Journal of Accountancy

Volume 30 | Issue 1 Article 6

7-1920

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Most of our accepted authorities on accounting terminology and procedure have correctly defined treasury stock in terms somewhat as follows: "Capital stock that has once been issued and is subsequently acquired by the issuing concern either by gift, donation or purchase and placed in the treasury. Treasury stock must not be confused with unissued stock."

With few exceptions, most of our authorities seem to have considered further discussion unnecessary. The few exceptions, however, have gone a little farther and state that treasury stock is an asset and must not be shown on the balance-sheet as a deduction from capital stock as the net worth will be thereby understated. This discussion is an attempt at answering two very important questions which our authorities have not elaborated.

What kind of an asset is treasury stock?

How is the net worth understated on the balance-sheet when treasury stock is shown as a deduction from capital stock?

When treasury stock is acquired by gift or donation there is much less to discuss, as there must be an offsetting credit to either an asset or an account called donated surplus, and it is evident that the gift or donation has been made on account of an over-valuation of assets. It is unlikely that the asset given in payment therefor is of equal value, unless the donation be considered a loan which is to be later repaid.

Treasury stock acquired by purchase is the subject of this discussion.

The assets received in exchange for shares of capital stock are construed as a "trust fund to secure creditors." To reacquire shares of capital stock by purchase, assets must be given in exchange, and when this is done the original amount representing the trust fund has been reduced.

It is a common fallacy of a great many accountants that a concern purchasing its own shares of capital stock is investing its funds in its own stock. Why is it not as reasonable to say that a concern, in liquidating its accounts payable, is investing its funds in accounts payable? This, of course, is reductio ad absurdum. In all probability, the reasoning thus advanced arises through the legal qualification of treasury stock as a form of collateral which may be hypothecated or pledged as such to secure loans; but the discerning banker or other pledgee has certainly not considered the value of such collateral the chief factor in granting the loan.

While the lender probably does not condescend to take so critical a view of the real worth of treasury stock, it is obvious that the funds lent on this class of collateral are in the same category as the original assets given in exchange for shares of stock.

If the purchase of its own shares of capital stock by a concern reduces the amount of the original trust fund, then the assets acquired from the re-sale of these shares out of the treasury is, in effect, only replenishing the trust fund.

We often hear it argued that an investment of the funds of a concern in its own shares of stock is as much an investment as if the funds had been invested in shares of another concern. An investment in shares of stock of another concern acquires an equity in the assets of the issuing concern, plus a right to share in the earnings. An investment in shares of a concern's own stock carries neither an equity in assets nor a right to share in earnings. Treasury stock does not draw dividends nor share in the distribution of assets.

Theoretically, if it be assumed that treasury stock is an investment, an investment in shares of another concern constitutes a real investment, while an investment in shares of a concern's own stock constitutes a nominal investment.

The nominal investment, therefore, is simply an investment in a right to re-sell a certain number of shares which have been placed in the treasury, and the cost of this investment can not be said to be the price paid for the shares, because the payment for the shares was only an exchange of assets for a capital liability. The right was gratis, and the value of this right is only determined by the value received when the shares are re-sold.

A definition of treasury stock, after giving effect to the foregoing, would be as follows:

Treasury stock: a term used to denote a reduction of assets originally placed with a concern as a trust fund to secure creditors. Its retention on the books may be only temporary; and its appearance on the books is indicative of a right to restore the trust fund in part or in whole.

It may be argued that the original assets received in exchange for shares of capital stock have been overlooked through merger with other assets acquired out of profits from operations. This is true; but the fact remains that, so long as the original shares are outstanding and owned by others than the concern itself, the trust fund remains intact. Although a concern may accumulate its earnings until they reach an amount far in excess of the amount represented by capital stock, the trust fund, as represented by capital stock, should, metaphorically, appear in alto-rilievo from the heterogeneous mass of assets composing the trust fund and accumulated earnings.

The net worth of a concern is the excess of assets over liabilities. If treasury stock is included among the assets of a concern the net worth will be thereby overstated. As an example, we shall assume the balance-sheet of the "A" company to appear as follows:

THE "A" COMPANY

Assets		*Liabilities and capital*	
Cash	$105,000.00	Accounts payable	$300,000.00
Inventory	200,000.00	Capital stock	250,000.00
Plant	455,000.00	Surplus	210,000.00
	$760,000.00		$760,000.00

The "A" company purchases from M, a stockholder, 50 shares at book value, viz: $184 a share, giving M a cheque for $9,200. The balance-sheet should then appear as follows:

THE "A" COMPANY

Assets		*Liabilities and capital*		
Cash	$ 95,800.00	Accounts payable		$300,000.00
Inventory	200,000.00	Capital stock	$250,000.00	
Plant	455,000.00	Less:		
		Treas. stock,	5,000.00	245,000.00
		Surplus		205,800.00
	$750,800.00			$750,800.00

The net worth, as shown by the first balance-sheet, is	$460,000.00
and as shown by the second balance-sheet	450,800.00
resulting in a net decrease in net worth of	$ 9,200.00

This is accounted for as follows:

Reduction of the original trust fund by giving back assets valued at	$ 5,000.00
and the distribution of accumulated earnings on 50 shares of capital stock amounting to	4,200.00
	$ 9,200.00

Going on the theory that the "A" company has invested $9,200 in its own capital stock, the balance-sheet would then appear:

THE "A" COMPANY

Assets		*Liabilities and capital*	
Cash	$ 95,000.00	Accounts payable	$300,000.00
Inventory	200,000.00	Capital stock	250,000.00
Plant	455,000.00	Surplus	210,000.00
Treasury stock	9,200.00		
	$760,000.00		$760,000.00

The face value of the net worth as shown on this balance-sheet is the same as the net worth shown on the first balance-sheet, although a change in assets is apparent.

This last balance-sheet is deceiving. A number of reasons may be advanced as to why a deceitful condition prevails; but the important reasons may be stated:

The total assets are inflated by the amount of treasury stock.

The net worth is overstated, because $9,200 thereof does not exist as an asset of the "A" company.

The item, treasury stock, may represent 92 shares at par value; 50 shares at book value or 100 shares purchased at $92.

When showing, on the balance-sheet, ownership of a concern's own shares, to avoid deceiving unwary creditors it is quite necessary to follow the plan of the second balance-sheet shown herewith. It should be understood that it is not necessary to cancel stock when placed in the treasury, nor is it necessary to deduct the amount from the capital stock account on the books, unless the stock has been duly retired as provided by the statutes.

There are many other points which may arise in an argument for or against the method of showing treasury stock as a deduction from capital stock, and it may be presumed that there are those who will consider the stress put upon the trust fund a somewhat copious display of sophistry. Nevertheless the facts are before us.