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The Capital Adjustment Theory of Treasury Stock

(*An educational inquiry into the application of the theory, and obviously not a pronouncement of firm policy.*)

TREASURY stock of a corporation is capital stock acquired by the corporation subsequent to its original issuance. If acquired in exchange for a consideration, the transaction results in a reduction of capital in an amount equal to the money-value of the consideration given for the stock. Capital stock outstanding is a representation that there is capital in the enterprise equal in amount to the par value or the stated value of such stock. Treasury stock, acquired in exchange for money consideration, is an admission that capital has been withdrawn from an enterprise. A sale of treasury stock results in an increase of capital equal in amount to the money-value of the consideration received for the stock.

In presenting this view of treasury stock for the purpose of discussing the effect on capital when a corporation buys and cancels, or buys and resells, shares of its own capital stock, it is necessary to establish concepts of capital, business capital, and legal capital, and to differentiate the two latter terms. In attempting to do so, it is the intention to make the definitions apply to amounts as invested originally by proprietary interests, regardless of any subsequent effects produced upon such amounts by profits or losses. The novelty of the capital adjustment theory makes necessary more detailed exposition and illustration than ordinarily is required.

Capital, in a business sense, is an abstract term used to denote the value, expressed in dollars, of the consideration transferred from one party to another in exchange for an interest in a business enterprise. Because it is possible to use the term "capital" in an abstract manner, it is possible to think and talk about capital, as a sum, without having to specify constantly the concrete representations of value involved. One may speak of capital as having been invested, or increased, or decreased, and mean thereby a sum of dollar-values, without particularizing the objects in which the values are embodied. Such is the manner in which the term is used in this discussion.

The business capital of a corporation is the value, expressed in dollars, of the consideration received by the corporation in exchange for the certificate of share-interest which it issues. If a corporation has received $125.00 for a certificate of share-interest, it has received that much business capital.

The legal capital of a corporation is the amount, expressed in dollars, of the par or of the stated value of its certificates of share-interest, which the corporation represents, through its capital stock account, to be outstanding. If a corporation receives

$125.00 for a share of stock having a par value of $100.00, the latter rather than the former figure denotes the amount of legal capital.

In a given corporation, the amount of business capital and the amount of legal capital may not coincide. The amount of legal par stock capital must be some multiple of the par value per share. Changes in the capital stock account follow the same rule. Business capital is the aggregate of the consideration received for the shares. Changes in the amount of the business capital are governed by the amount of consideration involved. Usually, a share may not be sold originally at less than par. It may be sold at more than par.

In the purchase by a corporation of its own par stock, there may be a difference between the par value and the price paid. Subject to statutory restrictions in certain jurisdictions, the price paid may be either below or above par. Treasury stock may be sold, according to the general notion, at any price, whether below or above par.

The conflict existing between capital which is measured by par value and capital which is measured by dollar consideration, when the two amounts do not coincide, may be reconciled in deliberating on treasury stock transactions as adjustments of capital, by recognizing a class of capital which, to coin a term, may be called "non-stock" capital. Imagination may permit one, for purposes of clarification, to think about the capital as in two fields: one, the field of stock capital; two, the field of non-stock capital. The field of stock capital may be taken to be that which comprehends the amount of capital as represented by the capital stock. The field of non-stock capital is that which embraces capital which, while arising from consideration received, is excluded from capital stock by the delimitations of par value, or stated value. Thus, when capital which arose from money consideration is released from stock capital by application of the par rule, it shifts to the non-stock capital field. This occurs, for example, when stock is purchased at a price which is less than par. Conversely, when, for example, a share of treasury stock is sold at cost, or above, but at less than par, and it becomes necessary to state the stock capital in an amount equal to the par value of the share sold, the difference between the par and the sale price must be shifted back to stock capital from the non-stock capital field.

The capital adjustment theory of accounting for share transactions when a corporation deals in its own stock is not concerned with the identity of the individual from whom a specific share has been purchased, nor with the identity of the individual to whom a specific share of treasury stock has been sold, nor with relating the price of any share sold to the price of any share purchased. Each transaction stands on the relation of its own price to the par value of the shares represented by the price. Thus, in embracing the capital adjustment theory, the profit and loss concept in respect of such transactions is discarded. The function of any account contrived under the capital adjustment theory to show the effect of the share transactions is to reveal, at rest periods, how much business capital (stock capital plus non-stock capital) there is to support the representations, made by means of the capital stock account, as to the amount of legal capital.

A short table, with the transactions shown in a running arrangement, will serve to illustrate how the items result in adjustments of business capital rather than in profits or losses:

Transaction	Stock Capital Par	Price	Non-Stock Capital	
			Increases	Decreases
Original Issue.	$10,000.00	$10,000.00	—	—
Purchase	− 100.00	− 100.00	—	—
Purchase	− 100.00	− 80.00	$ 20.00	—
Sale....	+ 100.00	+ 90.00	—	$10.00
Sale....	+ 100.00	+ 105.00	5.00	—
Purchase	−1,000.00	− 750.00	250.00	—
Result	$ 9,000.00	$ 9,265.00	$275.00	$10.00

An account might be designated as non-stock capital and be used to show the effect of the share transactions, but, as will be pointed out later, there is a better way of handling the matter. For the moment, however, it may clarify the situation somewhat to consider a non-stock capital account as one to which the prices relating to the transactions are charged and credited, respectively; with the corresponding par amounts simultaneously transferred from or to the capital stock account. For example, continuing the previous illustration:

Capital Stock		Non-Stock Capital	
(1) $100.00	(3) $100.00	(1) $100.00	(1) $100.00
(2) 100.00	(4) 100.00	(2) 80.00	(2) 100.00
(5) 1,000.00		(3) 100.00	(3) 90.00
		(4) 100.00	(4) 105.00
		(5) 750.00	(5) 1,000.00
− $1,000.00			+ $265.00

A corporation which buys a share of its own capital stock having a par value of $100.00 and pays therefor but $80.00, has reduced its stated legal capital in the amount of $100.00 and its business capital in the amount of $80.00. The effect on the capital structure is to shift $20.00 from the stock to the non-stock field. If the stock is resold at $80.00, that amount is obtained from the purchaser, and with the amount of $20.00 taken from the non-stock field, serves to restore the capital in the stock field to its original state.

If the par value of a share of stock outstanding is $100.00, there is an implication that the corporation has that much capital in the business. A corporation selling for $90.00 a share of treasury stock having a par value of $100.00 would be under the necessity of appropriating $10.00 from non-stock capital, or from surplus, in order to keep faith with creditors on account of the representations made with respect to capital stock. Likewise, if the share in question were to be sold for $70.00, it would be necessary to find the amount of $30.00, either in non-stock capital or in surplus.

Illustrating this point, the following tabulation may be used, basing the sale on the figures taken from the latter of the two preceding examples:

Legal capital represented as being held in the business for the benefit of creditors......	$100.00
Less, own stock purchased (cost)	80.00
Non-stock capital, being part of original money consideration....................	$ 20.00
Add, treasury stock sold (par value $100.00)............	70.00
Capital in the business for the payment of debts..........	$ 90.00
Capital now represented to be in the business for the payment of debts.............	100.00
Amount required from surplus (or other non-stock capital)..	$ 10.00

This proposal incidentally raises a question which not only is novel, but may be regarded, perhaps, as revolutionary. "May a corporation sell treasury stock at less than par, unless it has in non-stock capital, or in surplus, an amount sufficient to make up the difference between par and the amount realized?" One has but to consult the preceding illustration and recall the tenor of certain common law decisions to conclude in the negative. "The capital stock of a corporation is a fund set apart for the payment of its debts and the directors . . . hold it in trust for that purpose." (In re Fechheimer Fishel Co., 212 Fed. Rep. 357.)

When transactions involving the purchase and resale by a corporation of its own stock are treated as adjustments of capital, an account for treasury stock no longer is necessary, unless, perchance, it were to be desired for the purpose of recording the share-units. Such necessity does not seem likely unless a corporation is engaged actively in buying and selling its own stock. Even assuming that to be the case, the units of shares bought and sold just as easily may be noted in the capital account where the money is recorded.

A capital account, showing on its credit side the money consideration, par, and units representing the capital structure at the start, with subsequent charges for purchases and credits for sales, each recording consideration, par, and units, might be something of an innovation, but once tried its advantages might be so apparent that it would be continued in use. A capital account so set up and operated would supply, at statement date, the following information: number of shares represented to be outstanding; number of shares in treasury; amount of legal capital; amount of stock capital impairment; amount of non-stock capital; amount of non-stock capital available to make up impairment; amount of surplus required to make good the necessary amount of legal capital; in short, the real capital stituation of the corporation, from whatever angle it might be viewed.

A few transactions shown in account form will demonstrate the claims just made.

	Number of Shares	Par	Consideration		Number of Shares	Par	Consideration
Purchase.....	1	$ 100	$ 100				
Purchase.....	1	100	80	Original Issue.	100	$10,000	$10,000
Purchase.....	10	1,000	750	Sale.........	1	100	90
Balance......	90	9,000	9,265	Sale.........	1	100	105
	102	$10,200	$10,195		102	$10,200	$10,195
				Balance	90	$ 9,000	$ 9,265

This scheme will be found to be preferable to using the old capital stock account in which to record purchases and sales with concurrent offsetting credits and charges for surplus transfers. Such method would fail to disclose the existence of treasury shares and would result in losing the identity of non-stock capital in the surplus account.

The information required is found by consulting the account, as in the illustration above. The number of shares represented to be outstanding is 100. The number of shares in the treasury is 10, found by subtracting the balance in shares (90) from the top figure in the same column (100). The legal capital is $10,000.00. Repeating, in the par column, the process of subtraction, the amount of capital stock impairment is shown to be $1,000.00. The business capital is $9,265.00. The amount of non-stock capital available to make up the impairment of capital stock is $265.00. The amount of surplus required to make good the necessary amount of legal capital is $735.00.

The excess ($265.00) of business capital ($9,265.00) over actual stock capital ($9,000.00) in no sense may be taken as profit. The amount represented to be in the business for the payment of debts is $10,000.00. The actual amount is $9,000.00, unless the non-stock capital of $265.00 be so interpreted and included. The fallacy of any other interpretation is exposed by realizing that if the amount ($265.00) were to be considered as profit and were to be transferred to surplus, $1,000.00, rather than $735.00, would have to be taken out of surplus and appropriated to capital in order to meet the legal requirements.

The task of contriving an account to record the facts with regard to capital is much easier than deciding on a form of balance sheet set-up which would be satisfactory to everyone. A balance sheet presentation derived from the foregoing account, however, would show the capital structure as follows:

CAPITAL:		
Represented by:		
Capital stock (100 shares, par value $100.00 each)		$10,000.00
Less, par value of 10 shares held in treasury		1,000.00
Capital stock outstanding (90 shares)		$ 9,000.00
Add:		
Non-stock capital arising from transactions in corporation's own stock,	$265.00	
Surplus appropriated to maintain capital stock at legal value	735.00	1,000.00
Total Capital. .		$10,000.00

The statement with respect to surplus should represent more than a mere gesture at the balance sheet date. If the corporation is to keep faith with creditors, effect should be given to the representation by making a transfer on the general books so that the amount will be safeguarded against any possibility, as long as the treasury stock is retained, of being interpreted as surplus which justifies a cash dividend. This might be accomplished by transferring $735.00 from surplus to the column used for consideration on the credit side of the capital account, in which event that column would show, after the transfer, a balance of $10,000.00. For example:

Shares	Par	Consideration
Balance. 90	$9,000.00	$ 9,265.00
From surplus.	—	735.00
		$10,000.00

If, and when, the treasury shares are sold, the amount to be released from appropriated surplus to free surplus will depend upon the amount received for the shares. Assuming that the shares will bring $735.00, the entire amount may go back to surplus, inasmuch as the amount received, together with the amount of non-stock capital, will provide the amount of $1,000.00 which will be required in the capital stock account. Any amount received less than $735.00 will determine, by comparison with $735.00, how much appropriated surplus must remain in capital account to supplement the non-stock capital in making good the capital stock account. Any amount received in excess of $735.00 will determine how much may be deducted from the non-stock capital before determining how much of that capital must go to bring the legal capital up to $10,000.00.

The theory of treasury stock under which transactions are viewed as adjustments of capital, regards treasury stock, not as an asset, but as an instrument having asset-producing possibilities. Treasury shares are something which may be sold, as long as they remain uncanceled, for the purpose of regaining capital which has been taken out of the enterprise by the persons who surrendered the shares.

The effect of canceling, in accordance with legal proceedings, the treasury shares illustrated in the foregoing account form, would be to remove a potentiality existing before the shares were canceled. When the shares were held in the treasury, they constituted something which the corporation might sell. If the shares had been sold, the value of the consideration received in exchange for them would have determined the amount in which capital had been brought back into the enterprise. Having canceled the shares, the possibility of sale is removed and the corporation stands, as to capital, precisely where it stood before the cancelation, except that it is minus the instrument which was capable of producing capital.

Assuming cancelation to have been effected, the corporation rests with ninety (90) shares outstanding, capital of

$9,265.00 in the enterprise, and a representation to creditors that there is at least $9,000.00 in the enterprise. The excess of business capital over legal capital is $265.00. This amount was derived from adjustments due to differences between amounts of consideration received or paid and the par value of shares put out or taken in.

Tracing the effect of these transactions on capital by alternating the purchases and sales, the result is accounted for in the following table:

Capital obtained through original issue	$10,000.00
Deduct, capital returned to shareholder by purchase of 1 share	100.00
Capital remaining in the enterprise	$ 9,900.00
Add, capital obtained through sale of 1 share	90.00
Capital in the enterprise	$ 9,990.00
Deduct, capital returned to shareholder by purchase of 1 share	80.00
Capital remaining in the enterprise	$ 9,910.00
Add, capital obtained through sale of 1 share	105.00
Capital in the enterprise	$10,015.00
Deduct, capital returned to shareholders by purchase of 10 shares	750.00
Capital remaining in the enterprise	$ 9,265.00

Now, arises a controversial question which has disturbed the peace of mind of many thoughtful persons who like to be supported in their conclusions by sound reasons. Reduced to its most pointed form, and stated in terms of this illustration, the question is as follows: "The corporation having reduced its legal capital to $9,000.00, may the amount of $265.00 be paid out as cash dividends on the grounds that the amount represents profit?" The answer to this question depends upon the test which is applied.

If the test is to be whether the amount represents profit or capital, the answer is that it may not be paid out. The amount is a remainder of part of the consideration which was received by the corporation in exchange for capital shares and therefore is capital, not profit. Any distribution of the amount would be a distribution of capital. Cash dividends may not be paid out of capital.

If the test is to be whether any stockholder receiving a cash dividend based on the entire amount would be receiving, in the guise of profit, any part of the consideration which he advanced as capital, the answer again must be that it may not be paid out. But the amount is divisible into two parts: one, that which represents treasury shares sold at more than par; the other, that which represents shares purchased at less than par. A revised conclusion therefore is in order, and must be that as to the former class of items a cash dividend is inappropriate, but that as to the latter class it is permissible in the light of the test. Somewhere in the list of shareholders will be one from whom was derived the amount of consideration in excess of par. Nowhere in the list will there be anyone who parted with the amount of consideration represented by purchases at less than par. No creditor would have cause to complain, because there is in the business, for the payment of debts, all that the corporation claims to have for that purpose.

Deferring for the moment any final conclusion on the question, it is pertinent to inquire as to whether the situation would be different, if after the sale of all treasury shares and before reduction of capital by legal proceedings, there were to remain an amount of capital in excess of the legal requirements. In other words, assuming

that the ten treasury shares had been sold for $750.00, instead of being canceled, there would be $10,015.00 of capital with only $10,000.00 needed to meet the legal requirements. Would it not be safe to distribute the amount of $15.00 as a cash dividend without fear of criticism further than that which arises on the grounds of paying cash dividends out of capital?

The new situation would differ from the preceding one only in that the uncertainty concerning the possible sale price of ten shares of treasury stock, with a possible call on non-stock capital, has been removed. There still is among the outstanding shareholders one who paid an excess of $5.00 over par as a part of the consideration for his shares. The $10.00 amount came from consideration paid in by a shareholder no longer having any claim on the corporation. Because of the simplicity surrounding the illustration, it is possible to see that a retiring shareholder gave up his claim to $20.00; that $10.00 of that amount was used to restore the legal capital upon the sale of a share in the amount of $90.00; and, that the remaining $10.00 constitutes non-stock capital belonging to the corporation. But, if $15.00 were to be paid out as cash dividends, the shareholder who paid $105.00 as capital would be receiving part of it back under an implication of profit.

Where the list of shareholders is one of considerable length, it is impracticable to determine, except by arbitrary methods, how much of the capital remaining in excess of legal requirements after a series of transactions in the corporation's stock is attributable to retired stockholders. This is true because it is difficult to identify, when resold, the particular shares bought at a price under par. Were it possible to do so, an amount previously assumed to represent non-stock capital, on the theory that purchases at less than par establish such capital, might be found to have disappeared because of sales of the same shares at cost, or less. But the corporation always should know, if any treasury shares have been sold at amounts in excess of par, that somewhere there are one or more shareholders who would receive back, as profit, capital which they contributed, should the excess amount under discussion be distributed in the form of a cash dividend.

Three objections seem to combine generally to oppose the use, for cash dividends, of capital in excess of legal requirements resulting from purchases and resales by a corporation of its own stock: the reasons just given; the fact that the act would constitute the payment of a cash dividend out of capital; and the possibility of further purchases of stock at prices impossible of predetermination.

When an excess of capital over legal requirements resulting from transactions in the corporation's own stock exists after reduction of capital by due process of law, it appears that the main objection to the payment of a cash dividend out of such excess is that it violates the principle that cash dividends may not be paid out of capital. Borrowing a word from one of the statutes on the subject of dividends, it is "repugnant" to those who accept as their concept of capital that it is the value of any consideration received in exchange for a capital interest. This reason is sufficient, perhaps, lest by violating that principle there be broken down some of the pillars by which rational thought and sound conclusions are supported. But if an amount of such capital is to be appropriated for cash dividends after formal reduction of capital stock by legal proceedings, it should be done in an orderly manner, with knowledge of its significance and the formality of a resolution by directors authorizing and approving a reduction of the business capital.

The observations hitherto made concerning any net accretions to business capital which have resulted from comparisons between amounts of consideration and par valuations have taken no cognizance of any particular statute governing the matter. In some jurisdictions there are such statutes, and, obviously, where they exist they must be respected and followed. The New California Corporation Law, which became effective August 14, 1931, provides specifically for the treatment of such accretions when they arise as a result of reducing, as prescribed by that law, the amount of stated capital. In substance the specifications leave the disposition of the

amount involved to the discretion, within certain limits, of the directors; to the will, without limitation, of the holders of two-thirds of the shares of each class outstanding, but in the event that neither directors nor stockholders act in the premises, the amount becomes subject to disposition by the directors in the same manner as surplus paid in by the shareholders. Briefly, paid-in surplus may be appropriated to the payment of cash dividends to shareholders with preferential dividend claims, provided there is concurrent notice as to the source of the payment; to share dividends to any shareholders, with notice as to source; to extinguishment of a deficit, with disclosure; and to redemption under certain conditions.

What practical purpose is served by consideration of the capital adjustment theory of treasury stock and a detailed exposition of its application? Is it anything more than an ingenious scheme for doing the same thing in another way and reaching the same end?

In all the years during which the commodity theory of treasury stock has prevailed, it has failed to bring to light some of the important aspects of the situation which have been brought out by consideration of the capital adjustment theory. To wit:

(a) That a transfer from surplus to capital is necessary when a corporation buys its own shares. A corporation may not buy its own shares without an amount of surplus sufficient to cover the purchase price, except as in (b).
(b) That any non-stock capital resulting from adjustments of capital due to transactions by a corporation in its own shares may be treated as a reduction of the amount which must be transferred from surplus. In this there is an implication that non-stock capital resulting from the excess over par on sales of shares at time of original issuance, may be so used.
(c) That treasury shares having a par value, acquired in exchange for a money consideration, may not be given away, or be sold at less than par, unless there is in non-stock capital, or in surplus, an amount sufficient for transfer to capital to make up the par, if the shares, perchance, are issued without consideration, or to make up the difference between the sale price and the par, if the stock is sold at less than par.
(d) That any detachment from legal capital, resulting from adjustments of capital due to transactions by a corporation in its own shares, is capital, rather than profit.
(e) That the prices involved in any future purchases or sales by a corporation of its own shares which may affect the non-stock capital cannot be predetermined.
(f) That if any part of the non-stock capital has arisen from treasury stock sold above par and that non-stock capital is distributed as a cash dividend, some part of it will go back to some shareholder who contributed it as capital.
(g) That no part of any non-stock capital arising from shares purchased below par, if distributed as a cash dividend, will go back to any shareholder who contributed it as capital.
(h) That it is illogical, judged by the established concept of business capital, to distribute as cash dividends any part of non-stock capital resulting from adjustments of legal capital. If after reduction of legal capital by proceedings at law, it is considered desirable to reduce the non-stock capital, such action should result from corporate proceedings and not from automatic adjustment on an accounting theory of profit.

The foregoing discussion obviously has left untouched such topics as common shares purchased above par and sold above par, etc.; preferred shares purchased and resold, or purchased and canceled; shares donated, and their subsequent disposition; and the somewhat rare situation today wherein no-par shares have a stated value en block, but no stated value per share, etc. These, and perhaps related topics, will be discussed in the next number of the Bulletin.