University of Mississippi

eGrove

Haskins and Sells Publications

Deloitte Collection

1931

Capital reductions

Anonymous

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Bulletin, Vol. 14, no. 01 (1931 January), p. 2-5

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

organization. Business, undoubtedly, has slumped because of a decline in effective demand, which is demand accompanied by purchasing power. This country is overequipped to supply the present demand. Unless the equipment is to be reduced, demand must be increased. Spending, seems to furnish the answer. Governmental as well as private enterprises are engaged in a campaign of spending which will be enlarged in the near future. The result of the increased purchasing power should result in a return to more normal business conditions.

Capital Reductions

THE liberality which characterizes the corporation laws of some states tends to a frame of mind which dismisses from serious consideration reported actions of corporations organized under the laws of those states. One reads in the newspapers of certain actions taken by a corporation existing under authority of the laws of a certain state, and passes along to other news items with the thought that anything approved by formal vote of directors, is possible under such laws. The action need not be rational. It may be unsound economically. The effect may be a suppression of the facts. But if expediency so dictates, and the action is taken properly, the action has the stamp of legality. Such is likely to be the mental attitude of one who is familiar with these matters.

In fairness to such laws, it is interesting to consider, without prejudice, the proposed action of a certain holding company as reported in the news column. Is the action facilitated by the laws governing the organization and corporate conduct of the company in question? Is there anything questionable about the proposed action? Does it gain any improper advantage on account of the character of its shares of capital stock and the laws authorizing the issuance of such shares?

"The Blank Corporation has called a special meeting of class B stockholders for November 28 to vote on a proposal to reduce the stated value of the class B stock from $65,849,369.00 to $46,842,721.00, thereby creating capital and capital surplus and applying a portion of the capital and surplus to write investments down to market value.

"The purpose of the proposal is to reduce the paid-in capital of the class B stock from $10.00 to $5.00 and bring about a capital readjustment and thereby correct the existing situation under which the payment of dividends may be interrupted, while the corporation is receiving income from investments sufficient to cover dividend requirements."

The foregoing quotations, slightly disguised, are as reported by the press from the company's announcement. The discussion which follows is based on the newspaper statement.

Analyzing the announcement, it is apparent that the company issued some of its stock for, or purchased from the proceeds thereof, certain securities, at prices, which, on the basis of the market (October 31, 1930) would have to be reduced substantially. This would result in a material reduction of the balance sheet value of the securities owned. The paper loss incident to such devaluation presumably would be large. It would be too large to permit of absorption by the surplus accounts, the character of which is not disclosed. The corporation may have had earned surplus, or surplus arising from valuation of securities, or paid-in surplus resulting from arbitrary classification of paid-in capital. At any rate, whether from motives of necessity, or of expediency, there was not sufficient surplus to absorb the write down. And so, it is proposed that stated capital shall be adjusted, so reducing it as to make

available an amount sufficient to absorb the loss and still, presumably, leave a cushion to guard against further market declines and afford a reasonable remainder in the surplus available for dividends.

Action such as the foregoing, which recently has been followed by several corporations, particularly of the investment trust class, doubtless is facilitated by the laws of certain states. If a corporation such as the type in question had nothing but capital stock with par value, it would be necessary by formal action to reduce the par value of the stock, call in all the old stock and issue new stock in its place. This procedure in some cases would be a sizable undertaking. Where the shares have no par value, the matter becomes one merely of accounting based, however, on formal action. In other words, a resolution of the directors, ratified by the stockholders whose capital would be affected, transferring an amount per share from capital to capital surplus, would serve as the authority for the accounting action. Such action would consist in transferring an amount from capital to capital surplus and charging against that surplus the amount of decline in the value of securities from cost to the lower market.

This action would save the corporation from any charge of having paid dividends when its capital was impaired, as might have been the case if the capital had not been legally reduced. It is easy to understand that if the loss in asset value of securities had been charged against earned surplus or previous capital surplus, such surplus might have been insufficient to absorb the capital loss, and that even though subsequent income might be sufficient to pay subsequent dividends, a considerable portion of such income might be needed to restore capital before the dividends could be paid legally.

There is a doctrine running generally through the corporation laws of the various states, that dividends may not be paid legally while there is an impairment of capital. This is true of Delaware except that the protection of capital from the payment of dividends is limited to shares having a preference in liquidation, as will be seen from the following:

"Section 34. Dividends; Reserves:—The directors of every corporation created under this Chapter, subject to any restrictions contained in its Certificate of Incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (*a*) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14, 26, 27 and 28 of this Chapter, or (*b*) in case there shall be no such excess, out of its net profits for the fiscal year then current and /or the preceding fiscal year; provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a *preference* upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of the capital represented by the issued and outstanding stock of all classes having a *preference* upon the distribution of assets shall have been repaired." * * *

There is nothing further in the section that qualifies the foregoing. The sections referred to (Sections 14, 26, 27 and 28) cover respectively, issuance of shares, amendment of certificate of incorporation, retirement of preferred shares, and reduction of capital. The provisions therein do not interfere with the rules laid down in Section 34.

Out of the section just quoted, one might read that common capital may be paid away as dividends. "Capital * * * diminished * * * by losses, or otherwise, * * *" might so imply. Capital might be dim-

inished "otherwise" by the payment of dividends. It is doubted, however, if this would be a fair inference. The word "capital" used in a general sense is all embracive. It does not distinguish one class from another. It includes both preferred and common capital as those classes are denoted by preferred and common shares. Consequently, any excess of net assets over capital must mean any amount of net assets in excess of capital as represented by both preferred and common capital stock. If the directors may declare a dividend out of any such excess, it is fair to assume that they may not declare a dividend if there is no such excess.

The significance of the provision for declaration of dividends out of "its net profits for the fiscal year then current and /or the preceding fiscal year" is more difficult to interpret. Reference to the "current fiscal year" is understandable. A corporation might have had its common capital impaired by depreciation in the value of its property, or by losses, and yet make a profit during a current fiscal year. The meaning of the statute in this respect is clear, namely, that even though common capital may be impaired, profits for the current year may be appropriated for dividends without the necessity of first making up the impairment of common capital. The words "and /or the preceding year" appear to have been inserted by some zealous, although not fully informed, lawmaker in the excitement of legislative pressure, inasmuch as any profits in a preceding year, if not used to repair capital, would result in net assets in excess of capital in the current year. If profits in the preceding year had been used to repair capital, how could they be used for dividends in the current year without paying dividends out of capital? The statute must mean, therefore, that, if necessary, action through which capital was repaired in a preceding year may be reversed, if profits in the current year are not sufficient for dividends and profits for the preceding year may be made available for dividends in the current year. Only in this way does it seem possible to reconcile the apparent contradiction in the statute. It must not be forgotten, however, that preference stock marks the dead-line where the latitude stops.

In the light of the foregoing, one may say that there appears to be nothing questionable legally about the proposed action of various investment trusts to reduce their capital, where the corporation laws under which they were chartered are as elastic as those of Delaware. Further, there seems not to be anything morally or economically questionable about such proposed action. Price levels in the stock market patently are lower than they have been for some years. Perhaps they are permanently lower. At least the prospects are that they will remain lower for some time to come. And it seems to be the part of wisdom to recognize this condition and adjust the asset value of securities accordingly. However, when and if the price level definitely rises to a point where it may be expected to remain for a while, any readjustment upward of asset values should result in a credit to capital, not to earned surplus. The adjustment of capital downward is logical, if capital was invested originally in securities which have declined severely and somewhat permanently in market value. But any later adjustment upward should be consistent. If loss in security values impairs capital, a recovery in such values would repair capital. On the other hand, if such book losses were to be charged against earned surplus, or against capital surplus, it would not seem inconsistent to repair such accounts, if losses in value later are reinstated. This, however, raises a question concerning securities written down now and later sold at a price in excess of book value. Where should the profit be credited? The answer should not be difficult: to capital, if a loss in excess of the profit was charged against capital; to capital surplus, if the charge for decline was

made against capital surplus; to earned surplus, if the charge was against that account. But, none of these corporations probably will increase the stated value of its capital shares unless recovery becomes so marked as to result in a large capital surplus. And they will be within their rights, having taken formal action to reduce their stated capital. They would be within their legal rights also, undoubtedly, if they were to insist on crediting the profit to earned surplus and paying it out as dividends, inasmuch as the adjustment of stated capital is tantamount to apportioning their capital to absorb a loss. If the loss is not sustained, the action in segregating a part of their capital to absorb a loss has in reality served to create a surplus.

These corporations gain no improper advantage necessarily from shares having no par value and from laws permitting wide latitude of action. It would be a silly law that would not permit a corporation to adjust its capital account to give effect to capital losses. No legislation can prevent a corporation from losing money. One may take issue with a law that permits contributed capital to be apportioned at time of receipt between capital account and surplus account, and still find no fault with the same law that sanctions and encourages a corporation which has lost part of its capital to adjust its capital accounts accordingly. Any group of stockholders may agree among themselves to do anything legal or not to do anything illegal. If the stockholders in a given group agree that they have lost a part of their capital, what is more logical than to agree to give expression to that loss.

In a matter of shares without par value, nothing is gained through placing a stated value on each share except convenience in accounting for any number of shares less than the whole. The capital account might be reduced, or increased, as easily if the shares had no stated value. In the instant case, shares without par value permit of a ready reduction in capital without having to call in and exchange all outstanding shares.

Co-operation with the Bankers

A NOTABLE gathering occurred at Briarcliff Manor, New York, October 27, 1930. It was the occasion of the Fall Meeting of The Robert Morris Associates. There were present as guests Messrs. Campbell, Hurdman, Montgomery, Carter, Foye, Berdon, Webster and Klein, representing various committees of accounting societies having relations with the Committee on Co-operation with Public Accountants, of which Mr. Harvey Whitney is chairman.

The discussion which followed was extremely interesting. Mr. Whitney read various letters, dealing with matters contained in reports of public accountants, which he had solicited and received from members. On the basis of these he, and other members, interrogated the accountants.

Some of the matters submitted were as follows:

"(*a*) Possibly three years ago a complaint was filed with us involving an item of accounts receivable in a financial statement which included a substantial sum due from a 100% owned subsidiary. We took this up with the accountant, making the point that this amount should be segregated. There was considerable correspondence back and forth and finally an intimation that the item would be properly handled in future statements. This not being the case, we referred it to the American Institute Committee on Co-operation with Bankers, who in turn passed it along to the Committee on Professional Ethics, as we had registered this as a formal complaint. Before the matter was disposed of the accountant resigned from the American