various classes of stockholders.

It is apparent that a stockholder, in studying a balance-sheet, desires to know

(a) The financial condition of the company,
(b) His own share in the net worth of the company,
(c) What proportion of his share of the net worth represents the value of his permanent investment and what proportion represents funds available for dividends on his holdings.

Let us then consider the following specific items in relation to a company having stock of no par value:

1. Earned surplus
2. Treasury stock
3. Preferred stock
4. Stock dividends

EARNED SURPLUS

In spite of the fact that some states apparently permit the distribution, as dividends, of capital paid in, it seems quite important that the accumulated earnings of the corporation should appear as earned surplus on the balance-sheet. Simplicity on the balance-sheet should not be encouraged beyond the point where clarity is lost or where ambiguity begins. It is necessary that the nature of the assets and liabilities be shown, but quite as desirable that the net worth be exhibited in such fashion that the amount representing permanent capital invested by the stockholders may be distinguished from the accumulated earnings or deficits from operations.

The failure to make any distinction between earned and capital surplus (where such an item exists) may serve to conceal a condition in which dividends paid have exceeded accumulated earnings. Indeed, this condition may provide the motive for a refusal, on the part of the company's directors, to make a proper segregation of surplus.

In my opinion, whether the law permits or does not permit the payment of dividends out of capital or capital surplus, the segregation of earned surplus should be urged in order that the vitality of the corporation may be judged through a study of the changes in earned surplus. Of course, if dividends may be paid out of capital or earned surplus at will, a study of the earned-surplus figures, alone, from year to year will not present an adequate picture.

In this same relation we are led to a consideration of the advisability of segregating capital and capital surplus on the balance-sheet.

It is apparent that unnecessary subdivisions of items on a balance-sheet make it more difficult to comprehend quickly the financial condition which it portrays. The classification of the various elements on the statement should extend only far enough to present a clear picture without details which may divert attention from the salient features.

This applies not only to the assets and liabilities but to the group of items representing the capital of a company as well. The essential features in respect to the capital are the fixed capital (with explanation of any preferences involved) and the amount of undivided profits. Therefore, usually nothing is gained by dividing the fixed capital into so-called capital and capital surplus. It may, of course, be necessary in the case of par-value stock when the capital paid in is in excess of the par value of the capital stock issued, but the use of no-par-value stock obviates this.

However, it may be desirable even when a company has no-par-value stock to show capital surplus separately when such surplus arises after the formation of the company by reason of the reappraisal of the fixed assets. In that case the fact that such a revaluation has been made, and the amount, should be clearly shown by a properly explained capital surplus on the balance-sheet.

If such a policy be followed, the capital stock will ordinarily show the fixed capital of the enterprise, the capital-surplus account will measure any changes made in fixed-asset values upon reappraisement and the earned surplus will show the unextended profits of the business available for dividends.

It is very doubtful, however, whether much of value would be gained by such a procedure. Provided no part of the reappraisal

value was carried to earned surplus, I am inclined to prefer, for the sake of simplicity, that we stick to the use of two captions only: "capital" and "earned surplus." We can not insist upon the use of cost figures if the directors elect to use appraised values for their plant and property accounts, although we can indicate that appraised values have been used.

It may be of interest to discuss some problems of mergers and consolidations. While these are not peculiar to no-par-stock companies, their importance seems to be emphasized in such cases by reason of the varying treatment accorded capital.

Where, in the case of a reorganization or merger, part of the surplus of existing corporations has been brought over into the balance-sheet of the new company for the purpose of creating a reserve fund for dividends or other contingencies, there does not seem to be any valid objection for such a segregation provided none exists under the law. However, in such a case, I believe this fund should be clearly marked to distinguish it from the permanent capital and the earned surplus.

This brings us to the whole question of the treatment of earned surplus in the case of a merger of two or more companies.

Whether or not the earned surplus of merging corporations should be carried forward as available for dividends depends on whether or not an entirely new entity is created by the merger.

It is apparent that a new corporation at its beginning can have no earned surplus and the real question is whether or not the earned surplus of merged companies should appear at all on the balance-sheet of the new company and, if so, under what conditions and with what designation.

If a corporation having previously been in business acquires all the stock of another and elects to merge immediately, it merely itself acquires the net assets of the second company in exchange for the capital stock surrendered. It, therefore, should record the net assets so acquired at the value of the capital stock surrendered. Its own earned surplus is not affected and no surplus of the absorbed company should be transferred.

However, if a period of time had elapsed between the acquisition of the stock of the second company and the merger, the parent company would be entitled to take credit for the surplus earned between the date it acquired the stock of the other company and the date of the merger. The best course in such a case

would be to transfer such surplus to the parent company before merging.

In the case of a corporation which takes over all the assets and assumes the liabilities of two or more corporations whose capital stock it had previously owned, no new entity is created and, therefore, the surviving corporation is entitled to retain its earned surplus as such. However, if two or more corporations are merged to form an entirely new entity it is apparent that the new company can not of itself have any earned surplus, as the net assets acquired represent the values received as consideration for the issue of its capital stock. This I believe to be a sound general principle to which there should be few exceptions. It is unfortunately true, though, that in many cases accountants are not consulted as to the principle to be followed in recording mergers on corporation books, and I have known instances where earned surplus of merging companies has been carried forward as earned surplus of the new corporation.

Such a course does indeed appear defensible when the merger includes only companies which have previously been operating as one property with the same management and stockholders. It may be argued that such a merger involves only a technical change in the form of organization and that the amount available for dividends to the stockholders, who remain the same, should not be disturbed. The claim is undoubtedly a just one, but even in such a case I do not believe earned surplus should be brought forward without specific provision for such action in the merger agreement and should then be specifically labeled

> "Earned surplus of underlying companies available for dividends to stockholders of Blank Company".

I also believe that when the accountant is confronted with a condition where for any reason earned surplus of merged companies has been transferred to the new company, segregation of such surplus should be made on the balance-sheet of the new corporation with suitable description.

In respect to the individual corporations, the principal point I wish to make is that earned surplus should represent the accumulation of earnings less dividends of the corporation reporting. If the surplus of underlying or merged companies is represented as part of the earned surplus of the successor or parent company, this principle would be violated.

TREASURY STOCK

The treatment of treasury stock where no-par-value stock is used offers some points for consideration. Where stock is purchased for the treasury and it is desired to reflect this purchase on the liability side of the balance-sheet, we are confronted with the proper adjustment of the capital structure.

It has seemed to me that fundamentally we are concerned with the average issue price of all the no-par-value stock rather than the price at which any particular block was issued.

Assuming, therefore, that certain shares were acquired at a price in excess of the average issue price and that it is desirable to show such shares as a deduction from the outstanding shares, the first inquiry is as to what accounts include the issue price of the outstanding stock.

If the capital account and the capital-surplus account together represent the values acquired as consideration for the issue of capital stock, the proportion included in each should be deducted in respect to the stock reacquired. The treatment of the excess or deficiency from the average issue price may vary according to the purpose for which the treasury stock was purchased.

If such stock has a market value equal to the price paid for it and if the stock is held for resale, any excess over the average issue price may properly be carried as a deferred item on the debit side of the balance-sheet. In like manner any discount could be carried as a reserve. Either item would be eliminated on resale and the actual profit or loss on the transaction would be credited or charged to earned surplus.

If the treasury stock had been acquired for the purpose of retirement, the same procedure should be followed in respect to the average issue price, but in expectation of the retirement of the stock any differences should be shown as a deduction or an addition to earned surplus as

Earned surplus..........................	$12,000.00
Deduct: Excess over average issue price paid for treasury stock acquired for cancellation..................................	1,000.00
	$11,000.00

Percival F. Brundage, in his article, *Treatment of No-par-value Stock*, in THE JOURNAL OF ACCOUNTANCY, April, 1926, is inclined

to believe that the whole cost of the purchase price of treasury stock might be charged to surplus in order to keep the capital fund intact, until official permission is received from the state to reduce it.

This belief apparently is based upon the assumption that there are legal restrictions involved in the reflection of treasury-stock purchases on the liability side of the balance-sheet. This seems to be fallacious as the mere statement on a balance-sheet does not of itself reduce the amount of capital. Furthermore, if the treasury stock is shown as a deduction, no one is misled.

The fact is that par-value treasury stock has been accorded this treatment for years without serious objection, and it is difficult to see any valid reason against the procedure in the case of no-par-value stock.

STOCK DIVIDENDS

It is, of course, conceivable that a dividend may be paid in no-par-value stock, without any transfer of surplus to capital account, in much the same manner as $50 par-value shares may be substituted for $100 par shares. In either case the process merely results in a dilution of the value per share. Such action may have its advantages from a marketing point of view, but it is difficult to see how anything else is gained.

However, the purpose of a stock dividend is not, as a rule, the mere dilution of the shares of a corporation, but rather is to set aside a portion of the earnings as fixed capital. It, therefore, follows that the payment of a stock dividend in either par-value or no-par-value stock in such cases involves the transfer of a specific amount from surplus to capital. From the accounting viewpoint it does not essentially differ from the payment of a cash dividend followed by pro rata subscriptions to capital stock.

The procedure to be followed in the case of a stock dividend would involve the authorization to issue additional stock by the stockholders and declaration by the directors of a dividend of a fixed amount out of accumulated profits, payable in capital stock at a specified issue value per share.

It has been suggested that the amount to be transferred from surplus to capital should equal the market value of the stock distributed in the form of a stock dividend on the theory that the stockholder has received cash or its equivalent in that amount.

The case of the North American Company has been cited in support of that view. Since October 1, 1923, that company has

been paying 2½ per cent. quarterly in no-par common stock. Taking the year 1926 as an illustration, we find the common stock ranged in price from a high of 67 to a low of 42, or an average of 54½. During that year 389,804 shares were issued as a stock dividend, which, if figured at 54½ per share, would represent an equivalent in cash of $21,244,318. However, a sum of $3,900,000, approximately, was transferred from surplus to capital account and the total net income for 1926, available for common stock, was only $15,474,114.

This case does not, in my opinion, support an argument in favor of a transfer from surplus to capital of an amount equivalent to the market value of the stock at the time of issuance of the stock dividend. In fact, the market value has no more bearing on the point than would the declaration of a 50 per cent. stock dividend in par-value stock with the market value of stock so distributed two, three or ten times the par value of the stock distributed as a dividend. About all that happens in either event is a dilution of the per-share value, be it book or market value.

PREFERRED STOCK

Perhaps the principal source of difference among accountants arises through the issuance of preferred stock of no par value. It is argued by some that the proceeds received from the sale of such stock should be the value at which it is entered on the balance-sheet. However, it appears to me that the value at which such stock is to be redeemed in the event of liquidation should be the value shown. Of course, it is an anomaly to assign a value in liquidation to a stock and then to term it no-par stock. To my mind, the definite establishment of the amount of preference does give that stock a par value. It is argued against using the liquidation value on the balance-sheet that the callable values are not used with stocks of par value, but the cases are not analogous. Par-value stocks are usually preferred in the event of liquidation to the amount of their par value. They may be callable at a premium. The premium at which either par stocks or no-par stocks may be called has no place on the balance-sheet except for information. This is true because in either case the stock may never be called.

However, it is necessary, in order to establish the interest of the common stockholder, to show the actual amount of preference in liquidation. This is accomplished in the case of the par-value

stock by showing its par value and can only be accomplished in the case of the no-par-value stock by showing the value at which it is to be preferred in liquidation.

An instance comes to my mind wherein a corporation proposed to sell a block of its preferred stock at $22.50 per share with retirement running as high as $40 per share, calling for a premium of approximately 78 per cent. on the amount to be realized from the sale of this stock. It is obvious in such a case that no adequate appraisal of the common stock equity could be made without reference to this condition. It is apparent, however, that it would be improper to show this stock on the balance-sheet at either the value at which it was sold or at the maximum redemption value unless one of these values represented the preference in liquidation. It would be necessary, however, by suitable notation on the balance-sheet to draw attention to the fact that the common stockholders' equity was subject to the redemption premiums on the preferred stock. It would be impossible to do more, inasmuch as the retirement of the preference stock remains uncertain, and it is impossible to tell whether or not it will be retired before liquidation and the amount of the premium if it is retired.

The clearest statement, in my opinion, is one wherein the preference stock is set out at its preference value, the excess over the amount realized on sale being deducted from the paid-in value of the common stock. Such excess should not be deducted from the earned surplus.

The only advantage which no-par-value preferred stock has is that it may be issued at any price the directors see fit. The disadvantages would seem to outweigh the advantages. If the only preference was one of dividend return the matter would not offer the same complications.

The principal argument offered in advocating the use of shares without nominal or par value is that the discontinuance of an arbitrary dollar mark would prevent some misconceptions as to value and advise the holder that he is the owner of a certain proportion of the total net worth of a company, leaving it to him to determine what such net worth is instead of relying on the nominal value of his share certificates in determining their value.

This argument does not apply to preferred shares with a stated redemption value, as such shares do not represent an aliquot part of the net worth of a corporation. Such shares are substantially

in the same position as par-value preferred stock and the sole reason which can be advanced for their use is that they can be sold at a discount from the redemption price.

Thus the no-par-value-stock laws, instead of carrying out their high purposes, merely become the legal means of issuing stock at less than par, for the redemption value is in reality a par value.

It is difficult to see why this subterfuge should be adopted when preferred stock might be sold at a par value if the dividend rate were adjusted to meet money market conditions and to the limitations set by the company's credit. The reason that this is not done is due mainly to a feeling on the part of the issuing companies, and perhaps investment bankers, that a company's credit is injured by issuing preferred stock with a high dividend rate. However, a lower dividend rate on a lower issue price actually means the same as the higher dividend rate on par value and it would appear that any subterfuge employed to mislead the investing public should not be advocated by those who have sought a corrective for existing evils of capitalization in the no-par-value idea.

CONCLUSION

In conclusion it may well seem that the issuance of capital stock without par value has not really served any good purpose and, through careless legislation, has created unnecessary problems for the business man and accountant. If, however, we are to retain its use, it seems essential to secure remedial legislation correcting obvious faults in existing laws. I believe that it would be a wise plan for a selected group representing the legal profession to be appointed in conjunction with a similar group of accountants to study the subject and to prepare a model no-par-value-stock statute.

Such a joint committee should give special attention to the task of clearly defining surplus available for dividends.

Attention should next be directed to the abolition of no-par-value preferred stock with all its attending ambiguities. These steps would serve to eliminate many of our difficulties and would accomplish much toward clarifying the situation. I do not see how a sound and practical no-par-value-stock statute can be enacted without study and coöperation between the two professions which are most concerned with its use and are, together, acquainted with all the difficulties and complications which may arise.

The no-par-value-stock idea is inherently sound. If accountants had been called upon to explain some of the fundamental principles involved before the enactment of laws governing this issue, many of the difficulties now experienced would have been avoided. It will not be out of place to reiterate a few of these principles:

1. That no part of capital contribution should be used for the payment of dividends, as dividends essentially represent a distribution of earnings,
2. That stock having a definite stated preference upon liquidation has no place in a no-par-value-stock statute,
3. That where two or more classes of stock are issued for a mixed aggregate of property, the relative values or rights of each class should be clearly set forth at the time of issuance.

The first step in the solution of any problem is a clear understanding of its terms. Therefore, the immediate duty of accountants is to bring to the attention of legislators and the legal profession the difficulties which have been created through careless legislation on this subject, and then to work for coöperation in removing these difficulties by the enactment of uniform and consistent laws governing the issue of no-par-value stock.