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Some Questions on No-par-value Stock *

BY FREDERICK H. HURDMAN

At the annual meeting of the American Institute of Accountants, held in St. Louis in September last, certain questions relative to stock of no par value were suggested for consideration. These questions are used as the basis for the following comments:

1. Should earned surplus be segregated on the balance-sheet and not shown as part of capital or capital surplus?

As the balance-sheet of a company is prepared for the purpose of exhibiting its financial condition, it is quite essential that the statement be prepared in such a manner that none of the principal elements is obscured. It is necessary that the nature of the assets and liabilities be shown and quite desirable that the net worth be exhibited in such fashion that the amount representing the permanent capital invested by the stockholders may be distinguished from the accumulated earnings or deficits from operations.

As the invested capital should be represented by the capital stock and capital surplus, if such exists, it is important that these should be clearly distinguished from that part of the net worth which represents accumulated earnings. If this is not done an examination of the statement will not disclose the amount of the fund available for dividends nor advise possible creditors the amount by which the assets may be depleted through the payment of dividends. The failure to make any distinction between earned and capital surplus 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 a company's officers to make a proper segregation of surplus. Furthermore, it is conceivable, where no segregation is made between capital and earned surplus, that losses may be given the appearance of profits by adjustments through surplus for revaluation of property, franchises, etc., and a healthy tendency exhibited where the reverse may be true.

2. Is it necessary to show capital surplus separate from capital? If so, in what circumstances do you think it advisable to make this further segregation of capital?

* A paper read at a meeting of the Massachusetts Society of Certified Public Accountants, Boston, November 24, 1924.

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 only extend 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 in regard to it) 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 with 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 where 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 unexpended profits of the business available for dividends.

3. What constitutes earned surplus in the case of a merger of two or more companies?
4. Where the entire capital stock of one or more companies has been acquired by a newly organized company in exchange for its no-par-value stock would any part of the earned surplus of the companies so acquired form part of the earned surplus of the new company? We must assume of course that the basis of exchange was so many shares of the new company's stock for so many shares of the stock of the companies acquired.

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 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 when 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 the corporations cited no new entity was 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 cannot 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 in which 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.

Referring to the specific example set forth in question four, namely, a new corporation which acquired the stock of other companies, it is apparent that the new corporation cannot start with an earned surplus as it has had no earnings. It is in the same position as any other new corporation, regardless of the character of the assets acquired through the issuance of capital stock. Even in a consolidated statement of the corporation and its subsidiaries, if any surplus of the subsidiaries is shown it should be styled "surplus of subsidiaries at date of acquisition."

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.

5. In the case of treasury stock acquired at a price above or below the issued price, is it necessary to adjust capital surplus or earned surplus, where surplus is so segregated on the balance-sheet, or should the deduction be made in the capital account only, assuming it is desirable to show treasury stock as a deduction from capital and not as an asset?

The treatment of treasury stock on the balance-sheet, under the conditions cited, requires consideration of the average price at which the total outstanding stock was issued or is carried on the balance-sheet 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 anticipation 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
Deduct excess over average issue price paid for treasury stock acquired for cancellation	1,000
	$11,000

6. Is it feasible to declare and pay stock dividends in stock of no par value and if so what in your opinion should be the necessary procedure in so far as the directors and stockholders are concerned, and what should be the effect on capital and earned surplus?
7. Should the stock-dividend declaration require that a specific amount per share be transferred from earned surplus to capital?

As the purpose of a stock dividend is not merely the dilution of the shares of a corporation, but rather the setting aside of a portion of the earnings as fixed capital, it follows that the payment of a stock dividend by either a par-value or no-par-value corporation 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.

8. Where preferred stock of no par value has been issued with a definite redemption value, should the full redemption value be set up before assigning any value to the common

stock? If not, how would you indicate to the common stock holder the book value of his equity?

The balance-sheet of a corporation having preference stock should show clearly the preferences which one class of stock is to enjoy over the others in the event of liquidation. As has been stated already in answer to previous questions, the statement should also differentiate between fixed capital and earned surplus.

Let us consider a case in which the capital paid in and earned surplus are as follows:

Preferred stock:	
Value paid in	$ 8,000
Redemption value	10,000
Common stock—value paid in	20,000
Earned surplus	3,800

Inasmuch as the difference between the redemption value and the paid-in value of preferred stock will have to be paid out only in the event of liquidation and, therefore, no reduction in the funds available for dividends is created by the issuance of the preferred stock, it is obvious that no deduction should be made from earned surplus because of the difference between the paid-in value and redemption value of the preferred stock. However, in the event of liquidation this difference must abate what otherwise would be the common stock holders' equity, namely, the sum of their investment and the earned surplus.

It would, therefore, be quite proper to set forth the facts in relation to capital and surplus in the following somewhat lengthy manner:

Capital and surplus:		
Preferred stock—redemption value		$10,000
Common stock:		
Capital	$20,000	
Earned surplus	3,800	
	$23,800	
Less excess of redemption value of preferred stock over issue price	2,000	
Equity of common stock holders		$21,800
Total capital and surplus		$31,800

The above form tells all the facts in relation to capital and surplus, hides nothing and, assuming the real value of assets, obviates any mathematical calculation as to the equity of each class of stockholders. It is open, however, to at least one practical objection. The fact of the issuance of preferred stock at what really amounts to a discount is emphasized and this emphasis would be strongly objected to as unnecessary by many clients.

A second method of expression not open to this objection will be found in the following:

Capital and surplus:	
Capital	$28,000
(Consisting of—shares of no-par-value preferred stock —redemption value of $10,000 and—shares of no-par-value common stock)	
Earned surplus	3,800
Total capital and surplus	$31,800

This method shows distinctly the fixed capital and earned surplus and carries the information required to distinguish between the equities of the preferred stock holder and the common stock holder but avoids any statement as to the values paid in for each class of stock. However, that is not an essential fact which requires expression on a balance-sheet, but the plan is open to the objection that the equity of the common stock holders is not expressly stated and must be determined by a mathematical calculation.

A third method, which I believe to be the best, is not open to this objection and though susceptible to criticism is, in my opinion, the form which should be adopted by accountants:

Capital and surplus:		
Preferred stock—redemption value		$10,000
Common stock	$18,000	
Earned surplus	3,800	
		21,800
Total capital and surplus		$31,800

In this form the respective interests of the two classes of stock are shown definitely. Although the total fixed capital is not expressed in one figure, it is differentiated from earned surplus as the latter is shown in a specific item. The reduction from the paid-in value of the common stock of the discount on preferred stock is justifiable as the common stock holders' equity was unquestionably reduced, but no change occurred in the earned surplus or the fund available for dividends. The only item to be reduced, therefore, is the paid-in value of the common stock.

This appears logical if it be considered that the capital stock was all paid in at the inception of the business. There was no earned surplus at that date. Although the common stock holders paid in $20,000, they permitted a lowering of the value of their investment by allowing the issue of preferred stock with a redemption value of $10,000, while only $8,000 was paid in as consideration for such preferred stock.

It is to be noted, therefore, that while the total fixed capital can be obtained by a simple mathematical calculation from the information submitted, the amount paid in on each class cannot be determined. I do not think that this need be shown and in lieu of such information this method of presentation does show the reallocation of the fixed capital values occasioned by the issues of preferred stock.

9. Is there any justification for preferred stock of no par value when a redemption value and preference as to liquidation of assets are assigned to it?

The principal argument offered in advocating the use of shares without nominal or par value was that the discontinuance of an arbitrary dollar mark would prevent some misconceptions as to value and advise the holder that he was the owner of a certain proportion of the total net worth of a company, leaving it to him to determine what such net worth was 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 any price, or in effect at a discount from the redemption price. This reason does not, in my opinion, justify their issuance.

10. Cannot the object sought in the issuance of preferred stock without par value, namely, facilitating sale, be as easily

attained by fixing the dividend at an attractive rate instead of offering stock at a price below redemption value?

The justification offered for the issuance of preferred stock of no par value with a redemption value is that it permits of the sale of stock at a price less than the redemption value. 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 mainly a feeling on the part of 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.

11. Should the stated or declared value be assigned to capital stock on the balance-sheet and every thing over and above that stated value carried in capital or earned surplus, or should the stated value be merely noted for information in the capital section?

In the answers to previous questions it has been stated that fixed capital should be clearly differentiated on the balance-sheet from earned surplus. It is clear, therefore, that the excess of paid-in values over the stated or declared value should not be included in earned surplus, nor does there seem any good reason for carrying the stated or declared value as a separate item on the balance-sheet with the remainder of the paid-in capital set up as capital surplus. The balance-sheet primarily should show financial facts and the fact of importance in regard to the capital is the amount paid in or fixed capital.

Undoubtedly it is advisable to include information relative to the declared value, but this can be accomplished as well by a parenthetical note, without disturbing the proper structure of the statement.

12. Has the use of no-par-value stock corrected the evil of over-valuation it was intended to correct or do we still find patents, franchises, leaseholds and goodwill excessively valued in order to show a large capitalization?

I do not believe that the use of no-par-value stock has served to eliminate or reduce the over-valuation of intangibles nor even served to warn the investing public against the assumption of an arbitrary value for the stock. It is necessary in recording the financial facts of a corporation and in the preparation of statements to use values expressed in terms of money. The values so employed may be as unreal in the case of no-par-value stock as with stock having a nominal value. The real evil exists in the method of valuation and the corrective should be applied there.

13. What may the accountants do toward standardizing and suggesting improvements in legislation in the various states, relating to this question of no-par-value stock?

Accountants in the first instance should apply themselves to a better solution of capitalization evils than is apparently to be secured from the use of no-par-value stock. As to that device itself they should suggest the elimination of preferred stock without par value except where the preference is only in respect to dividends. They should ask for a very clear definition of the funds available for dividends, and this definition should expressly exclude any of the proceeds of the sale of capital stock or unrealized surplus arising from the reappraisal of fixed assets.

Finally, they should also urge more stringent requirements as to the valuation of assets contributed in exchange for capital stock whether tangible or intangible.