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Until about a decade ago and also during the period of prosperity caused by war conditions, it is doubtful if a very large percentage of businesses had what might be called real balance-sheets. This condition of affairs was due largely to a lack of interest in such statements and of appreciation of their real value and significance on the part of the average business man. Balance-sheets were regarded merely as necessary evils used for the purpose of obtaining credit from a bank or to facilitate the floating of new or additional issues of securities. Quite often were they utilized for reports to various governmental agencies and commissions in compliance with some legal requirement.

The preparation of the balance-sheet used to be as pleasant as the compilation of an income-tax statement and as interesting to read as the army regulations to the layman. Today, however, we are all interested in the balance-sheet. Every business man, whether manufacturer, banker or merchant, is reading balance-sheets. Directors of corporations are constantly endeavoring to discover the whys and wherefores of their respective businesses through the medium of these statements. In them they are attempting to find at least some of the reasons for the disappearance of the high profits made during the past few years, as well as the possibilities for their reappearance at some future predeterminable time. In a word, the scope of the balance-sheet has been widened considerably and its purposes multiplied. It is ofttimes as entertaining as a novel and as important to the management as the income itself.

With the above-mentioned facts in mind one will readily concede the urgent need that the utmost care be exercised in the preparation and display of the various items of this all-important statement.

It is extremely unfortunate that as yet so few corporations have lived up to the strict and exacting requirements of accuracy in the display of at least some of the items of these statements. Especially is this true of the rather romantic items of the balance-sheet designated as "surplus" and "reserves," whose more or less haphazard showing is in many instances both meaningless and misleading. It is, nevertheless, a source of great satisfaction that so many business men are turning their attention to these subjects and it is my purpose to attempt to clarify the many varying and confusing meanings and uses of the first of these accounts.

The term "surplus" may be considered either in a broad or narrow sense. Considered in the former sense it may be defined as the difference between the net worth of the business and the par value of the capital stock issued and outstanding. It is the excess of book or economic values over the amount which the liabilities and par value of the capital stock issued and outstanding represent. Where no-par-value capital stock has been issued, the surplus consists of the difference between the net worth of the corporation and the amount realized through the sale of the capital stock issued and outstanding. Where a value is assigned to the no-par stock by the directors of the corporation the surplus is determined the same way as if the stock had a par value equal in amount to that assigned to it by the directors.

There is another usage in which the term means what is sometimes labeled as "stockholders' surplus" or the amount of margin or leftover not required by the business and available for dividends. It is in the former and broader sense that the term will be used in this discussion.

A surplus may arise through the following types of transactions:

1. Payments directly by stockholders, forming the so-called "paid-in" surplus.
2. Capital stock premiums and purchase by the company of its own securities below par.
3. Stock assessments and conversion payments.
4. Stock donation and gifts and contributions from outsiders.
5. Sale of capital-stock assets for an amount in excess of their book value.
6. Reappraising and writing up the book value of certain assets.
7. Normal accumulations of profits as determined by the profit-and-loss account balances.

Another classification may be added for the sake of completeness by applying the term surplus to the amount which arises through the reduction of capital stock outstanding without recompense on the part of the corporation. This is sometimes practised during the abnormal conditions prevailing while a corporation is in process of reorganization and may be considered as an assessment.

Paid-in surplus: It is desirable that paid-in surplus should consist only of sums paid in directly by the stockholders of the corporation, usually at the beginning of the business, as in case of banking and insurance institutions. The primary purpose of such subscriptions is to inspire confidence of the prospective depositors and policy-holders, respectively, by giving these organizations an appearance of greater strength than they would possess otherwise. Another purpose in paying in an extra amount is to enable the directors sooner to commence to declare dividends, there being no need for an accumulation of a surplus from earnings before dividends can be declared, as required by law in some states and by conservative business practice more generally. The stock in these circumstances is subscribed for an amount in excess of par, the excess going into a paid-in surplus fund.

Sometimes the stockholders may be required to subscribe directly to the surplus fund in order to save the company from embarrassment due to unusually low credit. When an investment house suffers extraordinary losses due to unwise selection or concentration of investments, the stockholders may be asked to subscribe directly to the company's surplus and thus save its reputation and goodwill, so important to its future success. The same condition may arise when an insurance company is forced to make extra large payments to its policy-holders due to some catastrophe such as destruction of property by floods, etc. These payments may sometimes be in excess of the company's legal reserves. To prevent an exhaustion of the institution's surplus, which would be likely to impair its general credit, as well as to enable the company to meet its legal requirements the paid-in surplus is subscribed by the stockholders. It is, it seems to the writer, the intention of the stockholders in making the extra payments that should govern as to the proper designation and purpose of such surplus fund which is nothing more nor less than a true and only paid-in surplus. It is regarded accordingly as a part of the capital stock and seldom, if at all, used as a reserve for dividends.

Surplus from capital-stock premiums, etc.: When capital stock is sold at a premium the premium constitutes capital paid into the treasury of the company without a proportionate increase in its liabilities or proprietary-interest shares. This differs from amount paid directly into the paid-in surplus in that the intention and purpose of the stockholders in making these extra payments and the method of determining the exact amount of the excess above par to be added to the company's treasury are different in all cases. Capital-stock premiums are paid by the stockholders because the book value of the stock warrants it—there already exists a surplus which will ultimately be divided among the proprietors. The possibilities for increased and more steady dividend payments are, therefore, greater and the value of the stock is consequently enhanced. Other things being equal, the greater the regularity of dividend payments and the higher the rate of the established dividend the higher the market value of the stocks and the greater the premium paid by purchasers.

Stock premiums may be paid by the stockholders because of the expectation of a brighter future, greater earnings and consequent rise in the market value of the securities. This feature is of significance when securities are marketed on the up-grade of the business cycle. The speculative element is not a negligible item and often sends the prices of securities up many points higher than warranted by their book value and their immediate earning capacity.

When a company purchases its own securities below par, the effect is to cancel a liability or proprietary-interest shares greater than the amount of assets withdrawn for the purpose. The nature of this surplus is the same as that arising from capital-stock premiums and is displayed in a similar manner. It is often advisable to set aside this kind of surplus to absorb and cancel possible stock discounts which are represented by fictitious assets. The result of such treatment would be to obtain an equilibrium between the actual net worth of the business and the par value of the stock or, at least, a showing of the real worth of the stock issued and outstanding.

Surplus from stock assessments and conversions: During process of reorganization stockholders are frequently assessed a definite amount per share which brings about an increase in proprietorship in the form of a larger surplus. Amounts thus received should be credited to surplus from assessments and subsequently may be used by the corporation for whatever purpose desired. It is highly desirable to earmark all these surpluses according to the sources which give rise to them in order properly to display on the balance-sheet the exact results of the normal operations of the business, if for no other purpose.

In case of convertible issues of stocks, especially preferred converted into common at a high conversion ratio, the conversion privilege when exercised constitutes a decrease in the total par value of capital stock and a consequent increase in surplus. Let us assume for purposes of illustration that a certain issue of preferred stock is convertible within a certain stipulated time into the common stock, say, at 200. This means that whenever the privilege is exercised by the preferred stockholders the issuing corporation receives two shares of preferred, par value $100, for every share of the common, par value $100, given in exchange. Sometimes additional payments may be made by the common stockholders to convert their shares into preferred stock. This constitutes an actually realized profit and forms a part of the surplus. The same results are obtained when one form of bonds is converted into another form or when bonds are converted into stock at high conversion ratios.

Donated surplus: Stock donations create an increase in proprietorship on the books of the corporation and occasionally a real profit may result. At any rate the proprietorship is increased through a corresponding increase in the assets when the donated stock is sold for cash or other consideration, whereas the liabilities remain unchanged.

Since a surplus arising from stock donations is usually accompanied by over-capitalization and thus represents fictitious assets, it is advisable to follow the policy of never distributing these amounts as dividends as long as the fictitious values remain unabsorbed nor until all moisture is squeezed out. The title itself is a sufficient indication of the nature of the surplus. It is virtually an appropriated surplus.

Gifts and contributions from outsiders cause a real profit with no corresponding increase in the company's liabilities or proprietary-interest shares. A municipality or an association may donate a factory site and offer other similar gifts and bonuses to induce a manufacturer to establish a plant in a certain locality. A donated-surplus account is thus created. If such gifts and contributions are outright and unconditional there appears to be no objection to the disposition of the surplus thus created in a manner similar to that in which earned surplus is distributed. However, as long as these gifts and contributions are to be reserved and remain undistributed, the earmarking of the amounts withheld as "donated surplus" will be sufficient indication of the intention of the board of directors. If these gifts are contingent upon the performance of some act on the part of the recipient corporation the designation of the amounts as "donated surplus" seems to be unavoidable.

Surplus from sale of capital assets: A balance-sheet should display separately any surplus arising from the sale of capital assets for an amount in excess of their book value. The profits realized from the sale of such properties may be due to an appreciation in their value on account of rising prices generally or to an under-estimation of the life of the assets thus sold and a consequent over-estimation of the depreciation charges. In the latter case, there is every reason for reserving the profits as a capital-surplus account to absorb all possible losses suffered from the sale of other assets whose depreciation charges have been under-estimated due to an over-estimation of their life. By keeping these entries out of the general surplus arising from accumulated earnings of the business, a great deal of confusion is avoided and the results of the normal conduct of the corporation can be shown more accurately. Capital surplus may or may not be available for dividends, depending largely upon its origin. A distribution of such a surplus as dividends is in some instances prohibited by law or contract.

Surplus from appreciation: A surplus often arises through the acquisition of properties for which a smaller par value of securities is paid than the value of the assets acquired. Such surplus is similar to that arising from premiums paid on stock and may be treated in the same way. There may also be a readjustment of the book value of assets actually appreciated. Such a situation sometimes arises during the process of reorganization when assets are written up to facilitate the floating of new issues of stocks and bonds made necessary by the change in the financial structure. By-products of practically no value may become highly valuable to the parent corporation as a result of the formation of a subsidiary to utilize them. Amounts so derived are sometimes treated as capital surplus. The line of distinction between these two at best is faint.

When a complete analysis of the various sources of surplus is desired such items should be displayed separately on the balance-sheet. On the other hand, there seems to be no harm in merging the surplus arising from appreciation with that derived from the normal operation of the business, provided the surplus is bona fide and not a product of manipulation for the sole purpose of distributing part of the capital as dividends to the stockholders, which not only is in opposition to sound and conservative management but also is prohibited by law.

Earned surplus: Surplus arising from the normal accumulation of profits resulting from the ordinary operations of the business is commonly known as "earned surplus." This surplus together with any other surplus which with propriety under some conditions may be merged with it should be disposed of somewhat as follows:—

Earned surplus:—

1. Appropriated surplus:—
    a. For special reserves:—
        1. Reserve for unprofitable improvements.
        2. Reserve for market fluctuations and commitments.
        3. Reserve for reinvestments.
        4. Reserve for future dividends.
        5. Reserve for insurance (when own insurance is carried or for uninsurable items, such as breach of contracts, etc).
        6. Reserve for changes in demand for the product, etc., etc.
2. Unappropriated surplus:—
    a. Dividends.
    b. Balance carried forward.